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Firm-Level Corporate Governance In Emerging Markets: A Case Study of India

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FIRM-LEVEL CORPORATE GOVERNANCE IN EMERGING MARKETS: A CASE STUDY OF INDIA

By: N. Balasubramanian*, Bernard S. Black† & Vikramaditya Khanna††

ABSTRACT: We provide an overview of Indian corporate governance practices, based primarily on responses to a 2006 survey of 370 Indian public companies. Compliance with legal norms is reasonably high in most areas, but not complete. We identify areas where Indian corporate governance is relatively strong and weak, and areas where regulation might usefully be either relaxed or strengthened. On the whole, Indian corporate governance rules appear appropriate for larger companies, but could use some strengthening in the area of related party transactions, and some relaxation for smaller companies. Executive compensation is low by U.S. standards and is not currently a problem area.

We also examine whether there is a cross-sectional relationship between measures of governance and measures of firm performance and find evidence of a positive relationship for an overall governance index and for an index covering shareholder rights. We find an overall association, which is stronger for more profitable firms and firms with stronger growth opportunities. A subindex for shareholder rights is individually significant, but subindices for board structure (board independence and committee structure), disclosure, board procedure, and related party transactions are not significant. The non-results for board structure contrast to other recent studies, and suggest that India's legal requirements are sufficiently strict so that overcompliance does not produce valuation gains.

Keywords: India, securities law, corporate governance, Clause 49

JEL classification: G38, K22

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I. Introduction

This paper has three principal goals. First, despite the surge in research on corporate governance in emerging markets, we still know little about firms' actual corporate governance practices. In this paper we provide a detailed, descriptive account of the governance practices of firms in an important emerging market – India. Our account is based on a survey of Indian firms, which we conducted in the first half of 2006. We approached 506 firms with a detailed fifteen page corporate governance questionnaire. We obtained responses from 370 firms (a 73% response rate). The survey responses allow us to provide a rich picture of the governance practices of Indian firms. We are not aware of comparable efforts in other countries, other than a contemporaneous effort by one of us in Brazil, with a much smaller sample (Black, de Carvalho and Gorga, 2008).

Second, we contribute to the literature on corporate governance indices and the connection between governance and firm value. We use the survey responses to build a broad overall Indian Corporate Governance Index (*ICGI*) and investigate the association between *ICGI* and firm market value. Cross-country studies have shown a positive correlation between governance indices and firm market value (e.g., Klapper and Love, 2004; Durnev and Kim, 2005; Bruno and Claessens, 2007), although the effect depends on country characteristics (Doidge, Karolyi and Stulz, 2007a; Durnev and Fauver, 2007). So have some individual country studies (e.g., Black, Jang and Kim, 2006a (Korea); Cheung, Connelly, Limpaphayon and Zhou, 2007 (Hong Kong); Zheka, 2007 (Ukraine)). We find a similar correlation in India. However, the cross-country studies rely on multi-country governance indices, which cover only the largest firms in each country. These large firms have public visibility, solid analyst coverage, and often high foreign ownership. We find that the association between *ICGI* and firm market value extends to, and may even be stronger for,

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smaller firms. We also find a stronger association between firm value and governance for more profitable firms and firms with stronger growth opportunities (proxied by Tobin's *q*).

Third, we contribute to the literature on which aspects of overall firm governance are associated with firm market value. We construct separate indices (subindices) for board structure (board independence and board committees), board procedure (board procedures and audit committee procedures), shareholder rights, disclosure (substance and reliability), and related party transactions (transaction levels and approval procedures). The shareholder rights index is positively associated with firm market value; other indices are insignificant. The non-results for board independence contrast to other recent studies of emerging markets, which find a positive association (e.g., Dahya, Dimitriev and McConnell, 2008 (cross-country), Black and Kim, 2008 (Korea)). Our results suggest that India's legal requirements for board independence are strict enough so that overcompliance does not produce valuation gains. The non-results for procedures suggest that the substance of governance matters, but process may not (compare Black, Kim, Jang, and Park, 2008, who find non-results for board procedure in Korea).

Part II summarizes the relevant literature and India's corporate governance history. Part III discusses our survey methodology and data sources. Part IV discusses the results of our survey of the corporate governance practices of Indian private firms. Part V defines a corporate governance index and examines the relationship between index scores and firm market value. Part VI concludes.

II. Literature Review

We review here the literature on two aspects of governance in emerging markets: what we know about governance patterns, and to what extent does governance predict firm share prices or performance. We cover studies of India with care, and other studies in less depth. We do not cover studies of developed countries, or nonpublic firms.

A. What We Know About Firm-Level Governance in Emerging Markets

1. Cross-Sectional Snapshots

This paper's first goal is to provide a detailed descriptive analysis of firm-level governance in an important emerging market. We know remarkably little about the details of firm-level governance. Cross-country studies of governance often provide high level comparisons between countries -- for example, mean scores on disclosure (Patel, Balic and Bwakira, 2002) or overall governance (Bruno and Claessens, 2007). Individual country studies sometimes report summary statistics for overall governance and particular governance measures (e.g., Zheka, 2007, Ukraine); Drobetz, Schillhofer and Zimmerman, 2004, Germany; Black, Love and Rachinsky, 2006, Russia). One study of Brazil, inspired by this one, provides details on Brazilian governance (Black, de Carvalho and Gorga, 2008). And that's about it.

2. Indian Corporate Governance Research

Several studies examine Indian corporate governance generally. World Bank (2005), Sarkar & Sarkar (2000), and Mohanty (2003) examine how firm-level governance influences

the behavior of institutional investors, or vice-versa. Mohanty (2003) finds that institutional investors own a higher percentage of the shares of better-governed Indian firms. This is consistent with research in other countries (Aggarwal, Klapper and Wysocki, 2005; Ferreira and Matos, 2007).

Bhattacharyya and Rao (2005) examine whether adoption of Clause 49 (an important set of governance reforms in India) predicts lower volatility and returns for large Indian firms. Black & Khanna (2007) conduct an event study of the adoption of Clause 49. They rely on the phased implementation schedule, in which "large" firms were required to comply before "small" firms, and report positive returns to a treatment group of large firms relative to a control group of small firms, around the first important legislative announcement. Dharmapala and Khanna (2008) report that small Indian firms which are subject to Clause 49 react positively to announced plans by the Indian securities regulator to enforce the Clause, relative to similar firms not subject to clause 49. Khanna, Kogan and Palepu (2006), study instances of minority shareholder expropriation by Indian firms. Bertrand, Mehta and Mullainathan (2002) provide evidence on tunneling within Indian business groups.

B. Does Governance Predict Firm Value in Emerging Markets?

This paper's second goal is to assess the connection between firm-level governance and firm market values. A number of cross-country studies examine this connection (Aggarwal, Erel, Stulz and Williamson, 2006; Klapper and Love, 2004; Durnev and Kim, 2005; Bruno and Claessens, 2007; Doidge, Karolyi and Stulz, 2007a; Durnev and Fauver, 2007). However, these studies all rely on the same small set of cross-country governance surveys, and are limited to the largest firms in each country. The available governance measures are:

- Standard & Poor's transparency and disclosure survey (conducted in 2002, not repeated) -- covers 42 Indian companies.
- Credit Lyonnais Securities Asia governance survey (conducted in 2001, not repeated) -- covers 68 Indian companies.
- Institutional Shareholder Services (conducted 2003 on) -- limited to developed countries; does not cover India.[1]

Individual country studies can complement this cross-country work. These studies are, by their nature, country specific, and hence of uncertain generalizability. However, they have several potential advantages. One advantage is ability to study the association between governance and performance at smaller firms. A second is ability to develop country-specific governance indices which are tailored to the rules and practices of individual countries. In India, for example, all public firms must have audit committees and a one-share, one-vote capital structure, so there is no variation in these aspects of governance. A third is that the indices are current. In contrast, the S&P and CLSA indices are already becoming dated, and have other important limitations (the S&P index is limited to disclosure; CLSA relies in part on analysts' subjective opinions).

To our knowledge, published studies exist for the following emerging markets:

[1] Baker, Gottesman, Morey and Godridge (2007) report results from an index developed by Alliance Bernstein, which includes India (number of firms not stated), but provide too few details on the index elements for us to assess its reliability.

