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An Examination of Corporate Governance and Insider Ownership

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ABSTRACT
Corporate governance aims to align the interests of investors and managers, ensuring that companies are operated for the benefit of all classes of investors. However, in a broader sense, good governance entails running companies in an open and honest manner, fostering overall confidence, enhancing the efficiency of international capital allocation, and ultimately contributing to the nation's wealth and welfare. The significance of corporate governance lies in whether it should prioritize protecting the interests of all stakeholders or solely focus on shareholders. The role and contribution of independent directors are crucial for fostering good governance. Given the current landscape, it is imperative for both the corporate world and civil society to play an active role in facilitating the restructuring and transformation of governance practices.

Keywords: *Good Governance, Interests of Investors and Managers*

INTRODUCTION

Corporate governance is concerned with aligning the interests of investors and managers and in ensuring that firms are run for the benefit of all classes of investors. In broader sense however good governance the extent to which co.'s are run in an open & honest manner creates overall confidence entrances efficiency of international capital allocation and contribute ultimately to the nations overall wealth & welfare. (The overall importance of corporate Governance Should governance be concerned with protecting the interests of all stake holders or only one class of stake holders i.e. share holders.

The role contribution of the independent directors for good governance is high highlighted.) Noticing the situation it is the time that the corporate world & civil Society need to take a more active role in ensuring the restructuring & Transformation of governance.

The lack of expectation from managers with no cash flow rights also applies to ownermanagers with less than hundred percent cash flow rights. This fundamental governance problem arises due to a variance in the cash flow and control rights of the firm's stakeholders. Existing contract mechanisms however efficient can only mitigate this problem. Jensen & Meckling (1976) demonstrated that reduction in ownermanager's equity tends to encourage appropriation of corporate resources in the form of perquisites. This is attributed to a reduction in the claim on the outcomes (cash flow) without equivalent reduction in control rights. They demonstrate that such behavior gives rise to agency costs leading to expenditure of resources in mitigating the same.

OBJECTIVES OF THE STUDY

1. To ensure the restructuring and Transformation of Governance.
2. To lay down the framework for creating long turn trust between company and the external providers.
3. To limit the liability of top management and directors by carefully articulating the decision making process.
4. To ensure degree of confidence that is necessary for the proper functioning market economy.
5. To make attempts at better governance need more muscle to all co' s that use public funds

Good corporate Governance is intended to improve performance and transparency thus safe gnarling the interests of all stakeholders. In general the manner in which organization particularly limited co.'s are managed and the nature of accountability of the managers to the Owens is itself Corporate Governance.

Corporate governance is important for the following reasons

1. It lays down framework for creating long term trust between co.'s and the external providers of capital
2. It improves strategic thinking at the top by inducting independent directors who bring a wealth of experience & a host of new ideas
3. It rationalizes the encouragement & monitoring of risk that a firm faces globally
4. It limits the liability of top mgmt & directors by Carefully articulating the decision making process

5. It ensures the integrity of financial reports & finally it helps provide a degree of confidence i.e. necessary for the proper functioning of a market economy

Accounting policies followed by a company must be known. The top management must authenticate all the figures. If they mislead or do not disclose reality, the law must provide for severe punishment when discovered. In India, SEBI's clause 49 has stipulated the conditions that an individual should meet to classify as an independent director. Independent directors must have access to the account's and operations to provide some over night. As the name suggests; an independent director is a director who is not aligned with either the management or the promoter, and is capable of exercising independent judgement. His key responsibility is to ensure that the management of the board takes decisions that are in the interests of all share holders & don't favour any one class of shareholders.

However, legislation and rules alone can't make corporate & other managers honest. The pressures of showing constantly improving performance are now accentuated by the requirement to declare quarterly results. The rich rewards that apparent good performance brings via bonuses; stock options, promoting & fringe benefits overcome inhibitors. Each dishonest manager expects that his misdemeanors will be missed. An active and involved board consisting of professional & truly independent director's plays an important role in creating trust between a company and its investors and is the best guarantor of good corporate- governance. Competent and qualified in dependent directors plays over important role in the stewardship and strategy formulation. Indian corporate that has appointed such directors have benefited from their guidance & inputs.

Clause 49 seeks to ensure that individuals who have materially significant financial transactions with company or its promoters, directors, senior management or who have a share holding of more than 2% in company are disallowed from becoming independent directors in that co. In listed company 50% of the board should consist of independent directors of the co has an executive chairman. In case of a non- executive chairman 1/3 of the board should consist of independent directors.

