GOVERNANCE-LED CORPORATE PERFORMANCE

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GOVERNANCE-LED CORPORATE PERFORMANCE: THEORY AND PRACTICE

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Contents

List of Tables *ix*

List of Abbreviations *xi*

About the Authors *xiii*

Preface *xv*

1. Conceptual Approach of Corporate Governance *1*

1.1. Introduction *1*
1.2. Corporate Governance and Its Various Dimensions *2*
1.3. Corporate Governance Mechanisms *3*
1.3.1. Ownership Structure *4*
1.3.2. Board of Directors *5*
1.3.3. CEO Characteristics *6*
1.4. Theories of Corporate Governance *6*
1.4.1. Agency Theory *6*
1.4.2. Stewardship Theory *7*
1.4.3. Resource Dependence Theory *8*
1.4.4. Stakeholder Theory *9*
1.4.5. Signalling Theory *9*
1.4.6. Managerial Hegemony Theory *9*
1.4.7. Political Theory *10*
1.5. Motivation of the Study *10*
1.6. Chapter Plan of the Book *11*

2. Corporate Governance in India *13*

2.1. Introduction *13*
2.2. Three Historical Models and their Development Impact in India *14*
2.2.1. The Managing Agency Model (1850–1956) *14*
2.2.2. The Business House Model (1956–1991) *15*
2.2.3. The Anglo-American Model (1992 to Date) *16*
2.3. Features of Corporate Governance in India *17*

2.4. Corporate Governance Codes in India *18*
2.4.1. CII Code on Corporate Governance (1998) *19*
2.4.2. Kumar Mangalam Birla Committee on Corporate Governance (1999) *20*
2.4.3. Naresh Chandra Committee on Corporate Audit and Governance (2002) *21*
2.4.4. Narayana Murthy Committee Report on Corporate Governance (2003) *22*
2.4.5. Dr J. J. Irani Committee Report on Company Law (2005) *24*
2.5. Corporate Governance and Legislations in India *25*
2.5.1. Amendments to the Companies Act 1956 *25*
2.5.1.1. The Companies (Amendment) Act 2000 *25*
2.5.1.2. The Companies (Amendment) Act 2001 *26*
2.5.1.3. The Companies (Amendment) Bill (2003) *26*
2.5.1.4. The Companies (Amendment) Bill (2008) *27*
2.5.2. The Companies Act 2013 *28*
2.5.3. SEBI: Regulation of Capital Market *29*
2.6. Good Governance Indicators *30*
2.7. Summary *32*

3. Literature Review *33*

3.1. Introduction *33*
3.2. An International Approach *34*
3.3. A National Approach *48*
3.4. Research Gap *51*
3.5. Objectives of the Study *52*
3.6. Research Hypotheses *53*

4. Data and Methodology *55*

4.1. Data *55*
4.1.1. Data Source *55*
4.1.2. Sample Selection Procedure *55*
4.1.3. Study Period *56*
4.1.4. Selection of Variables *56*
4.1.4.1. Dependent Variables *56*
4.1.4.1.1. Cash Earnings Per Share *56*
4.1.4.1.2. Return on Capital Employed *57*
4.1.4.1.3. Tobin's *Q* *57*
4.1.4.1.4. Market Value Added *58*
4.1.4.2. Independent Variables *58*
4.1.4.2.1. Promoters' Shareholding *58*
4.1.4.2.2. Institutional Investors' Shareholding *59*
4.1.4.2.3. Board Size *59*
4.1.4.2.4. Proportion of Executive Directors *59*
4.1.4.2.5. Proportion of Independent Directors in Board *59*