- Brazil (Leal and Carvalhal-da-Silva, 2007)
- Hong Kong (Cheung, Connelly, Limpaphayom and Zhou, 2007a)
- Korea (Black, Jang and Kim, 2006a)
- Russia (Black, 2001; Black, Love and Rachinsky, 2006)

There are also working papers on China (Cheung, Connelly, Limpaphayon and Zhou, 2007b) and Ukraine (Zheka, 2007).

C. Overview of Indian Corporate Governance

Since its financial liberalization began in 1991, India has undergone significant corporate governance reform.[2] By the time of Independence in 1947 India had functioning stock markets, an active manufacturing sector, a fairly developed banking sector, and comparatively well developed, British-derived corporate governance. However, from 1947 through 1991, the Indian government pursued socialist policies. The state nationalized most banks, and became the principal provider of both debt and equity capital for private firms. The government agencies who provided capital to private firms were evaluated based on the amount of capital invested rather than return on investment. Competition, especially foreign competition, was suppressed. Private providers of debt and equity capital faced serious obstacles to exercising oversight over managers due to long delays in judicial proceedings and difficulty enforcing claims in bankruptcy. Public equity offerings could be made only at government-set prices. Indian corporate governance deteriorated, and Indian firms looking for outside capital had to rely primarily on government sources (Bhattacharyya & Rao, (2005; World Bank, 2005). The Indian economy performed poorly.

In 1991, the Indian government faced a fiscal crisis. It responded by enacting a series of reforms including reduction in state-provided financing, bank privatization, and general economic liberalization. The Securities and Exchange Board of India (SEBI) -- India's securities market regulator – was formed in 1992. By the mid-1990s, the Indian economy was growing steadily, and Indian firms began to seek equity capital to finance expansion into the market spaces created by liberalization and the growth of outsourcing.

The need for capital, amongst other things, led to corporate governance reform. The Confederation of Indian Industry (CII), an association of major Indian firms, issued a voluntary Corporate Governance Code in 1998, and then pressed the government to make the central elements of the code mandatory for public firms, which SEBI did the following year, by adopting a reform package known as Clause 49. The principal elements of Clause 49 include (see Appendix A for details):

- firms should have 50% outside directors if the CEO and Chairman are the same person, and 30% outside directors if the firm has a nonexecutive chairman;
- firms should have an audit committee with at least three nonexecutive members, all with experience in financial matters;
- the CEO and CFO should certify the firm's financial statements and the adequacy of its internal controls; and

[2] This Part is adapted from Khanna (2008); see also Goswami (2003); Chakrabarti (2006); and Khanna and Palepu (2007).

- firms should provide disclosure similar to that required for firms cross-listed in Europe.

Firms that do not comply with Clause 49 can be delisted and face financial penalties. However, at the 2006 date of our survey, SEBI had not yet imposed sanctions on noncomplying firms. The first enforcement actions were in 2007. Legal reform has been ongoing, with SEBI amending Clause 49, the government amending the Companies Law, and a recent Irani Committee report (2005) recommending further changes.

III. Survey Methodology and Data Sources

A. Survey Methodology

This study relies on an extensive survey we conducted in early 2006 of 506 Indian public companies ("India CG Survey 2006"). We received 370 responses, for an overall response rate of 73%. The survey was conducted with support from the Bombay Stock Exchange (BSE), which provided a cover letter urging firms to respond, and from IIM Bangalore, one of India's top business schools. We mailed a written survey to each firm, followed up with additional mailings and phone calls, and arranged site visits to each firm by the A.C. Nielsen survey research firm. We promised confidentiality to all respondents, and thus do not name individual firms in this paper.[3]

We surveyed firms with central offices in one of India's six largest cities -- Bangalore, Chennai, Hyderabad, Kolkata, Mumbai, and New Delhi. We approached essentially all firms in the BSE 200 index with central offices in these cities; these firms include 26 of the firms in the BSE 30 index and 131 of the BSE 200 firms.[4] For smaller firms, we asked A.C. Nielsen to select firms at random, with a tilt toward BSE 500 firms. Overall, we approached 275 firms in the BSE 500 (55%); these firms represent about 80% of the market capitalization of the BSE 500 and 76% of the market capitalization of all Indian public firms. The BSE groups are largely but not completely size-based.

Table 1 provides summary information on the firms we approached and those which responded. The response rates were higher for the BSE 30 firms, but exceeded 50% for all BSE group ranges. The higher response rates for BSE 201-500 firms, and especially non-BSE-500 firms reflect A.C. Nielsen's tilt toward contacting firms with whom they had prior relationships. Some questions call for detailed knowledge of the company. Thus, it was important to ensure that the survey was completed by a knowledgeable person. Of the 370 respondents, 309 were the company secretary or chief legal officer, 42 were the CFO or another senior official in the finance department, 10 were CEOs, and 9 were other company officials.

Table 1. Surveyed and Responding Firms

Number of firms approached, number of respondents, and market capitalization of approached and responding firms in different size ranges, for India CG Survey 2006. Market capitalization and BSE data is at

[3] A copy of the survey is available on request from the authors.

[4] The standard stock price indices for Indian firms are BSE 30 (also called Sensex); BSE 100, BSE 200, BSE 500 and, for the National Stock Exchange, the Nifty Fifty. Most large Indian firms are listed on both exchanges.

year-end 2005. Amounts in thousands of Rupees crores (1 crore = 10 million Rupees =~US$220,000). Total row includes all firms in Prowess database.

	Number of firms			Market capitalization		
Size Group	**No in group**	**Approached(% of total)**	**Responded (% of surveyed)**	**All firms**	**Approached (% of total)**	**Responded (% of surveyed)**
BSE 30	30	26 (87%)	20 (77%)	1,216	1,150 (95%)	845 (73%)
BSE 31-100	70	45 (64%)	26 (58%)	537	379 (71%)	233 (62%)
BSE 101-200	100	61 (61%)	31 (51%)	229	131 (57%)	70 (54%)
BSE 201-500	300	143 (47%)	82 (56%)	276	137 (50%)	73 (53%)
Subtotal BSE 500	***500***	***275 (55%)***	***160 (58%)***	***2,258***	***1,797 (80%)***	***1,221 (68%)***
Other[5]	2,007	231 (15%)	210 (91%)	202	59 (29%)	44 (74%)
Total	**2,507**	**506 (20%)**	**370 (73%)**	**2,459**	**1,866 (76%)**	**1,270 (68%)**

Of the 370 respondents, 31 were government-controlled and 38 were foreign-controlled. Below, we limit our analysis to the remaining 301 "Indian private firms." Of the 301 Indian private firms, 165 are part of an Indian business group which includes one or more other public firms.[6] The response rate for Indian private firms was 77% (301/393).

B. Sample Selection Bias and Other Data Limitations

A key question for any survey is sample selection bias. Selection bias can enter our results in two ways: In the choice of which firms we approached, and in which firms responded. We address each in turn. At both levels, the degree of sample selection bias appears small. Within the six metro areas we surveyed, approached firms are similar to nonapproached firms and responding firms are similar to nonresponding firms.

1. Bias in Our Choice of Firms to Approach

We limited our survey to firms with their main office in the six largest Indian cities. This could introduce bias if these firms are different than firms located in other cities -- for example, technology firms are often concentrated in Bangalore and Hyderabad, which were two of our six cities. Outside the BSE 200, we relied on AC Nielsen to select firms to survey, which could also introduce bias. For BSE 201-500 firms, they approached 143 of the 184 firms located in these six cities. For smaller firms, AC Nielsen largely approached firms with whom they had prior contacts; these firms might be different than firms with whom AC Nielsen had no relationship. Our survey design also tilted toward larger firms, which are likely to do better than smaller firms on formal governance measures.

Table 2 provides summary statistics for selected industry and financial measures for approached and non-approached Indian private firms, in or near our six metro areas, with financial data available from the Prowess database (Prowess is the principal source of

[5] Market capitalization for "other" firms is understated because some firms have missing data in Prowess.

[6] We expect to study the governance of government-controlled firms in separate research. We classified as foreign-controlled 35 firms with a majority foreign owner, plus 3 firms with a 40% foreign owner who held more than any other shareholder. Prowess classifies all of these firms as "private-foreign" by Prowess. We classified as government-controlled 25 firms which are majority owned by the central government or a state government, 5 firms with at least 39% government ownership, and Cement Corp. of India, which has missing ownership data. Prowess classifies all of these firms as government firms. No firms have between 11% and 39% government ownership.

financial information for Indian firms, analogous to a combination of Compustat and CRSP for U.S. firms). We have partial or complete financial and ownership information for 358 of the 393 approached firms, including 283 of the 301 responding firms.

