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Extended Abstract

Impact of Ownership Structure and Board Characteristics on Firm Value: Evidence from China and India

Aghila Sasidharan

Indian Institute of Technology, Madras

E-mail; aghilak4@gmail.com

George Varghese

IFMR-GSB, Krea University, Sri City,

E-mail: georgevarghese215@gmail.com

Abstract

Corporate governance plays a decisive role in the financial performance of a firm. While majority of the firms in China and India are owned and managed by its promoters, the present study attempts to examine the impact of ownership structure and board characteristics on firm value for these two economies. The study employs panel data methodology with industry and time fixed effects on a sample of 1042 firms listed in NSE of India and 450 firms listed in SSE of China. We find promoter ownerships to positively impact a firm's value creation process, while institutional investors exert a negative influence. Although CEO duality enhances firm value in China, the results show otherwise for Indian firms. Additionally, while board independence is positively correlated to firm value in India, it has a negative effect on firms in China. Lastly, we find that larger board size contributes favorably towards better decision making.

Keywords: Corporate governance; Board characteristics; Ownership structure; Agency theory

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Extended Abstract[1]

1. Introduction

Corporate governance to a company is as important as its initial business plan. Its significance has been on the rise over the past few decades with corporate governance practically encompassing every sphere of management of a company, from action plans and internal controls to performance measurement and corporate disclosure. It is essentially a multi-level multi-tiered process that calls forth a better performance from corporate executives that will then get on to reflect on the performance of every stratum of a company.

With corporate governance, a company takes more responsibility for its own actions and helps those in charge remain more aware of the public image of the corporation. When executed efficiently, it prevents corporate frauds, scandals, and any other criminal practices of the company. The amount of transparency that comes with corporate governance makes a company widely accepted in public. Full disclosure and the availability of complete information to all stakeholders of the company uniformly impart in them a higher level of trust. It portrays the company's image in the public's eye as a responsible organization worthy of investment by shareholders. Further, corporate governance ensures that the image of a company remains clean and also maximizes its corporate value, for it is difficult for a company to be successful just by making enough profits.

Additionally, more than ever, corporate governance has emerged as a crucial decision making factor for foreign institutional investors in their investment decision-making endeavors. Put simply, foreign investors take notice and respond quickly and positively to well-managed companies. On this ground, having a clean image on the corporate governance front makes it much easier for firms to attract foreign capital at a reasonable cost. Indicatively, considering its social and institutional aspects, the scope of corporate governance is very broad. In essence, corporate governance encourages a trustworthy, moral, and ethical environment as it is grounded on the principles of a) transparency in all transactions, b) accountability and responsibility towards all stakeholders, and c) taking decisions with integrity and fairness.

From the above discussions, we can deduce that good corporate practices are quintessential for the growth, profitability, and sustainability of any business. While there are ample studies that examine the impact of corporate governance mechanism on firm value when it comes to developed economies, similar studies are limited in the case of emerging countries like India and China which have often faced the problem of weak investor protection and poor corporate governance. Moreover, while corporate governance mechanisms such as ownership structure and board characteristics play a vital role in the success of the organization, there is still an ongoing debate in the corporate finance literature on whether the ownership structure or board characteristics are actually adding value to the firm. Accordingly, in light of this plurality among researchers and gap in the literature, the present study attempts to meaningfully aid in the understanding of how ownership structure and board characteristics impact firm value in the context of Indian and Chinese corporations. In doing so, the study considers board size and board independence as a

[1] Please contact the authors for a full version of the paper

proxy for board characteristics while promoter ownership, institutional investor and CEO duality are used as a proxy for ownership structure.

2. Literature Review and Hypothesis Development

2.1. Corporate Governance and Firm Value

Literature has an abundance of studies that analyze the impact of corporate governance on various aspects related to firm performance. Bai et al. (2004) found that listed companies in China with better governance tend to have higher firm valuation. Brown and Caylor (2004) found a positive relationship between governance valuation and dividend payout for a large sample of U.S firms. Gompers et al. (2003) in their study further evidenced that a firm with better governance receives a higher market valuation, operating performance, and lower capital expenditure. Emmons and Schmid (2000) find that strong investor protections lead to the emergence of broader and deeper financial markets, often leveraging its financial performance. The 2004 OECD report suggests that good governance leads to a positive relationship between company management and its stakeholders.

Most of the studies indicate that there exists a positive relationship between corporate governance and firm value. However, similar studies in the Indian and Chinese contexts are relatively rare. Balasubramanian et al. (2010) reported a positive and significant relationship between corporate governance and financial performance. Venkatraman and Selvam (2014) examined the relationship between firm performance and corporate governance and found that the firms under government ownership were able to create more opportunities for growth as compared to other firms. The positive impact of corporate governance on the stock market performance of the firms was also evidenced by Samontary (2010). A study by Motwani and Pandya (2013) observed corporate governance in the Indian context for companies in select sectors and found that corporate governance does not have a significant influence on the firm's profitability.

2.2. Ownership structure and Firm Value

In literature, the ownership structure is more often than not measured using data pertaining to promoter holdings, CEO duality and institutional ownership. CEO duality refers to a situation where the CEO additionally holds the position of chairman of the company. Prior literature (Adams et al., 2010; Arosa et al., 2010) states that when the responsibilities are restricted to one person, it might lead to a better decision which then translates to a reduction in agency cost and enhancement of firm value. Vo and Nguyen (2014) studied the relationship between firm performance and corporate governance for listed companies in Vietnam and found the duality role of CEO to have a positive effect on firm performance. A study on non-financial firms in Pakistan as listed in Karachi Stock Exchange also showed similar results (Sheikh et al., 2013). Mak and Kusnadi (2005), Krivogorsky (2006), Kapopoulos and Lazaretou (2007) and Cho and Kim (2007) find that ownership structure has a positive impact on firm performance. In contrast, Villalonga and Amit (2006), Abor and Biekpe (2007), Lefort and Urzúa (2008) and Belkhir (2009) find that ownership structure is negatively related to firm performance since excessive managerial ownership may allow managerial consumption of perquisites and reduce probability of managers working in the best interest of the company. Motivated by these findings, in the present study we proceed to hypothesize that:

H1: Ownership structure such as promoter holdings, CEO duality, and institutional investors have a positive impact on firm value.