4.1.4.2.6. Multiplicity of Directorship *59*
4.1.4.2.7. CEO Duality *60*
4.1.4.2.8. CEO Tenure *60*
4.1.4.3. Control Variables *60*
4.1.4.3.1. Executive Remuneration *60*
4.1.4.3.2. Size of the Firm *60*
4.1.4.3.3. Growth in Profit After Tax *61*
4.1.4.3.4. Debt Equity Ratio *61*
4.1.4.3.5. Assets Turnover Ratio *61*
4.2. Research Methodology *61*
4.2.1. Statistical Methods Used *61*
4.2.1.1. Descriptive Statistics *62*
4.2.1.2. Bi-variate Data Analysis *62*
4.2.1.3. Test for Multicollinearity *62*
4.2.1.3.1. Detection of Multicollinearity Property *63*
4.2.1.4. Test for Heteroskedasticity *63*
4.2.1.5. Test for Autocorrelation *63*
4.2.1.6. Panel Data Model *64*
4.2.1.6.1. Advantages of Panel Data Model *64*
4.2.1.6.2. Techniques of Panel Data Model *64*
4.2.1.6.3. Constant Coefficient Method or Pooled OLS Method *64*
4.2.1.6.4. FEM or Least Square Dummy Variable Regression Model *65*
4.2.1.6.5. REM or Error Component Model *65*
4.2.2. Scheme of Investigation *67*

5. Analysis and Findings *69*

5.1. Descriptive Statistics *69*
5.2. Analysis of Bi-variate Correlation *71*
5.3. Detection of Multicollinearity Property *72*
5.4. Detection of Heteroskedasticity *72*
5.5. Analysis of Multiple Regressions: Panel Data Model *74*
5.6. Key Findings and Its Interpretations *82*
5.6.1. Ownership Structure and Corporate Performance *82*
5.6.1.1. Promoters Shareholding and Firm Performance *82*
5.6.1.2. IINV and Firm Performance *84*
5.6.2. BS, Composition and Corporate Performance *84*
5.6.2.1. BS and Corporate Performance *84*
5.6.2.2. EDs and Firm Performance *85*
5.6.2.3. IDs and Firm Performance *85*
5.6.2.4. MD and Firm Performance *86*
5.6.2.5. CEO Characteristics and Performance *86*
5.6.3. Control Variables and Corporate Performance *86*

6. Summary and Conclusion *89*

6.1. Summary *89*
6.2. Conclusion *90*
6.3. Contribution of the Study *91*
6.4. Policy Recommendation *92*
6.5. Limitations and Scope for Further Research *92*

Bibliography *95*

Index *103*

List of Tables

Table 1. Descriptive Statistics of Dependent, Independent and Control Variables *70*
Table 2. Bi-variate Analysis: Correlation Analysis *72*
Table 3. Correlation Matrix and VIF Values of Independent and Control Variables *73*
Table 4. Tests of Heteroskedasticity *74*
Table 5. Regression Results: Dependent Variable – ROCE *75*
Table 6. Selection of an Appropriate Model of Regression Analysis *76*
Table 7. Regression Results: Dependent Variable – CEPS *77*
Table 8. Selection of an Appropriate Model of Regression Analysis *78*
Table 9. Regression Results: Dependent Variable – T*Q* *79*
Table 10. Selection of an Appropriate Model of Regression Analysis *80*
Table 11. Regression Results: Dependent Variable – MVA *81*
Table 12. Selection of an Appropriate Model of Regression Analysis *82*
Table 13. Summarized Regression Results *83*

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List of Abbreviations

ATR	Assets Turnover Ratio
BSE	Bombay Stock Exchange
BS	Board Size
BSC	Balanced Scorecard
CEO	Chief Executive Officer
CEO_DUA	CEO Duality
CEO_TEN	CEO Tenure
CEPS	Cash Earnings Per Share
CG	Corporate Governance
CVA	Cash Value Added
D/E	Debt and Equity Ratio
DPS	Dividend Per Share
DP	Dividend Payout
EPS	Earnings Per Share
ED	Executive Director
ER	Executives' Remuneration
EVA	Economic Value Added
FEM	Fixed Effect Model
ID	Independent Director
IINV	Institutional Investors' Shareholding
M-Cap	Market Capitalisation
MD	Multiplicity of Directorship
MVA	Market Value Added
PAT	Profit After Tax
P/*E* Ratio	Price Earnings Ratio
PS	Promoters' Shareholding
REM	Random Effect Model
RI	Residual Income
ROA	Return on Assets
ROCE	Return on Capital Employed
ROI	Return on Investment
SIZE	Size of the Firm
SEBI	Security Exchange Board of India
SR	Shareholder Return
SROI	Social Return on Investment
SVA	Shareholder Value Added