Differences in financial characteristics are small and generally insignificant, suggesting that any bias in the choice of firms to approach, within our six metro areas, is limited. However, when we look at *all* non-approached firms, whether in our 6 metros or not (unreported), we find a somewhat different picture. For BSE 200 firms, approached and non-approached firms again appear quite similar. However, for BSE 201-500 firms, non-approached firms outside the six metro areas tend to be smaller and less profitable than firms in these metro areas.

Table 2. Comparison of Approached and Nonapproached Firms

Table shows percentage (for industries), or mean (other variables), for approached and nonapproached Indian private firms located in or near top 6 metro areas in India for India CG Survey 2006, with data available on Prowess. Industries shown (agriculture and manufacturing, chemical, and computer) have the most firms included in the BSE 500. Financial variables are defined in Table 4. *t*-statistics are reported in parentheses, from test of differences in proportion for industries, and difference in means for financial variables. *, **, *** indicates significance at the 10%, 5% and 1% levels, respectively; significant results (at 5% level or better) in **boldface.**

	BSE 200 Firms			**BSE 201-500 Firms**			**Other Firms**		
	Approached	Non-approached	Mean diff NA-A	Approached	Non-approached	Mean diff NA-A	Approached	Non-approached	Mean diff NA-A
No. of firms	83	10		112	26		198	1,333[7]	
Financial Characteristics (means)									
Ln(Market capitalization)	8.41	8.34	0.31 (1.04)	6.57	6.36	0.31 (1.71)	4.57	3.88	**-0.70*** (-8.40)**
Return on assets	0.16	0.13	0.05 (1.64)	0.16	0.13	0.03* (1.92)	0.143	0.156	0.01 (0.21)
Sales growth	0.11	0.23	-0.05 (-0.90)	0.13	0.17	-0.09 (-0.50)	0.28	0.22	-0.07 (-1.25)
Tobin's *q*	3.80	1.99	1.54 (1.44)	2.49	2.07	0.92* (1.87)	1.73	1.70	-0.03 (-0.16)
Leverage	0.56	0.72	-4.17 (-0.59)	0.59	0.57	1.92 (0.71)	0.001	0.001	0.001 (1.28)
Percent in selected industries									
Agriculture and Manufacturing	55%	40%		62%	65%		69%	63%	
Chemical	2%	0%		4%	4%		4%	5%	
Computer	13%	0%		14%	19%		6%	8%	
Other	29%	60%		25%	12%		22%	24%	

The industries of the approached and non-approached firms are also similar. The table shows some differences for BSE-200 firms, but these likely reflect the small number of non-approached BSE-200 firms (10 firms), rather than systematic differences in which firms were approached. For the other groups, approach rates were similar.

[7] There are 6,432 private Indian firms near the top 6 metros that were not approached for the survey. The table limits the number of firms to 1,333 of these firms as they are within the top 2000 firms in India and the approached firms were within the top 2000 firms in India.

2. Bias in Whether the Approached Firms Responded

Bias can also enter in the decisions by the firms we approached on whether to reply to the survey. Our 77% response rate for Indian private firms is excellent for surveys of this type, but responding firms could still differ systematically from nonresponding firms. For example, firms that score well on formal governance measures could be more likely to respond. Table 3 provides a comparison of responding versus nonresponding firms. The format and variables are similar to Table 2. To assess whether the likelihood of responding correlates with governance measures, we also include selected governance measures extracted from annual reports.

On the whole, the financial characteristics of responding and approached but nonresponding firms were similar. Within the BSE 500, differences in means were generally insignificant. There are only 13 nonresponding "other" firms, and we have data from Prowess for only 6 of these firms, so it is hard to conclude that there were systematic differences in which firms, once approached, responded to the survey.

Table 3. Comparison of Responding and Nonresponding Firms

Table shows percentage (for industries), or mean (other variables), for responding and approached but nonresponding Indian private firms located in or near top 6 metro areas in India for India CG Survey 2006. Industries shown have the most firms included in the BSE 500. Financial variables are defined in Table 4. Data on governance characteristics is limited to 294 responding and 69 nonresponding firms with available annual reports. *t*-statistics are reported in parentheses, from test of differences in means or differences in proportions, as appropriate. *, **, *** indicates significance at the 10%, 5% and 1% levels, respectively; significant results (at 5% level or better) in **boldface.**

	BSE 200 Firms			BSE 201-500 Firms			Other Firms		
	Responding	Non-responding	t-stat	Responding	Non-responding	Mean diff NR-R	Responding	Non-responding	Mean diff NR-R
No. of firms	50	33		66	46		185	13	
Financial Characteristics (means)									
Ln(Market capitalization)	8.45	8.36	0.31	6.54	6.62	0.76	4.63	6.79	**5.71*** **
Return on assets	0.14	0.12	0.54	0.15	0.14	0.14	0.11	0.10	0.26
Sales growth	0.07	0.16	**2.03****	0.13	0.15	1.47	0.11	0.14	0.80
Tobin's *q*	3.64	4.02	0.32	2.63	2.30	0.68	1.73	1.70	0.04
Leverage	1.01	0.71	0.83	0.91	1.25	1.43	2.03	1.66	0.11
Percent in selected industries									
Agriculture and Manufacturing	50%	64%		62%	61%		68%	77%	
Chemical	2%	3%		5%	2%		4%	0%	
Computer	18%	6%		11%	15%		5%	8%	
Other	30%	27%		23%	22%		23%	15%	
Percent with indicated governance characteristic									
annual report found (not found)	40 (10)	25 (8)		53 (13)	36 (10)		146 (39)•	6 (7)	
board size	10.1	9.9	0.34	8.8	8.5	0.64	7.5	10.7	**3.81*****
independent/total directors	53.3%	53.6%	0.06	51.2%	49.7%	0.48	53.3%	49.8%	0.47
CEO = chairman	34.0%	24.0%	0.88	36.9%	25.0%	1.22	44.9%	40.0%	0.21
audit committee	100%	100%		100%	100%		100%	100%	

For governance characteristics, we rely on annual reports. Under Indian law, companies should provide their annual reports to SEBI and to shareholders, but compliance is incomplete. We searched SEBI's website, company websites, and other sources, and were able to obtain annual reports for 363 of the 393 approached Indian private firms, including 294 of the 301 responding firms. Although we obtained a good number of annual reports, they were not located in one place and took quite some time and effort to locate in many instances. This may suggest an area of improvement in India's corporate governance system.

Governance differences are small for firms with annual reports available. There is a tendency, however, for annual reports to be harder to find for nonresponding firms (75% of non-responding private Indian firms had annual reports we could locate, whereas 98% of responding private Indian firms had reports we could locate). The nonavailability of an annual report, coupled with failure to respond to our survey, suggests inattentiveness to shareholder interests and perhaps to corporate governance, but we lack the data to confirm these firms' governance characteristics -- the data is in the missing annual reports.

3. Self-Reporting Bias

Respondents might self-report with bias. For example, they might overreport compliance with legal requirements. We cannot directly assess the extent of this bias, but it seems likely that this bias is not severe. First, India has explicit rules for board composition (a public firm must have either 50% independent directors, or 33% independent directors and a separate CEO and board chairman). Even so, a significant number of firms do not comply with these requirements, which is readily verifiable from both their annual reports and their survey responses. If there were severe reputational consequences for noncompliance with these or other governance norms, we might expect greater compliance. If not, it is not clear that respondents would intentionally misreport to us. Second, for some governance elements, we have data both from annual reports (which are public, hence misreporting may be potentially riskier) and from our survey; there are occasional differences between the two sources, but no apparent systematic differences.

4. Incomplete Respondent Knowledge

We were able in almost all cases to interview an appropriate person, but that person's knowledge may have been incomplete. This could lead to missing or "don't know" responses, and could also bias inferences from usable responses. For example, respondents may be more likely to be aware of the presence of a particular practice than its absence, so absence could be more likely to lead to a missing or don't know response. Fortunately, for most questions, the number of don't know, missing, or other ambiguous responses was low.

D. Non-governance Variables and Descriptive Statistics

Table 4 defines the principal financial and other non-governance variables used in this paper. We obtain information on these variables principally from Prowess. Data on cross-listing was provided by Kate Litvak, based on merging the databases of cross-listed firms maintained by Citibank, Deutsche Bank, JP Morgan, and the Bank of New York. Because we use these variables primarily in the regressions in Part 5, and exclude banks from these regressions, Tables 4-6 exclude the 5 private Indian banks in our sample.