For corporate-governance rules to make a real difference there must also be fast, effective & detailed regulatory over sight and sever penalties for violations. Indian over sight is poor and here the penalties are right.

Conscientious auditors qualify the account's with notes but these are worded in cautions legalese and hidden in many pages of company reports. The lay investor mayn't even appreciate the seriousness of an issue from the care with which it is wordered. It takes an expert to understand what exacting is being pointed out. With many companies, good governance is just a façade put on because it enhances their reputation for probity. Credit rating agencies are paid by companies to conduct ratings for governance. Paid by the companies they are rating, they may find it difficult to apply high standards. Many public enterprises neither provide annual reports on time nor make full disclosures. Their boards are packed with pliable exbureaucrots, out of work politicians, rarely management professionals with corporate experience.

Departmental enterprises like ordinance factories and state electricity boards (SEBs) are worse. Their management rests with government departments. Their performance is hidden in ministry reports. They lack commercial attitudes and have soft budget constrains. Government is there to pick up their losses, letting them continue in their inefficient ways.

Why should all enterprises owned wholly or controlled by governments also not be subjected to the same corporate governance requirements as listed companies and those under the company law? Why should they not have the legal requirements to appoint truly independent directors, audit and remuneration committee to ensure transparency in operations?

The sector of maximum neglect is that of the 4 million or so "non – profit "organizations that in India are registered as trusts, societies and section 25 companies. Each of these has a different set of regulations relating to registration , reporting and taxation at the state levels (charity commissioner , register of societies / companies) and central level (income tax department , home ministry for foreign contributes as per FCRA) . Yet, there are no mechanisms to check that these organizations are fulfilling obligations proclaimed by them or required by law. Donations to these chainable organizations cost the central government an estimated Rs 11 billion in taxes lost by deductions available to donors. Information (especially financial) is not in the public domain regarding most of them. Government loses additional huge sums as tax revenues

because many of these organizations use "not for profit '" status as cover for what is really committee activity. Why should this sector also not be required by law to have independent directors(or trustees) , audit committees , mandatory publication of account and reports and be penalized for violation ?

These questions must asked of many of the private entrants in the school, technical and professional education. Management schools are a good example. They are supposed to be governed by the All India Council for Technical Education or the university that has granted them affiliation, but many violate all rules and norms. Most charge exorbitant fees, provide poor facilities , engage untrained faculty , and sometimes charge under –the – table fees . The regulators do little to discipline and improve them and their boards are rubber stamps for the promotes , Surely , there is a case for applying good governance concepts to them as well ?

Government enterprises and non profit organizations are under very poor regulatory oversight this must change. Regulatory must have enough staff and funds to study reports, investigate, and catch violations and to punish. Our attempts at better governance need more muscle and must be extended to cover all enterprises that use public funds.

Insider ownership reflects the governance problem arising due to variance in the cash flow and control rights such ownership entails. Insider ownership as defined in the governance literature has two dimensions. In the first case insider ownership can be defined as managerial ownership (managerowner). Where managers are assigned ownership rights as a

post facto incentive Mechanism by owners. In the second case insider ownership is defined by the de facto ownership rights held by an insider who promotes and also manages (owner- manager). The behavior of the insider due to a discrepancy in cash flow and control rights in both the cases need not be similar due to a divergence in both motivation and expectations. The Indian governance mechanisms particularly the insider ownership of firms follows the latter pattern where owners are de facto promoters as well as managers.

The effect of insider ownership on the governance and by extension on the performance of the firm has been a topic of research in the past few decades. Most of this research is concentrated on the developing economies and in recent years on the emerging economies. In a majority of the 1above studies insider ownership is defined as managerial ownership and the above distinction between manager-owner and owner-manager is not very clear. We believe that without taking due care of this distinction any generalization of prior conclusions relating insider ownership with performance particularly in the Indian context will not be meaningful.

The difference may arise due to various factors like the nature & level of ownership, the return horizon, source & magnitude of investment of owner- managers as opposed to manager owners.

The nature of ownership is a very crucial factor in defining the insider's behavior. It has already been mentioned that in case of manager-owner it's more of a post facto incentive mechanism as opposed to the ownership rights purchased by the owner- manager. This would alter the risk profile of an owner-manager as compared to a manager-owner. The level of ownership also varies significantly between these two categories. It might be anywhere between 010% and rarely above 30% in case of manager owners5, in the latter it can be anywhere between 1 and 100% 6. The level of ownership defines the control exercised by the ownermanager and hence is normally higher than a manager-owner.