TBR	Total Business Return
TSR	Total Shareholder Return
T*Q*	Tobin's *Q*
VIF	Variance Inflation Factor
WAI	Wealth Added Index

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Preface

The economic growth of any nation largely depends on the vitality of its industry and capital market at large. The responsibility of maintaining the health of the industry as well as capital market mostly depends on the efficiency and effectiveness of the controlling agencies of government and their implemented policies, practices, rules, regulations, etc. A major part in the subject of corporate governance deals with these issues and ensures their apt implementation in the business corporations. The industrial growth in India along with the development of corporate culture started after independence in 1947 but the expression 'corporate governance' remained in vogue until 1990. The concept of corporate governance and its problems are as old as the concept of a business corporation and especially the joint stock companies. It started gaining importance after experiencing a number of corporate scandals come out mainly after economic liberalisation. In India, the crucial need for corporate governance was first realised with the occurrence of Harshad Mehta's scam that was exposed in April 1992. During the last two decades along with many developed and developing economies, India also witnessed a number of serious cases of corporate misgovernance in a handful of joint stock companies. It was clearly indicating the nature and extent of corporate misgovernance that exists in those Indian companies.

In this context, the impact of corporate governance on corporate performance is gradually becoming a key area in research. Although a number of notable studies have been conducted to establish the relationship most of them typically focussed on developed economies and the effect of these corporate governance issues on the firm performance in emerging economies like India has got little attention. The results of earlier studies also provide contradictory findings. By considering the stewardship theory, some studies have suggested that larger board size is better for the firm, whereas by considering the agency theory some studies support small boards and less outsiders. Believing the resources dependency theory some studies have stated that large numbers of outsiders in the board help the organisation to get key resources for the organisation conveniently.

These contradictory findings of the earlier studies became the principal drive behind conducting this research work. This extensive research regarding the effect of corporate governance variables on firm performance in India addresses basic questions for specific areas viz., corporate board, ownership structure and chief executive officer characteristics. Findings of this study provide a comprehensive understanding of the dynamic relationship between corporate governance variables and corporate performance in Indian companies. It discusses the theoretical

hypotheses of this relationship and compares with empirical evidence as available from earlier research works. The present study is expected to add several primary contributions to the extant literature. Besides investors, findings of the study help an organisation to determine their policies regarding ownership structure and board composition. Again this study may also provide support to the corporate governance policy-making agencies of the country to provide recommendations regarding board size, independence of the board, multiplicity of directorship, etc.

Thus, such a study is worth undertaking in emerging economies like India, in view of the fact that the study contributes to managerial science by providing scientific elements through identification and validation of the effects of corporate governance variables on corporate performance.

Chapter 1

Conceptual Approach of Corporate Governance

1.1. Introduction

The origin of governance crisis can be traced back to the very inceptive idea about a corporate form of business having two distinct entities, that is, control and ownership. Corporate Governance (CG), however, has predominately become an area of academic research and public debate in both the developed and developing nations since the 1990s; although the area has been attracting the interest and attention of scholars and academicians since a long time. In very simple terms, CG is the mechanism which deals with direction, administration and controlling of organisations. CG systems and processes are also related to different organisational issues such as delegation of authority, measurement of performance, assurance mechanisms, reporting requirements, accountabilities for stakeholders, etc. CG mechanisms state the rules, regulations and methods for taking decisions on corporate issues and problems through which the companies' objectives are set, as well as the means of attaining those objectives and monitoring the performance. It also looks after the relationship in various CG participants, in determining the strength and direction of the relation and their effect on the performance and operation of organisations. The central participants or players of CG are the owners or shareholders, management, board of directors and so on.