Table 4. Other Variables

This table describes the principal non-governance variables used in this paper. Governance variables are defined in Table **[xx]**. Sample is 296 private non-bank Indian firms which responded to the India CG Survey 2006. Share values and balance sheet amounts are measured at year end 2005. Income statement variables are measured for 2005 unless otherwise specified.

Variables	Description
Tobin's *q*	Estimated as market value of assets as [book value of debt + book value of preferred stock + market value of common stock]/book value of assets.
Market-to-Book Ratio	Market value/book value of common stock. We drop 4 firms with negative book value of common stock.
Book Value of Debt	Book value of total liabilities.
Book Value of Assets	Book value of assets.
Market Value of Total Equity	Market value of common stock plus book value of preferred stock.
Debt/Equity	Book value of debt divided by market value of common stock.
Debt/Assets	Book value of debt divided by book value of total assets
Years Listed	Number of years since original listing.
Sales Growth	Geometric average growth rate of sales from 2003 to 2005 (or available period if less).
R&D/Sales	Ratio of research and development (*R&D*) expense to sales. Assumed to be 0 for 8 firms with missing data for *R&D* expense (there were an additional 180 firms that had zero as the amount of *R&D*).
Advertising/Sales	Ratio of advertising expense to sales. Assumed to be 0 for 7 firms with missing data for advertising expense (there were an additional 110 firms that had zero as the amount of advertising).
Exports/Sales	Ratio of export revenue to sales. Assumed to be 0 for 7 firms with missing data for export revenue (there were an additional 34 firms that had zero as the amount of exports).
PPE/Sales	Ratio of property, plant and equipment to sales. Assumed to be 0 for 7 firms with missing data for PPE/Sales.
Capex/Sales	Ratio of capital expenditures to sales. Assumed to be 0 for 14 firms with missing data for Capex/Sales.
EBDIT/Sales	Ratio of earnings before income and taxes to sales. Assumed to be 0 for 15 firms with missing data for EBDIT/Sales.
Share Turnover	Common shares traded during 2005 divided by common shares held by public shareholders (common shares outstanding) * (nonpromoters' fractional ownership, from Prowess).
Foreign Ownership	Foreign ownership of the firm's common shares divided by common shares outstanding.
Market Share	Firm's share of total sales by all firms in the same 4-digit industry listed on *BSE*.
Cross-Listing Dummy	1 if firm is cross-listed on a foreign exchange.
US Regulation Dummy	1 if firm has issued level 2 or level 3 ADRs in the United States and is therefore subject to U.S. securities rules; 0 otherwise.
Promoter Ownership	Percentage share ownership by promoters (from Prowess).
Business Group Dummy	1 if a member of a business group (from Prowess), 0 otherwise.
MSCI Dummy	1 if a firm is included in Morgan Stanley Capital International Index at year-end 2004 (the latest date for which we have data), 0 otherwise.
Industry Dummy Variables	10 industry groups, plus a residual "other" category for a total of 11 groups, constructed based on information from Prowess and company websites.

Table 5 provides summary statistics for these variables. Data for all characteristics are from year end 2005 or calendar 2005, as appropriate. We have partial or complete financial and ownership information from Prowess for 283 of the 296 responding private

non-bank firms. A little more than half of the firms belong to a business group (165/296 = 55%); the mean inside ownership is 49%; while the mean foreign ownership is 8%. The age of the responding firms, measured by years listed, varies greatly – from 2 years to 105 years. The mean and median Tobin's q's are over 2 -- values which suggest a combination of strong growth prospects for most firms and investors not expecting a high level of tunneling.

Table 5. Descriptive Statistics for Nongovernance Variables

Monetary amounts are in Rs. crores (10M rupees ~ $220k). Sample is 296 private non-bank Indian firms which responded to the India CG Survey 2006. Balance sheet amounts are measured at year-end 2005; income statement amounts are for 2005 unless otherwise specified.

	No. of Observ.	No. of "1" values (for dummy variables)	Mean	Median	Standard Deviation	Minimum	Maximum
Tobin's *q*	276	--	2.26	1.54	1.73	0.32	13.88
Ln(Tobin's *q*)	276	--	0.49	0.43	0.74	-1.25	2.89
Market/Book Ratio	283	--	3.21	2.20	9.32	-17.24	149.53
Market Value of Common Stock	286	--	1949	260	7961	3.49	81737
Book Value of Common Stock	279	--	394	94.2	1122	1.0	10582
Book Value of Debt	286	--	1942	139.06	17315	0	283402
Book Value of Assets	290	--	904.86	199.16	3134	9.01	42545
Sales	289	--	693.87	169.57	1760	0	15871
Debt/Market Value of Equity	281	--	1.18	0.72	1.97	0	19.46
Debt/Assets	283	--	1.34	0.66	2.67	0	36.21
Years Listed	295	--	29.72	21	22.34	3	126
Sales Growth (2003-2005)	288	--	0.35	0.17	1.46	-0.39	21.32
EBDIT/Sales	280	--	0.18	0.15	0.82	-11.71	5.99
R&D/Sales	287	--	0.002	0	0.013	0	0.17
Advertising/Sales	287	--	0.009	0	0.022	0	0.18
Exports/Sales	287	--	0.232	0.07	0.31	0	1.02
PPE/Sales	287	--	0.65	0.40	0.95	0.004	9.89
Capex/Sales	281	--	1.19	0.62	2.58	0.044	36.59
Market Share	290	--	0.02	0.005	0.056	0	0.44
Share Turnover	284	--	0.01	0.002	0.017	0	0.15
Foreign Ownership (%)	288	--	8.38	2.92	12.29	0	66.02
Promoter Ownership (%)	289	--	49.11	49.78	18.47	0	98.19
Cross Listing Dummy	295	23	0.08	0	0.27	0	1
US Regulation Dummy	295	3	0.01	0	0.10	0	1
Business Group Dummy	295	157	0.53	1	0.50	0	1
MSCI Dummy	296	9	0.03	0	0.17	0	1

Table 6 provides industry breakdowns, again excluding 5 banks. Following Black and Khanna (2007), we divide Indian public firms into 15 broad industry groups, of which 11 are represented in our sample. Almost half of the firms are in a broad agriculture and manufacturing industry; but there were not easy ways to further subdivide this group.

Table 6. Industry Groupings

Sample is 296 private non-bank Indian firms which responded to the India CG Survey 2006.

Industry Groupings	Number of Firms
Agriculture & Manufacturing	151
Chemicals	42
Trade	9
Metal	8

Construction	10
Energy	2
Services	25
Computer	20
Finance	15
Transport	7
Other	7
Total	**296**

IV. Survey Results

This Part provides a detailed overview of the corporate governance of responding Indian private firms. Part V provides regression analysis of the association among governance, firm value, and other firm characteristics.

A. Board Composition and Independence

Clause 49 contains minimum board independence requirements. It requires listed firms with net worth greater than Rs. 25 crores or paid up share capital greater than Rs. 3 crores at any time in their history to have either a majority of independent directors, or at least 1/3 independent directors plus a board chairman who is not the CEO (but need not be independent).[8] Table 7 provides information on the board composition of the responding Indian private firms. Data on board composition is taken from annual reports where available, and from the survey otherwise (7 firms). We rely on the Clause 49 separation of directors into:

- executive directors;
- nonexecutive but not independent directors; and
- independent directors.

Some Indian firms have complained that it can be hard for them to find qualified independent directors. Table 7 suggests that most surveyed firms are managing to find independent directors, or at least directors that they are willing to call "independent." This might not be true for all firms that are subject to Clause 49, some of which are quite small and trade only occasionally. There is a strong correlation between firm size, measured by ln(market capitalization), and board size (Pearson correlation coefficient = 0.20, $p < .01$).

Table 8 provides information on the number of boards with different percentages of inside, nonexecutive (non-independent) and independent directors. The final column of Table 8 shows the number of firms, within a particular range for percentage of independent directors, who have separate CEO and chairman. This practice is reasonably common; it is present in 175 (59%) of responding firms. Subject to the vagaries of inaccurate reporting, 20 firms (7%) do not comply with the requirement of at least 33% independent directors. In addition, of the 68 firms with 33-49% independent directors, 18 do not have a separate CEO and chairman; and thus also do not comply with Clause 49. In all, 257 firms (87%) comply with the board independence rules.