It is intuitive to assume a variance in the return horizon between these two categories of insiders. The owner- managers return horizon is driven by considerations like transfer of wealth to the next generation whereas the manager- owner's horizon would be limited more by the length and security of his tenure. Given the above it would be reasonable to expect that any appropriation behavior by these two categories of insiders for a given level of ownership would not be similar in nature.

Other than the above any appropriation behavior will also be driven by the source and magnitude of investment by the ownermanagers. Other than the financial outlay which differentiates the two types of insiders, the percentage of the wealth of the insider invested in the firm would also impact his behavior. This would be independent of the owner-manager's holding and would be driven by other considerations. This aspect would further complicate things when we consider the fact that in most cases the insider would source his investment not only from his savings but augment it from soliciting investment from family members, relatives and friends before approaching outside investors both debt and equity.

This paper attempts to study this anomaly by examining the role of insider ownership on the performance of the firm in the Indian context. Past studies in this direction have used insider Ownership in the role of a control variable assuming that any relationship is similar to earlier studies in other countries. The time frame of these studies is also confined to a one year period which limits the scope of these studies. Since any generalization of results from these studies a priori assume that the direction of this relationship is impervious to exogenous changes.

Past 'insider ownership-performance' studies in the governance literature can be categorized into two, one which assume a positive relationship between insider ownership and performance and the other which assume a negative relationship between insider ownership and performance. The former argue that higher the insider ownership lower the motivation for appropriation and hence better the performance the latter argue that lower the insider ownership higher the monitoring from the other stakeholders particularly the block holders like institutional investors and hence lower the appropriation by the insiders. The probability of the former relationship is generally expected in manager-owner governance systems due to alignment of performance incentives with ownership rights. The latter relationship can be expected in both governance systems depending on the empowerment and active nature of the block holders.

The accuracy of both the arguments will depend on the perceived cost of appropriation technology at a given level of insider ownership. This cost is dependent among others on monitoring by the other stakeholders, efficiency of institutional, market and legal mechanisms in place. Given this it would not be prudent to generalize the behavior of insiders using studies from developed economies and for that matter even from studies in the emerging economy context. Since each country will have a unique governance mechanism which normally evolves over a period of time and reflects historical factors, social ethos and institutional mechanisms prevalent. **Conceptual Framework**

As mentioned earlier owner-manager governance system dominates governance of an Indian firm. Another dimension of ownership which is not normally considered is the role of family and community in the governance of the firm. Any understanding of role of insider ownership on governance and by default performance would not be complete unless this is taken into consideration. Other than being owner managed the Indian firms are mostly family owned and a majority of them belong to specific communities. These communities have evolved over time and regard business as their main or sole occupation. These communities evolved into distinct groups with their own set of social and cultural norms. Raychaudhuri and Habib (1982) observe that the same communities continued to dominate business over the millennia. According to a 1991 estimate8these communities constitute of around 1.88% of the Indian population Theoretically the insiders need for assuming full control might be driven by various compulsions imposed by the environment. La Porta et al. (2000) argue that entrepreneur firms may wish to keep control of their firms when investor protection is poor. Since in such situations the entrepreneurs or his family's personal reputation is the only way to raise external funds. On the other hand they also quote Bennedsen and Wolfenzon (2000) argument that when investor protection is poor, dissipating

control among several large investors none of whom can control decisions of the firm without reaching a consensus might be useful to limit expropriation.

The question now is if an entrepreneur retains control of a firm how can he raise external Funds from outside investors for financing or for diversification when they expect to be Expropriated? They argue that according to Jensen and Meckling (1976) cash flow ownership by an entrepreneur reduces incentives for expropriation and raises incentives to pay out dividends.

Hypotheses

The following hypothesis postulated below are aimed at gaining an insight into the relationship Between Insider ownership and 1. Overall efficiencies of the firm

2. Operational efficiencies of the firm
3. Residual Income of the firm
4. Capital Structure of the firm
5. Market Perception (Domestic and Foreign)

Hypothesis 1: tries the capture the effect of appropriation behavior if any on the overall return of the firm. Insider ownership is invariant with the overall performance of the firm in a varying environmental context. After a careful review of the three measures Return on Equity (ROE), Return on Capital Employed (ROCE) and Return on Assets (ROA), ROA was considered as the most appropriate measure to quantify the overall performance of the firm. The reasons for the same are elaborated below. Considering shareholder wealth maximization as the fundamental objective of a business entity, appropriation would affect the shareholders most, particularly the outsider shareholder. Given this ROE would be a more suitable measure to capture the effect of appropriation behavior of the insider. But ROE suffers from certain deficiencies when used in econometric testing, particularly when the sample also contains the worst performing companies. Some of these draw backs are elaborated below.