CG is an essential tool in improving the economic efficiency of a firm, the industry as well as of a country. Healthy CG practice helps corporations to take into account the interests of a wide range of constituents, as well as of the spheres within which they perform. Moreover, it ensures the accountability of corporate board to the shareholders. This system helps corporations to operate in such a manner that benefits society. The reliability proposed by good CG system also helps retain the confidence of foreign investors as well as the domestic one. It helps to provide stable sources of financing by reducing the cost of capital. However, it is not the above-mentioned thoughts that have made CG an interesting

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area of research. Often, the financial crises of different countries have increased attention on CG. The Asian financial crisis can be considered to have brought the issue of CG to the Asian corporate world.

In developed countries, CG has become an important policy issue, but in case of developing countries such as India, it is becoming a part of developing an agenda as industrialisation, economic reforms, financial liberalisation, etc. CG has earned an interest of paramount significance after the failure of high-profile corporate in the world, even in developed countries with relatively more mature CG system. In the Indian context, the need for CG has been highlighted not only for liberalisation since 1991 but also after the bitter experience of the corporate scandals. India had to deal with the Harshad Mehta scam, Ketan Parikh scam, Bhansali scam, Vanishing Company scam and so on. The UTI scam represented another dimension of the corruption which raised questions about the competence of CG practices in the Indian financial sector. The various scams represent the failure of the regulatory authorities as well as of the legal framework. However, these scams and cases of corruption in the post-liberalisation period highlight the need for better CG. Moreover, a recent Indian corporate scam that took place in Satyam Computer in 2009 enhanced the importance of CG issue and still, it is an imperative area of research. Again, it is seen that the practices of CG and the shareholder alignment is becoming an operational necessity in the post-liberalisation period.

1.2. Corporate Governance and Its Various Dimensions

CG is described as a set of systems and processes which ensure that an organisation functions and is managed to the best interest of all stakeholders. It also assures the suppliers of finance about getting a return on their investment and maintains a co-operative environment by ensuring the healthy relationship among the owners, directors and managers. The study of CG can be undertaken for different purposes and form different perspectives namely, the positive, the normative and the strategic. The positive analysis makes claims of truth and deals with how the existing state of affairs and their cause can be explained. This approach states that CG is the manner in which a corporation is governed. The normative analysis makes claims of goodness and correctness (Mukherjee & Reed, 2004). It supervises the criteria through which people, policy effect and so on can be evaluated. According to the said approach, (responsible) CG is defined as how corporations should be governed. Strategic analysis is about effectiveness and supervises how given ends can be achieved most efficiently. Following this approach, (efficacious) CG can be defined as how corporations can most efficiently achieve their given ends.

CG has been explained in different ways by different writers and organisations. CG provides different meanings to different people but the basic essence is protection and creation of value for stakeholders. Thus the needs of good governance practice become an important agenda to all the players who are related to this. Important issues related to CG are as follows:

Through aligning the managers' and shareholders' interests, minimising the cost of self-interested managerial behaviours is the basic purpose of CG (Jensen & Meckling, 1976).

The mechanism through which companies are directed and controlled is known as CG (Cadbury, 1992).

> In India, the corporate governance has come into notice mainly after liberalization deregulation and privatization of the economy, accordingly the demand for a new corporate culture and stricter compliance with law has gradually increased. In the context of India where the shareholding of institutions is too high, therefore the accountability of the director, including non-executive nominees, the CG issue has come into exact notice. (Corporate Governance: The New Paradigm, Chartered Secretary, October 1997)

CG and corporate management can be distinguished based on the following aspects. First, there are two outcomes of company management, good or bad management. But the concept of CG implies only to good or effective company management. There is no ineffective or inefficient element in CG. Second, the company management generally deals with the aims of maximising the shareholders' or owners' wealth, whereas CG stands for all stakeholders.

As said earlier, 'CG', as a term, is an outcome of the post-liberalisation economic phase. During that period, different committees were appointed by regulatory agencies in different countries under the circumstances of the governments.

These committees are appointed to inspect the causes of corporate failure in these countries and suggest some recommendation to check them. In this context, various CG codes have already been recommended and the legislations of different countries are consequently incorporated into them. But corporate frauds are still taking place all over the world behind which the role of shareholders, board and management have found to be more crucial.