[8] Clause 49 I(A)(i)-(iii).

Table 7. Board Composition for Indian Private Firms

Table shows number of inside, nonexecutive (non-independent), independent, and total directors, for Indian private firms. Sample is 295 Indian private firms with data on board composition available, out of 301 private Indian firms which responded to the India CG Survey 2006.

No of directors	Inside	Nonexec (not indep)	Independent	Total
0	7	152	7	
1	49	58	5	
2	83	37	18	
3	70	26	69	3
4	46	11	81	10
5	28	6	50	21
6	5	1	30	37
7	3	2	13	43
8	3	1	11	57
9	1	0	8	48
10		1	2	30
11			0	17
12			1	12
over 12				17
Total	295	295	295	295
Mean	2.82	1.09	4.35	8.27
Median	3	0	4	8
mean %	34.7%	12.7%	53.0%	100%
Median %	33.3%	0.0%	50.0%	100%

If the independence rules are appropriate (a topic we do not explore here), noncompliance of around 10% of the sample could be worrisome. Yet, in assessing the reliability of survey responses, reports of non-compliance may be good news. That some firms provided information indicating that they were not complying with Clause 49 gives us more confidence that the firms who report complying are in fact doing so.

Table 8. Percentages of Different Types of Directors

Table shows number of Indian private firms with inside, nonexecutive (non-independent) and independent directors in each percentage range. Sample is 295 firms with board composition data available, out of 301 private Indian firms which responded to the India CG Survey 2006.

Percentage range	Inside	Nonexecutive (not indep.)	Independent	Separate CEO and chairman (for firms in range for independent directors)
0%	7	152	7	2
1-32%	121	97	13	9
33-49%	98	31	68	50
50%	35	4	70	34
51-74%	31	9	108	67
75-100%	3	2	29	13
Total	**295**	**295**	**295**	**175 (59%)**

We next explore the backgrounds of the directors. Table 9 shows the percentage of responding firms with one or more directors in the indicated categories. We see some interesting patterns. On the plus side, almost all firms have one board member with financial or accounting expertise. Clause 49 requires firms to have an audit committee, and requires the audit committee to have at least one such person.[9] Over 20% of firms have a director who explicitly represents minority shareholders or institutional investors. There is also a fair bit of gender diversity, with 30% of firms having a female director (but typically only one).

Some aspects of firms' choices for directors provide some basis for concern. One may doubt the degree of business expertise that a typical scholar has. Yet 40% of firms turn to scholars to fill the ranks of independent directors, and often add several such persons to their boards. Scholars may be popular choices because they who are formally independent. A similar percentage of firms have a lawyer on the board, but typically only one. Perhaps reflecting the continued importance of government regulation and government connections, 30% of firms have a former government official or former politician on their board, and some have more than one such person.[10]

Table 9. Director Background

Table shows number of Indian private firms (% of responding firms) with one or more directors having the indicated characteristic. Sample is 301 Indian private firms which responded to the India CG Survey 2006. Number of missing responses ranges from 1 to 7. Percentages are of firms with non-missing responses.

Director Characteristic	Firm with one or more such directors (%)	Mean (median) if yes
Expertise in accounting or finance	290 (96%)	2.7 (2)
Scholar	116 (39%)	2.6 (2)
Lawyer	115 (38%)	1.1 (1)
Former government official, politician	90 (30%)	1.5 (1)
Female	90 (30%)	1.3 (1)
Represents institutional investor or minority shareholder	68 (23%)	1.7 (1)
Elected under shareholder agreement	58 (20%)	3.4 (3)
Represents employees	5 (2%)	1.0 (1)

B. Board Practices and Processes

We turn next to a series of questions that assess board practices and processes. These are summarized in Table 10. Table 10 and some later tables indicate, for legally required practices, when the requirement was adopted. For Clause 49, implementation was staggered; we report the year when compliance was required for large firms.

Indian law requires either (i) annual terms or, (ii) if the company uses longer terms, at least two-thirds of the directors should serve staggered terms, with a 3-year maximum term.

[9] Clause 49 II(A)(i)-(ii).

[10] By way of comparison, Choi, Park and Yoo (2007) report, for Korean directors over 1999-2002 (period of rapid change in Korean boards, partly due to legal mandates), the average firm had 32% outside directors; and 25% of firms had one or more academics as outside directors; 16% had one or more lawyers, and 13% had one or more former politicians or government officials.

The maximum term for any director is five years.[11] Most Indian firms have multiyear terms for both executive and nonexecutive directors. For executive directors, the most common term is 3 years or 5 years. For directors who serve staggered terms (typically nonexecutives, sometimes some executives as well), the term is almost always 3 years.

For board meetings, Indian law requires a minimum of 4 meetings in the year, Clause 49 also requires no more than 3 months between meetings.[12] All but eight firms met the 4-meeting rule; the median number of physical meetings per year is 6.[13] However, three outlier firms reported that their board never met during the year!

Indian law requires firms to prepare minutes for board meetings and board committee meetings.[14] Almost all firms prepare minutes for meetings of board committees. We did not ask about minutes for board meetings, but presumably the responses would be similar. Only 75% said that dissents would be recorded in the minutes. However, some "no" answers could reflect lack of dissents, rather than a practice of not recording them.

Table 10. Board Practices and Processes

Table shows number of Indian private firms (% of responding firms) with the indicated characteristic. Sample is 301 Indian private firms which responded to the India CG Survey 2006. Number of missing or ambiguous responses ranges from 0 to 18. Percentages are of firms with usable responses.

Characteristic	Required (year)	Firms with characteristic (%)	mean (median)
Director terms	(1956)		
nonexecutive directors have staggered terms		275 (91%)	
executive directors have multiyear terms		261 (92%)	
Board meetings			
Minimum of 4 physical meetings	(2001)	293 (98%)	
No. of physical meetings			6.9 (6)
phone or other electronic means used in some meetings		32 (11%)	
Committee minutes			
committee minutes prepared	(1956)	297 (99%)	
dissents recorded in minutes	(1956)	211 (75%)	
Evaluation of CEO and other executives			
regular system for evaluating CEO		151 (51%)	
regular system for evaluating other executives		248 (83%)	
succession plan for CEO		86 (29%)	
annual separate meeting for nonexecutive directors		46 (15%)	
board replaced CEO in last 5 years		0	
board replaced other officers in last 5 years		3	
Evaluation of nonexecutive directors			

[11] Companies Act §§ 255(1), 256(1), 317(1).

[12] Companies Act § 285; Clause 49 (I)(C)(i).

[13] We have data on number of physical meetings and number in which "some" directors participated electronically. Thus, we lack reliable data on the total number of meetings. However, electronic meetings were uncommon, so the number of physical meetings is a good proxy for the total number of meetings.

[14] Companies Act § 193.

Characteristic	Required (year)	Firms with characteristic (%)	mean (median)
regular system for evaluating nonexecutive directors	(2001) (recommended)	76 (25%)	
retirement age for nonexecutive directors		44 (15%)	
Nonexecutive directors receive retirement pay		4	
Did not renominate director due to performance during last 5 years		4	
Did not renominate director due to policy disagreement during last five years		1	
director resigned due to policy disagreement		2	
Other			
code of conduct	(2004)	275 (91%)	
policy restricting insider trading		278 (92%)	
board members typically receive materials at least one day in advance of meeting[15]		291 (96%)	
regular director training	(2001) (recommended)	30 (13%)	

About half of Indian private firms report that they regularly evaluate the CEO; a larger number (83%) evaluate other executives. One wonders, however, how rigorous these evaluations are, given that zero firms reported that the board had replaced the CEO in the last 5 years! Perhaps we framed the question too directly, and some CEOs were quietly encouraged to pursue other opportunities. In some cases, the respondent may not have known the circumstances under which a CEO left. Still, Indian CEOs do not appear to be at grave risk of losing their jobs for poor performance. We also asked about the existence of a CEO succession plan; only about 30% of respondents had one. Only 15% held an annual board meeting solely for nonexecutive directors.

Clause 49 includes both required and recommended items (under the odd name of "non-mandatory requirements"). Among the recommendations is that firms have a system to evaluate the performance of nonexecutive directors. [16] About one-quarter of responding firms have such a system. In addition, about 15% of respondents had a retirement age for directors. There was occasional willingness to not re-nominate a fellow director due to performance (four firms reported doing so in the last five years) or policy disagreement (one firm in the last five years). At two firms, a director had resigned due to a policy disagreement within the last five years. Here too, one may doubt whether reporting was complete, or whether the respondent knew the reasons for board turnover.