2.3. Board Characteristics and Firm Value

The effectiveness of the board in maximizing firm value can be measured using board size, board independence, and gender diversity. The board of directors acts as monitoring mechanisms to reduce the conflict between the shareholder and the manager. The more power the board holds less will be the probability of opportunistic behavior by the managers. Put simply, when the monitoring by the board is not adequate, it incentivizes the managers to take resources from the firm for their benefit (Liu and Fong, 2010). As such, there is an ongoing debate in the literature on board independence and its impact on firm value. Many academics hold the view that independent directors are not independent in their decision makings, rather they act according to the interest of the large net-worth shareholder community that holds a significant say in the performance of the company. Notwithstanding that, independent directors control the activities of the firm at all levels and even hold the power to appoint and dismiss top-level managers in the best interest of the organization at any point in time (Gillan, 2006; Baranchuk and Dybvig, 2008). Yermack (1996) investigates the relationship between large board size and firm performance using 452 US industrial firms for the period of 1984-1991 and finds the relationship to be negative. In contrast, Mak and Li (2001) investigate the relationship between board size and firm performance using a sample of 147 firms listed in the Stock Exchange of Singapore in the year 1995 and find the results to show a positive relationship. Further, Dalton and Dalton (2005) perform a Meta-analysis based on 131 studies and find a positive correlation between large board size and firm performance.

According to the resource dependence theory, the more the members to the board, the better would be the quality of decisions taken by the firm. This would then enhance firm performance. On the contrary, a lesser number of members on the board would increase the chances of managers overdoing on personal pursuits and utilizing firms' resources for meeting personal needs (Jensen,1993). Based on the above discussion, we hypothesize that:

H2: Board independence has a positive impact on firm value, while board size has a negative effect on firm value.

3. Data and Methodology

3.1. Data

Our sample includes all firms listed in the National Stock Exchange of India and Shanghai Stock Exchange of China for the period 2005 to 2017. The data was obtained from the CMIE Prowess database for firms listed in NSE and Bloomberg for firms listed in SSE. After dropping those firms which had not disclosed Related Party Transactions and those with missing data, our final sample constitutes 10240 firm-year observations with 1032 firms for India and 958 firm-year observations with 350 firms for China.

3.2 Methodology

The study uses panel data methodology with industry and time fixed effects. Panel data allows us to control for firm-specific time-invariant unobserved heterogeneity in the data. Additionally, we use the Hausman specification to identify the suitability of the fixed effects model for our analysis. We also include year and industry dummies in our analysis to control for industry and time-related effects. The following model is used to examine the relationship between the ownership structure and firm value.

$$TQ_{it} = \alpha_0 + \beta_1 PROMO_{it} + \beta_{2it}\ INSTI_{it} + \beta_{3it} CEO\ Duality_{it} + \beta_4 Size_{it} + \beta_5 Leverage_{it} + \alpha_i + \alpha_i + \varepsilon_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(1)$$

The model used to examine the relationship between board characteristics and firm value is as follows:

$$TQ_{it} = \alpha_0 + \beta_1 BS_{it} + \beta_{2it}\ BDIND_{it} + \beta_4 Size_{it} + \beta_5 Leverage_{it} + \alpha_i + \alpha_i + \varepsilon_{it} \ldots\ldots\ldots\ldots\ldots\ldots\ldots\ldots(2)$$

Here, TQ (TOBIN'S Q) is measured as the market value of equity plus book value of debt divided by total firm assets. Board Independence (IND) is measured as the proportion of independent directors on the board to the total number of directors on the board. Board size (BS) is measured as the total number of directors on the board. A dummy variable is used to measure CEO duality where the value 1 is assigned if the chair and CEO is the same person and 0 otherwise. Institutional investors (INSTI) are measured using the percentage of shares held by the institutional investors while promoters are measured by using the percentage of shares held by the promoter. Among the control variables, firm size is measured as the natural logarithm of total assets and leverage is measured by using the ratio of borrowings to total assets.

4. Key Findings

The findings of the study indicate that while promoter ownerships positively impact a firm's value creation process, institutional investors tend to affect the firm's value negatively. This finding is consistent across both China and India. The result, however, is mixed when it comes to the impact of CEO duality on firm value across both nations. In the case of China, we find CEO duality to have a positive impact on firm value while the results showed otherwise in the Indian context. As with board characteristics, the empirical results indicate that a larger board size leads to an increase in firm value while board independence tends to have a negative impact on firm value for firms in China. Meanwhile, for Indian firms, board independence has a positive impact on the performance of listed companies in India.

5. Conclusion

In congruence with our presupposition that good corporate governance practices help foster a reliable corporate culture which in turn translates to higher firm valuations, the findings of this study reaffirms that the financial performance of companies can be improved by way of implementing effective corporate governance mechanisms. The study's findings would be very insightful to the heterogeneous investor community that invests in the stocks of companies. We suggest that investors invest their money in those firms that observe good corporate principles in order to ensure that their funds are channeled in the right avenues. The study also pinpoints the need for top corporate management to resort to an ethical and transparent mode of business in order to nurture confidence among both domestic and foreign investors.

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