Therefore, CG is

> the mechanism through which corporate entities are directed and controlled. It includes the entire procedure of the functioning of the company and also put emphasis to maintain interest-balance between shareholders', directors and the management. (Narayanswamy, 2003)

1.3. Corporate Governance Mechanisms

CG covers a number of internal and external mechanisms within a corporation which leads to an increase in firm value. This chapter considers three important governance mechanisms to capture the overall state of CG of a company. These three governance mechanisms are the (1) ownership structure, (2) board of directors and (3) chief executive officer (CEO) characteristics.

1.3.1. Ownership Structure

Ownership Structure implies the proportion of shares held by different parties in the equity capital of the company. The principal groups of shareholders of the company in India are Promoters, Institutional investors, Private corporate bodies, Indian public, Non-resident Indians (NRIs) and other corporate bodies and any other (including non-promoter executive directors and their relatives, independent directors, clearing members, foreign collaborators, employees, Hindu Undivided Family [HUF], etc.). One of the essential internal mechanisms of CG is the ownership structure of a publicly held firm which has been widely studied in the developed nations, principally in Japan, UK and US. Recently, the said mechanism has been the subject of much research in emerging economies also.

The ownership structure has an important implication in ownership control. The ownership control depends upon the equity ownership held by the different group of shareholders. It also differs depending upon whether equity ownership is concentrated among a few large shareholders or diffused.

The ownership structure and control mechanism of a firm is the source of agency costs in firms and the origin of CG problems. The literature on ownership focusses on how the different stockowners or shareholders, separately or in conjunction, are able to mitigate the agency costs and influence the firm's value. In light of agency problem, the role of owners as an aligning mechanism first came as an idea since the very inception of an organisation with a separated ownership and control structure.

In owner-controlled firms with concentrated ownership, there may be a division of management and ownership but there owners have strong motivations to monitor activities of managers. Sarkar, Sarkar, and Sen (2012) argued that higher shareholding by controlling insiders of family-controlled firms, makes possible to create wealth and enhance the value of the corporation which help themselves as well as outside minority shareholders of the institute. Agency theorists suggest that one way of reducing this agency cost is to have outside blockholders with relatively large equity positions. These large shareholders have considerable investments at stake, as well as the voting power to certify that the investments are not lost. Shareholders having a large amount of share can also help to reduce the free-rider problem associated with small shareholders. Moreover, blockholders like foreign institutional investors and domestic financial institutions can engage in rational investing and are likely to be more committed to the company, which will facilitate the organisation in the long run.

Again, according to the financial theory, an inherent motive of the owners of a firm is to maximise their profit which follows efficient utilisation of the available resources. But the ways of nurturing investment, participation in controlling and monitoring activities are different for different group of owners. Therefore, they may affect the performance of a corporation in a different manner so far as the behaviour of the different group of owners are concerned.

In view of the above discussion, the share of promoter ownership and the share of foreign institutional ownership are taken as attributes of the ownership structure to determine their effect on corporate value.

1.3.2. Board of Directors

Board composition is another important issue in CG. Board of directors is quite known as the principal policy-making agency in any institution and plays a fundamental role in implementing governance by supervising management, controlling agency costs, selecting top management, providing adequate resources and preparing strategy for the firm. Hence, board composition is an important factor in determining the performance of a firm. According to the Anglo-American Model of CG, the prime responsibility of the board is to ensure that the management is running the firm in the best interest of the shareholders of the institution. Board composition includes the size of the board, the proportion of outside directors on the board, etc. As per Companies Act 1956, Section 2(13), a director includes any person engaging the chair of the director by whatever name called. In other words, a director may be described as a person having the authority to control over direction, conduct, management or superintendent affairs of the company. A typical board of modern corporations takes into account both inside and outside directors. Inside director is a full-time working employee of the company who is involved in the day-to-day operations, known as executive director. Outside director, known as a non-executive director, does not have any executive responsibility and mostly play an advisory role. Outside director can be further classified as 'affiliated directors' (or) and 'non-affiliated director'. Affiliate director is the former company officer or one who has an existing business relationship with a company such as investment banker, lawyers, etc. Affiliate director is also known as 'grey director' and is defined as the complement set of a non-executive director who is not independent. Non-affiliate director has no such affiliation and is commonly known as 'non-executive independent' director, who is liable to perform the monitoring activities and is widely regarded as the fiduciaries of shareholders' interest. They help the management to give advice and draw up the strategy for future expansion of the firm. The basic duties of directors are as follows: (i) fiduciary duties, (ii) duties of care, skill and diligence, (iii) duties to attend board meeting, (iv) duties not to delegate their function except to the extent authorised by the act to the constituation of the company and disclose his or her interest. The director must employ his power honestly and for the benefit of the organisation as a whole. The director should avoid situations where he has faced a conflict between his duties to the company and his personal interest. He should carry out his duties with rational efficiency and care and such degree of skill and diligence as it is practically expected from a person of such knowledge and status. A strategic board may ensure better CG, which has an optimum board size, proper independence, adequate diversity and well-informed directors.