Since 2004, Clause 49 has required firms to adopt a code of conduct. [17] About 90% of respondents reported having such a code; a similar number had a policy restricting insider trading. A full 96% normally provide materials to directors at least one day before board

[15] See Clause 49 I.C(i) stating the information to be placed in front of the board is contained in Annex. I A., but it does not specify that the information be provided before the meeting.

[16] See Clause 49 I.D(6).

[17] See Clause 49 Annex I D(i).

meetings. However, only 13% comply with the Clause 49 recommendation to provide regular director training. [18]

C. Audit Committee

Clause 49 contains extensive requirements for audit committees. The committee must exist, have at least three members, all members must be nonexecutives, the chairman must be independent, and at least one member must have expertise in finance or accounting. The committee must meet at least four times per year and has prescribed minimum powers.[19] All but three responding firms report have an audit committee. Of the firms with a committee, all but three have the required number of members and only one lacks a member with accounting or finance expertise.

Practice is less uniform once one digs further into the details of how audit committees operate. Only 65% of respondents reported that the audit committee recommends reappointing or dismissing the external auditor, even though Clause 49 requires that the audit committee have this power. Only 68% of respondents have a bylaw to govern the audit committee, and only 72% report that the independent members of the committee meet separately at least once per year. Seventy-nine percent have the required 4 meetings per year, but another 18% report having three meetings; only 11 firms report 0-2 meetings.[20] One lone firm gives minority shareholders the power to appoint an audit committee member.

Table 11. Audit Committee Practices and Processes

Table shows number of Indian private firms (% of responding firms) with the indicated characteristic. Sample is 301 private Indian firms which responded to the India CG Survey 2006. Number of missing or ambiguous responses ranges from 0 to 3. Percentages are of firms with usable responses.

Characteristic	Required (year)	Firms *without* characteristic	mean (median)
Existence and membership			
audit committee exists	(2001)	3	
Remaining rows limited to firms with audit committee			
committee has at least 3 members	(2001)	3	
number of members			3.6 (3)
committee includes at least one member with expertise in finance or accounting	(2004)	1	
Powers and processes		**Firms *with* characteristic (%)**	
recommends external auditor to full board	(2001)	196 (65%)	
independent members meet separately at least once/year		215 (72%)	
bylaw to govern committee exists		204 (68%)	
audit committee meets at least 4 times per year		227 (79%)	
minority shareholders can elect an audit comm. member		1	

[18] See Clause 49 I.D(5).

[19] See Clause 49 II A-E.

[20] We did not ask when the audit committee was created. Recent creation is one possible explanation for a low number of meetings.

D. Compensation of Executives and Nonexecutives

Table 12 provides information on executive compensation, and on disclosure and approval procedures for compensation of both executives and nonexecutive directors. For most questions, complete responses were the norm, but not so for compensation, either because respondents did not have the information or chose not to provide it. Table 12 reports the number of responses for each question.

Executive compensation is modest by U.S. standards. Only 16% of Indian private firms compensate executives using stock options, which are the usual road to riches for U.S. executives. When options are granted, the numbers are modest, given that a typical Indian share price is around 100 Rupees (about $2). The median grant to a CEO of 100,000 options might have an implied value at date of grant of 100,000 x $2/share x 0.40 = $80,000. Here 0.40 is a rough estimate of option value as a fraction of share price. The mean (median) CEO receives annual cash compensation of 64 (30) lakhs, or around $141,000 ($66,000).

Under Indian company law, public companies need government approval to pay compensation above levels set forth on Schedule 13 of the Companies Act. To oversimplify a complex system, Schedule 13 permits companies to pay the greater of (i) 5% of net profits for one manager, and 10% for all managers; or (ii) if the firm doesn't meet the percentage of profits test, between Rs. 9 lakhs for small firms (< 1 crore in book value of equity) and 24 lakhs for large firms (> 100 crores in book value of equity). Executive compensation under clause (ii) must also be approved at a shareholder meeting.[21] In practice, it is usually possible to obtain government approval to exceed the Schedule 13 levels, but the combination of these levels, company desire to avoid seeking government approval, and the need of some firms to obtain approval could all constrain executive pay. Seventeen percent of the responding firms (52/301) obtained government approval.

[21] Companies Act § 310, *id.* Schedule 13.

Table 12. Executive and Director Compensation

Table shows number of Indian private firms with the indicated characteristic. Sample is 301 Indian private firms which responded to the India CG Survey 2006. Cash compensation is in Rupees lakhs (1 lakh = 100,000 Rupees, ~$2,200), option amounts are in thousands of shares. For compensation questions, number of usable responses is shown in the table.

Characteristic	Required	Responses	mean (median)
Overall Executive Compensation			
CEO cash compensation		251	64 (30)
Compensation of all other executives		184	2273 (154)
Stock Options			
Executives receive stock options			49/299 (16%)
If options granted, how many (thousands)			
to CEO		11	182 (100)
to all other executives		25	326 (150)
to all other persons		29	112 (74)
Disclosure and Shareholder Approval		**Disclosed**	**Approved**
CEO total pay	(1956)	286	267
total pay of nonexecutive directors	(1956) & (2004)	231	183
total pay of all directors	(1956) & (2001)	267	211

Indian company law and Clause 49 require companies to disclose the total pay of the CEO and each director.[22] We asked firms to indicate if pay was disclosed, approved, or both, for the CEO, for non-executive directors, and for all directors. Because of the question form, we cannot distinguish between "no" and missing responses. Most companies provide a fair bit of disclosure on executive compensation, but a few do not comply with the disclosure rules.

Indian company law requires shareholders to approve the pay of all directors as a group, but does not require separate approval of CEO pay.[23] Most firms report that shareholders approve the pay of the CEO, as well as the pay of all directors. Oddly, more firms (267) report that shareholders approve CEO pay than report approval of the pay of all directors (211), even though the latter is the legal requirement.

E. External Auditor

Table 13 summarizes the responses to questions about auditor independence. The external auditor provides non-audit services at about half of the firms. When the auditor provides non-audit services, the mean (median) fee for the non-audit services is 18% (10%) of the auditor's total fees for the most recent year.

There are no legal requirements for rotation of audit firms, or of the lead partner within the same audit firm. Nonetheless, almost half of firms report that their audit firm rotates the lead partner responsible for the client's account every 5 years. We did not ask about rotation of audit firm. We did ask whether the firm had dismissed its auditor.

[22] Companies Act § 309(1); Clause 49 I.B, IV.E(ii)(d).

[23] Companies Act § 309(1).

Dismissal is rare -- only 2 firms noted dismissals in the last 5 years. We asked why -- one firm reported that the reason was fees charged, the other did not respond.

We also asked a board process question. Auditors often recommend changes to auditing or accounting practices. We asked whether these recommendations are reviewed by the full board, or (implicitly) only the audit committee.[24] At 95% of responding firms, the full board reviews the auditor's recommendations.

Table 13: External Auditor

Table shows number of Indian private firms (% of responding firms) with the indicated characteristic. Sample is 301 Indian private firms which responded to the India CG Survey 2006. Number of missing or ambiguous responses ranges from 0 to 14. Percentages are of firms with usable responses.

Characteristic	Firms with characteristic (%)	Mean (median)
Independence		
auditor also provides non-audit services	148 (49%)	
mean (median)non-audit fees as % of total fees		18% (10%)
audit partner rotates every 5 years	123 (43%)	
company dismissed auditor within last 5 years	2	
Processes		
full board reviews auditor recommendations	280 (95%)	

F. Shareholder Rights

Table 14 summarizes the responses to a number of questions related to shareholder rights. Indian law has required companies to allow for postal ballots since 1956.[25] Yet only 73% do so. Given that most firms have a controlling shareholder, the fraction of shares voted at the most recent annual shareholder is surprisingly small, at a mean of only 58%. This suggests that -- postal ballots or no -- minority shareholders often do not vote. At the same time, shareholder resolutions are moderately common. About one-sixth of firms have had one or more resolutions proposed in the last 5 years.