1. Firms reporting very low book values for equity are likely to be over- leveraged, in spite of 2. Having a high ROE ratio, excluding the same by a systematic search for outliers may not be successful.
3. In case of negative book value of equity, the resulting ratio will have no meaning in financial analysis. If these firms are eliminated then a serious source of sample bias might result as the worst performing firms will be eliminated.
4. For firms whose earnings and equity are negative, a “false- positive” ROE might result.

In case of the current study to capture the effect of insider ownership on the performance of the firm exclusion of the worst performing companies would undermine the results. Susanne (2002) has compared the results of various empirical studies and also statistically tested the relative merits of using ROA and ROE. She has concluded that in situations where the worst performing companies are included in the sample for econometric testing ROA provides a more robust result than ROE in spite of ROA suffering from an inherent bias due to historical valuation of assets. She concludes that there is no mathematical, statistical or econometric adjustment that makes ROE a useable measure of firm performance and simply should not be used in large sample econometric models.

In case of ROCE, capital employed does not include current liabilities. In the Indian context the current liabilities consist of bank borrowings which are used as permanent funds than short-term borrowing. Due to this reason the efficacy of ROCE as a measure of performance is suspect. Keeping the above problems in view ROA was considered as the most appropriate measure to quantify the overall performance of the firm.

Hypothesis 2: below is aimed at ascertaining as to the nature of this appropriation behavior by capturing the relationship if any between insider ownership and various operational efficiency parameters of the firm. Keeping this in view the following null hypothesis is proposed.

Insider ownership is invariant with the operational efficiency parameters of the firm.

Four accounting variables representing overall cost efficiencies, material, human resource and financial efficiencies are used to test this hypothesis. The profit margin, Asset Turnover ratio, Manpower to sales ratio, and Interest cover ratio are used as the dependent variables to proxy for the operational efficiencies of the firm. Literature suggests that the owner managers having lower financial stakes would rather reinvest the free cash flows than distribute the same as this is the cheapest source of finance available.

Keeping this in view the following null hypothesis is proposed.

Hypothesis 3 : Insider ownership is invariant with reinvestment rate and this association is independent of external environmental characteristics.

Similarly in the matter of raising external finance, given the choice of proportional cash investment to losing control and cash flow rights, concentrated owners would prefer to use debt rather than equity. Keeping this in view the following null hypothesis has been proposed.

Hypothesis 4 : Promoters' ownership is invariant with debt in the capital structure of the firm. We used the accounting measure Debt/Equity to represent the capital structure of the firm. Corporate debt is proposed to represent the domestic market perception and foreign debt the global market perception with respect to the concentration of ownership. There is

some doubt regarding the effectiveness of these measures to reflect the perception of outside investors. There is no indication whatsoever that these measures were ever used in this context to the best of our knowledge. Availability of market credit particularly short-term credit is perceived as a measure of promoter's reputation and the firm's performance. The quantum of credit available to a firm definesthe perception of the market on this aspect particularly in the Indian context. Keeping this in view in our opinion this accounting measure may be used to represent the perception of outside investors due to the lack of reliable market measures. Given the fact that the corporate borrowings figure used here to measure short-term market credit does not include borrowings from group companies it was felt that this can be safely used to proxy for market perception. Availability of foreign credit is dependent on various factors, prominent among them is the firm's capacity to access this form of finance. Since the costs involved are high and the viability of this source of finance is dependent on the magnitude of finance accessed. Though access was simplified in the post 1992 period still the barriers of access are very high as can be seen by the low number of industries in each period where firms have accessed this form of finance. Even when the entry barriers due to the high cost of accessing are surmounted access to this form of finance is further constrained by the stringent criteria imposed by the creditors. Both foreign debt and corporate debt are used to proxy for the perception of the outside investor with respect to the percentage of insider ownership and related performance. Individual reputations and community network may be very helpful for accessing short-term credit but the same is not true in case of foreign debt.

Hypothesis 5 : Promoters holding is invariant with respect to the level of corporate debt

Hypothesis 6: Promoters holding is invariant with foreign debt we used ratios corporate debt to total debt and foreign borrowing to total debt separately as the dependent variable to proxy for the same.