The composition of the board and its effect on corporate performance has attracted a number of notable researchers earlier. Many previous research studies have arrived at contrary findings regarding the relationship between the various characteristics of corporate boards and corporate performance. The studies found heterogeneous results and could not reach a consensus as to whether there exists any relationship and, if so, in which direction, positive or negative. For example, Chatterjee (2011) observed board size to be negatively related to firm

performance and board independence as having no significant impact on firm performance. However, Javed, Saeed, Lodhi, and Malik (2013) showed the opposite result: not only empirically, but the relationship or the impact is also theoretically dubious and debatable.

Where agency theory states that higher proportion of non-executive and independent directors is the precondition to better performance, the Stewardship theory (Donaldson & Davis, 1991) claims that managers are basically trustworthy and to get superior corporate performance more inside or executive directors are needed. It is also argued that large shareholders or block owners may be more capable of monitoring and controlling the management leads to better corporate performance (Shleifer & Vishny, 1997).

1.3.3. CEO Characteristics

CEO duality and CEO tenure represent CEO characteristics. A situation where the CEO of an institution holds the position of the chairman of the board is termed as CEO duality. CEO duality is also a conflicting issue of CG and the reason behind it is two different views among the researchers. One group opines duality (both positions being held by the same individual) is good for an organisation as it ensures unified command at the top of the organisation. It permits smooth leadership of the firm and facilitates formulation and implementation strategies.

Another thought is that duality eliminates the essential checks and balances for good governance. The contradictory situation arises when compensation of CEO has to be approved by the CEO himself holding the board as chairman. In that situation, CEO compensation should be significantly affected by CEO duality which implies ineffective monitoring and control of executive management (Balasubramanian, Barua, & Karthik, 2015). As CEO duality is ultimately a conflicting issue, this study attempts to evaluate empirically the effect of CEO duality and CEO tenure.

1.4. Theories of Corporate Governance

In large, modern joint stock firms' managers are usually not the owners. In fact, most of today's top managers own insignificant portion share in the institution which is managed by them. The actual owners (shareholders) decide boards of directors who hire managers as their agents to run the firm's day-to-day activities. Once hired, such questions as 'are the executives trustworthy?' and 'do they place the interest of their own or the organisation's first?' can be asked (Wheelen & Hunger, 2004). To deal with such questions some important theories are developed which are known as CG theories. These theories are discussed below.

1.4.1. Agency Theory

Agency theory is a theory of ownership (or capital) structure of the firm and the central idea is about the principal–agent relationships in a corporation.

Agency theory describes organisations as a nexus of contracts among self-interested principals and agents, including managers, stockholders and board of directors. It argues that the contractual arrangements that survive are those that best solve the problem of minimising agency costs. As per Agency theory, a term coined by Berle and Means (1932), modern corporations are characterised by the widely held ownership shareholders where managerial actions do not always guarantee actions required to maximise shareholders' return. Ideally, there exists a contractual relationship between managers and owners as per which managers should act as agents of the owners and has delegated the authority of decision-making in the best interest of the owners. Agents usually know more about the tasks than the principals (information asymmetry). Principals try to get information (by inspection or evaluation) to develop incentive systems which ensure agents' deeds for the interests of the principal. But the reality is not so, as exposed by the agency theory, the managers try to guard their own interest ahead of the interest of the owners. This lack of cohesion has been named as 'agency problem'. This, in turn, affects the performance of the companies adversely.