India is among the many countries which provide takeout rights on a sale of control. These rights require the new controller to offer to buy all shares, typically at the price paid for controlling shares.[26] We asked whether minority shareholders receive takeout rights on a sale of control. Only 21 firms (8%) reported doing so. Possible explanations include poor question phrasing (we asked whether the *firm*, rather than the new controller, provides takeout rights), or ignorance of this legal requirement.

The famously slow Indian judicial system limits the effectiveness of shareholder remedies. A modest number of firms (20 firms, 7%) reported that disputes with shareholders are resolved by arbitration, rather than by recourse to the courts.

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[24] Companies Act §§ 292(A)(8), (10) requires that audit committee review the recommendations of the external auditor.

[25] Companies Act § 192(A)(1).

[26] Securities & Exchange Board of India (Substantial Acquisition of Shares and Takeovers) Regulations, 1997 (as amended in 2006) §§ 10 – 12, 15, 16.

Under Indian law, shareholders holding 10% of a company's shares can demand that the company hold a special shareholder meeting.[27] This had happened at 14 firms (5%) during the last five years. Only one firm reported that shareholders had asked SEBI or a special appellate court, the Companies Appellate Tribunal, to investigate oppression by the controlling shareholder during the last five years. Finally, only one firm has issued preferred shares. Thus, Indian firms are not using these shares to avoid the general one common share, one vote regime.

Table 14: Shareholder Rights

Table shows number of Indian private firms (% of responding firms) with the indicated characteristic. Sample is 301 Indian firms which responded to the India CG Survey 2006. Number of missing or ambiguous responses ranges from 1 to 31. Percentages are of firms with usable responses.

Characteristic	Required	Firms with characteristic	mean (median)
shareholders can vote by postal ballot	(1956)	218 (73%)	
percentage of shares voted at most recent AGM			58% (60%)
company had shareholder resolution in last 5 years		52 (17%)	
disputes w. shareholders resolved by arbitration		20 (7%)	
shareholders requested extraordinary meeting in last 5 years		14 (5%)	
shareholders asked SEBI or Tribunal to investigate oppression within last 5 years		1	
company has preferred shares		1	

G. Related Party Transactions

Table 15 provides information on related party transactions (RPTs). The good news is that 78% of the responding firms have policies requiring RPTs to be on arms-length terms. The less good news is that there are lots of RPTs. Clause 49 requires the audit committee to approve all RPTs and requires the firm to disclose "materially significant" RPTs to shareholders.[28] Ninety-four percent of firms reported that they reported RPTs to shareholders, but this includes some firms which reported having no or negligible RPTs, and thus nothing to disclose. When asked to quantify RPTs as a percentage of sales, 142 firms (67%) reported that RPTs were 1% of revenue or greater, and 42 firms (20%) reported that RPTs were 5% of revenues or greater. For these 42 firms, the mean (median) level of RPTs was 16% (10%) of sales; 33 of these firms require RPTs to be on arms-length firms.

Another measure of the significance of RPTs is how many firms reported board review of RPTs. Sixty percent of respondents reported that their board reviewed at least one RPT in the last year; 36% reported board review of five or more transactions.

[27] Companies Act § 169.

[28] See Clause 49 II (D((4)(f) and Annexure I C 7 (i).

Table 15: Related Party Transactions

Table shows number of Indian private firms (% of responding firms) with the indicated characteristic for related party transactions (RPTs). Sample is 301 Indian private firms which responded to the India CG Survey 2006. Number of missing or ambiguous responses ranges from 5 to 67. Percentages are of firms with usable responses.

Characteristic	Required	Firms with characteristic	Mean (median)
RPTs disclosed to shareholders	(2004)	275 (94%)	
firm requires RPTs to be on arms-length terms		230 (78%)	
company has outstanding loan(s) to insider(s)[29]	(1956)	20 (7%)	
company rents real property to or from insider(s)		50 (20%)	
RPTs are ≥1% of revenues		142 (67%)	
RPTs are ≥5% of revenues		42 (20%)	16% (10%)
board reviewed at least one RPT in last year		107 (60%)	14 (6)
board reviewed at least 5 RPTs in last year		63 (36%)	

It is one thing to ostensibly require RPTs to be on arms-length terms, but potentially another to put procedures in place to make it more likely that the policy is adhered to. Table 16 provides information on RPT approval requirements, separately for transactions with an inside director and transactions with a controlling shareholder. For transactions with an inside director, approval by non-conflicted directors is uncommon (26 firms require this) and approval by non-conflicted shareholders is rare (two firms). Approval requirements are similar for transactions with a controlling shareholder.

Table 16: Approval Requirements for Related Party Transactions

Table shows number of Indian private firms with the indicated approval requirement for related party transactions (RPTs) with specified counterparties. Sample is 301 Indian private firms which responded to the India CG Survey 2006.

Nature of RPT approval	with inside director	with controlling shareholder
no specific requirement	81	102
approval by audit committee	96	82
approval by board of directors	212	182
approval by shareholders	37	44
approval by non-conflicted directors	26	20
approval by non-conflicted shareholders	2	3

H. Disclosure

We asked a number of questions related to disclosure, and also reviewed firms' annual reports and websites to determine their disclosure practices. Some responses are tabulated above -- see Table 12 (executive compensation) and Table 16 (related party transactions). We do not discuss those responses here.

[29] See § 295 of the Companies Act.

Table 17 summarizes information on cross-listing and financial disclosure. We evaluated which firms are cross-listed on foreign exchanges; this cross-listing may, depending on the destination exchange, require the firm to provide additional disclosures. Twenty-two firms (7%) are cross-listed. Table 16 indicates where firms are cross-listed -- the totals for country listings sum to more than 22 because some firms are listed on more than one non-Indian exchange. Only four firms are cross-listed in the US on levels 2 or 3 -- four firms on the New York Stock Exchange and none on NASDAQ -- and hence are subject to U.S. reporting requirements and the U.S. Sarbanes-Oxley Act.. The rest are cross-listed on European markets, which impose more limited disclosure requirements (Doidge, Karolyi and Stulz, 2007b).

We also evaluated which provide financial statements which comply with U.S. GAAP or International Financial Reporting Standards (IFRS). We also asked whether the firm's officers meet regularly with analysts.

Table 17. Financial Disclosure

Table shows number of Indian private firms (% of responding firms) with a positive response to the indicated ith items. Sample is 301 Indian private firms which responded to the India CG Survey 2006.

Question	Yes	% Yes
Company has shares cross-listed in another country	22	7%
If yes, which country:		
U.S. - New York Stock Exchange	4	
U.S. - OTC (non-NASDAQ)	6	
London	12	
Frankfurt	5	
Berlin	5	
Luxembourg	11	
Company provides IFRS or U.S. GAAP financial statements	20	6.8%
Company officers hold regular meetings with analysts	188	62%

A majority of firms (188 firms, 62%) report that company officers meet regularly with analysts. Of the firms which do not meet regularly with analysts, some may be small enough so that they have little no analyst coverage.

B. Website Disclosure

One important means of disclosure is through company websites. We asked whether companies provide different types of information on their websites. Table 18 summarizes the responses. Consider financial disclosure first. About two-thirds of the firms (182 firms) provide annual financial statements on their website. Surprisingly, a somewhat larger number (198 firms; 73%) also provide quarterly financial statements. This information is also available, in theory, from a website maintained by SEBI, but in practice this website has quite incomplete information. About half of the firms also post the annual report to shareholders and the directors' report (which provides textual discussion of the firm's results, similar to management's discussion and analysis for U.S. firms). About 54% provide press releases.

Turning to governance related items, 148 firms (54%) post their annual legally required corporate governance report and 73 firms (27%) provide information about members. This information is also available from the annual report. No firms post their

bylaws. For shareholder meetings, 137 firms (46%) provide notice of the meeting on the company website; but no firms appear to provide the voting results of the meeting on the web. Finally, 18 firms have no website (or one that we could not find).

Table 18. Information on Company Website

Table shows number of Indian private firms (% of responding firms) with a positive response to the indicated ith items. Sample is 296 Indian private firms which responded to the India CG Survey 2006. Number of responses varies from 276 to 278.