The model has the following functional form:
Performance = a + b Size + c Insider + d Age + u (1)
Size is represented by 'LnSales' (natural logarithm of sales) and along with Age (current year minus date of incorporation of the firm) are used as control variables to account for the size and experience of the firm. The coefficients a, b, c and d are parameters and u is a stochastic disturbance term. 'Insider' variable is defined as a percentage of promoters holding in the firm.
The control variable 'LnSales' reflects the effect of various unobserved factors related to the size of the firm. In case of the product market, size reflects a) possible entry barriers that might result from economies of scale, b) the extent of market power of a company. In case of the capital market, size reflects financial barriers of entry due to the ability of large companies to finance investment projects from internal sources as well as their capacity to raise additional resources through the issue of new equity. The variable 'Age' is used to control for life cycle effects as profits of older and mature companies may be enhanced owing to reputationbuilding and learning efforts. This is particularly true in case of India due to the business-family ownership of the firm. Older firms may also be handicapped by management entrenchment which reduces their propensity to respond swiftly to changes in the environment.
The most common observations in case of all the nine performance parameters used in ascertaining the relationship between insider ownership and performance are provided below:

1. Insider ownership did not have any influence on the various performance parameters used in the study in case of a majority of industries.
2. This is true in case of all the 4 periods of the study and also in case of the two ownership categories
3. In case of the few industries where insider ownership was found to influence the performance, no specific pattern is observed
4. This trend is true both in case of the performance parameters and the different time periods The results indicate overwhelmingly that insider ownership in the Indian context has no influence on the performance of the firm in a majority of industries. This is true irrespective of the time period of the study. For those few industries where insider ownership was found to have an effect on the performance parameter, the following section provides the summarization of conclusions. This would help in providing an overview of the nature of the relationship between insider ownership and performance with a caveat that these conclusions cannot be generalized. These pertain to and to some extent applicable to insiders behavior for a given time period and a given variable. Provided that insider ownership affects the performance, these results indicate the nature of this relationship In case of the few industries where insider ownership influenced the performance with or without the control variable being significant, the results indicate that:

- Insiders influence on overall performance of the firm is not conclusive since even for a given time period the direction of this relationship is different for different industries.
- Insiders and overall cost efficiencies were negatively related in the first two time periods and positively in the last two periods.

Asset utilization was positively associated with insider ownership irrespective of the time period under consideration. Insiders with high investment in the firms assets seem to have better servicing capacities of their fixed obligations

particularly in the post 1992 period Higher insider ownership is also associated with higher employee productivity and lower human resource expenditure.

The recent worldwide accounting scandals, have underscored the role of corporate governance in protecting the interests of investors. However, the growing awareness of corporate governance has also made it more difficult to define good governance. The complexities behind corporate governance can be classified into two broad categories. First, is the multi-disciplinary nature of the subject. Among other disciplines, Accounting, Financial economics, Law, Philosophy and Political Science have linkages with corporate governance. The diversity of disciplines involved makes it difficult to arrive at one single measure of corporate governance. Thus, we assume that most of the mispricing is to poor corporate governance.

We can test the following hypotheses:

1. Good governance companies should have less mispricing compared to bad governance companies.
2. Good governance companies should have less private information before events than bad governance companies.
3. Good governance companies should have lower volatility compared to bad governance companies

CONCLUSION

In this paper we have defined corporate governance as a mechanism for allocating resources efficiently in order to maximize social welfare. We have shown that welfare costs are high if assets are not fairly priced. Mispricing has been linked to corporate governance with an assumption that most of the mispricing in the stock market is attributed to the information disseminators or the corporate entities.

Good corporate governance is intended to improve the performance and the transparency thus safe garding the interest of all stakeholders. Defining good governance is a complex issue. Currently used conventional ranking methods typically use endogenous variables that can be controlled by the information providers. Recent accounting scandals have exposed this weakness. In this paper, we show that share of measuring corporate observations in case of all the performance governance using reactions is parameters used in ascertaining. Corporate
consistent with the S&P ranking of corporate ownership and this effect the market governance. However, by measuring the performance. Here the relationship is taken information adjustment process during event into consideration.

mispricing, which is more exogenous and announcements, we believe deeper insights market determined is a simple but effective can be obtained. The most common measure of corporate governance. Business Week (2004). ‘Special report: corporate governance, investors fight back’, 17 May Butz, C. (2003). Decomposing SRI Performance, Geneva, Pictet & Cie.

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