To shrink agency problems, two mutually exclusive steps may be adopted: first, activities of top management should be carefully supervised by the controlling owners' group and second, escalate management ownership through partial payment of executives' remuneration in shares or stock of the organisation instead of cash, thus making them holding more stake in the company than before.

According to different agency theorists, the purpose of studying the agency theory is to identify points of conflict among the key players and suggest the following mechanisms of CG to reduce it:

(a) *Separate functions of CEO and Chairman*: this helps to avoid agency losses and managerial opportunism (Jensen & Meckling, 1976).
(b) *Provide financial incentives to managers*: these include fixing executive compensation and levels of benefits should be linked to benefits of owners or shareholders, e.g., of shareholders' returns, the issue of stock options, etc. (Donaldson & Davies, 1991).
(c) According to A. C. Fernando, there are two broad mechanisms that help reduce agency cost and these are (i) fair and accurate financial disclosure and (ii) efficient and independent directors.
(d) More managerial ownership may enhance the performance of corporation as the managers are highly able to oppose a takeover threat from the market for corporate control and as a result, the raiders in the market will have to forfeit higher premiums for takeover (Stulz, 1988).

1.4.2. Stewardship Theory

Stewardship theory was introduced and developed by Donaldson and Davis (1991) to understand the associations between ownership and management mainly in corporate. According to this relation-based theory, a steward functions in a cooperative manner for the advantage of the organisation than to satisfy self-interest and try to perform for institutional success and a principal's satisfaction.

Hence, unlike an agent of agency theory, a steward overcomes the trade-off by aligning his personal needs with the goal of the organisation. Where agent focusses on extrinsic rewards that serve such lower-level needs as pay and security, there stewards recognise a range of non-financial rewards for managerial behaviour. These non-financial rewards include the need for achievement and recognition, the intrinsic satisfaction of successful performance, respect for authority, etc. As per this theory, the executive managers, far from being an opportunity seeker, essentially want to do a good job and want to be a good steward of corporate assets. Managers are considered as loyal to the company and paying attention to achieving high performance and they are motivated by non-financial rewards. This theory explains why the shareholders are free to sell their stock at any time in a widely held corporation, and a diversified investor may care little about risk at the company level, but the management of a corporation assumes the extraordinary risk so long as the return is adequate. This is because executives in a firm cannot easily give up their job responsibilities, mainly in difficulty, and put heavy emphasis on the continuous survival of the organisation. Thus, stewardship theory would describe that the reallocation of corporate control from owners to professional managers empowers managers to maximise corporate profits. The stewardship model favours the insider-dominated boards due to their access to current operating information, adequate knowledge in handling different corporate issues and hazards, technical expertise and commitment to the firm which implies an expectation to the maximisation of shareholder returns.

1.4.3. Resource Dependence Theory

Resource dependence theory states how external resources affect the behaviour of the organisation where managers can perform to shrink environmental ambiguity and dependence. As per Pfeffer and Salancik (1978), the resource dependency theory about the corporation is an open system, which depends on the external environments' contingencies. The external resources accumulation is important to both the technical and strategic management of a corporation. In this context, by removing the environmental uncertainties, the directors serve as arbitrator and allow corporations to procure external resource. Basically, they use their knowledge, experience and professional communications to avail timely information and critical resources. As per this theory, the director also helps in maintaining inter-organisational linkages which helps an organisation in hiring experts from other companies or the appointment of outside directors through managing environmental contingency. Such environmental linkages also help to minimise the cost of transactions which linked with acquiring environmental resources. This concept has important implications for the role of the board and its structure, which in turn affects performance. In summary, resource dependence theory provides a realistic justification for the linkage creations between the corporation and its external environment through boards. The efficient organisation is highly successful to create the said linkages which could improve their way of survival and performance. Same as stewardship theory, this theory supports that, directors are highly essential in value creation of an organisation.