Information Item	Yes	% Yes
Financial information		
annual financial statements	182	67%
quarterly financial statements	198	73%
annual report to shareholders	137	50%
directors' report	143	52%
share price information	145	54%
press releases	154	57%
Other information		
corporate governance report	148	54%
information about board members	73	27%
Bylaws	0	0%
notice of upcoming shareholder meetings	137	46%
results of shareholder meetings	0	0%
Website not located	18	6%

I. Since When?

For a number of governance practices, we asked firms how long these practices had been in place. Table 19 provides selected responses. Many governance practices are of fairly recent vintage, especially practices which were adopted after becoming legally required -- such as having a written code of conduct for directors and executives. Most firms now have such a code; almost all adopted such a code since 2000. Similarly, policies on insider trading, on recommendation of the external auditor by the audit committee, and on disclosure of RPTs are mostly of recent vintage. Stock options are usually of recent vintage as well; only 9 firms used them prior to 2000.

In contrast, the practice of separating the positions of CEO and chairman has a long vintage. Its greater popularity since 2000 may partly reflect the Clause 49 rules, under which a firm is permitted to have at least 33% independent directors if these positions are separated, versus 50% otherwise. But many firms have voluntarily separated the two posts, including firms that had this separation before Clause 49 was adopted, and the 114 firms that have both this separation and 50% independent directors (see Table 7).

The practice of having a retirement age for non-executive directors was apparently once in favor, but no longer. Of the 44 firms which have a retirement age for non-executive directors, all adopted this practice before 1990.

Table 19: Since When Has a Practice Existed

Table shows number of Indian private firms which have the indicated characteristic and answered the related "since when question. Sample is 301 Indian private firms which responded to the India CG Survey 2006. For some questions, number of usable responses may not sum to total firms with practice because some firms did not respond to the "since when" question or gave an imprecise answer.

		Since When		
Practice	**Usable responses**	**2000s**	**1990s**	**Earlier**
When was company incorporated	298	6	83	209
Firm has separate CEO and chairman	163	46	57	60
Firm has system for evaluating CEO	137	71	43	23
Firm has system for evaluating other execs	205	92	70	43
retirement age for non-executive directors	44	0	0	44
code of conduct	266	246	13	7
policy restricting insider trading	251	218	37	6
audit committee recommends external auditor	180	149	24	7
auditor provides non-audit services	111	52	45	14
executives receive stock options	48	39	7	2
RPTs must be on arms-length terms	185	111	31	43
RPTs are disclosed to shareholders	224	170	31	23

J. Government Enforcement

In some countries, company law is enforced privately or not at all. In the U.S., for example, the Securities and Exchange Commission enforces securities law; including the portions of the securities laws that are company law in effect though not in name. But Delaware corporate law is enforced only privately. Enforcement comes from suits by shareholders, creditors, or less often, the company itself. The Indian government, in contrast has a variety of powers to sanction directors and companies. These include the power to provide relief in cases of oppression and mismanagement, remove management, demand a special audit, inspect the company's accounts, and impose fines for certain Companies Act violations.[30]

These powers, however, are rarely exercised. Table 20 provides information about how often the relevant government agency, the National Company Law Tribunal, or its predecessor, the Company Law Board, has exercised its powers against responding firms over the last five years. The government has removed a director or blocked a director from serving at one Indian private firm and one foreign-controlled firm, dismissed an executive at one government firm, and ordered a special audit at three Indian private firms.[31]

To be sure, powers that are infrequently exercised can still be important deterrents. Or, as in the U.K., enforcement might be mostly against private firms.[32] Our survey cannot address whether the government's powers are exercised in appropriate cases, whether the

[30] Companies Act §§ 397-409 (oppression remedy); § 388B (remove management); § 233A (special audit); § 209A (inspect books); § 168 (fines).

[31] Due to the small number of positive responses, we include all three types of firms in Table 16, not only Indian private firms.

[32] See Cheffins and Black (2006).

risk of enforcement deters misbehavior, or whether the potential for government enforcement leads boards to be either more lax or more vigilant in policing companies themselves.

Table 20: Government Enforcement

Table shows number of responding firms with positive responses to the indicated questions about government enforcement. Sample is 301 Indian private firms and 69 government- or foreign-controlled firms which responded to the India CG Survey 2006. Number of missing responses ranges from 1 to 2.

Enforcement action by Tribunal (last 5 years)	Type of firm		
	Indian private	Government control	Foreign-control
removed director or blocked director from serving	1	0	1
dismissed CEO	0	0	0
dismissed another executive	0	1	0
ordered special audit	3	0	0

V. Does Corporate Governance Predict Firm Value?

We turn next to the association between the corporate governance practices of Indian firms and measures of firm market value. We use *ln*(Tobin's *q*) as our principal measure, and market/book and market/sales in robustness checks.

Some limitations: We have only cross-sectional data, and no good instrument for governance, so we can assess only association, not causation. We cannot assess the extent to which our results generalize to other emerging markets. In addition, our measure of market value depends on trading prices, which are the prices of noncontrolling shares. Governance changes could produce market value gains for outside investors by increasing overall firm value, reducing the private benefits of control enjoyed by insiders, or both.

A. Index Construction

We rely on a combination of data from the survey and information from annual reports to construct an overall India Corporate Governance Index (*ICGI*) that provides a corporate governance "score" for each private Indian firm, as well as scores for the component parts of the index. We exclude five banks from the analysis, which reduces our sample to 296 firms.

ICGI is constructed as follows. We identify a total of 49 firm attributes that are often believed to correspond to "good" governance, on which we have reasonably complete data, reasonable variation across firms, and sufficient difference from another element included in *ICGI*. Manifestly, there is some judgment involved on which elements to include. Each is coded as "1" if a firm has this attribute; "0" otherwise.

We group these elements into indices as follows:

- Board Structure (with subindices for board independence and board committees)
- Disclosure (with subindices for disclosure substance and for auditor independence)
- Related Party Transactions (with subindices for the volume of related party transactions a firm engages in and for approval procedures for these transactions)

- Shareholder Rights
- Board Procedure (with subindices for overall procedure and for audit committee procedure)

Table 21 describes the components of each index and the number of "1" values for each element.

Table 21. Corporate Governance Index: Elements and Summary Statistics

Description and summary statistics for the 49 elements included in India Corporate Governance Index (*ICGI*), for 296 private, non-bank Indian firms which responded to the India CG Survey 2006. All variables are coded as yes=1, no=0. In the "responses" column the first number indicates the number of "1" responses, the second number indicates the total number of responses.

Label	Variable	Responses	Mean	% Responding
Board Structure Index				
Board independence subindex				
BdIn.1	Board contains of *at least* 50% independent directors	205/290	0.71	98%
BdIn.2	Board contains *over* 50% independent directors	135/290	0.47	98%
BdIn.3	CEO is NOT chairman of the board	175/296	0.59	100%
BdIn.4	Compliance with Clause 49: Either (i) board consists of at least 50% independent directors or (ii) board consists of at least 1/3 independent directors and CEO is not chairman	253/290	0.87	98%
Board committee subindex				
BdCm.1	Audit committee exists and has majority of independent directors.	268/284	0.94	96%
BdCm.2	Compensation committee exists.	213/296	0.72	100%
Disclosure Index				
Disclosure substance subindex				
Di.1	Related party transactions are disclosed to shareholders	270/287	0.94	97%
Di.2	Firm has regular meetings with analysts	185/296	0.63	100%
Di.3	Firm discloses direct and indirect 5% holders	216/294	0.73	99%
Di.4	No shareholder agreement among controlling shareholders, or agreement exists and is disclosed.	264/270	0.98	91%
Di.5	Firm puts annual financial statements on web	182/271	0.67	92%
Di.6	Firm puts quarterly financial statements on web	198/271	0.73	92%
Di.7	Firm puts annual report on web	137/273	0.50	92%
Di.8	Firms puts directors' report on web	143/273	0.52	92%
Di.9	Firm puts corporate governance report on web	148/273	0.54	92%
Auditor independence (disclosure reliability) subindex				
Dr.1	Auditor does not provide non-audit services	151/296	0.51	100%
Dr.2	Auditor does not provide non-audit services or non-audit fees are < 25% of total auditor fees	185/296	0.63	100%
Dr.3	Full board reviews auditor's recommendations	275/290	0.95	98%
Dr.4	Audit partner is rotated every 5 years	120/282	0.43	95%
Related Party Index				
RPT volume subindex				
Re.1	Firm does not have loans to insiders	273/291	0.94	98%
Re.2	Firm does not have significant sales to or purchases from insiders	270/291	0.93	98%
Re.3	Firm does not rent real property from or to an insider	233/291	0.80	98%
Re.4	Firm had negligible revenue from RPTs (0-1% of sales)	139/209	0.67	71%

Label	Variable	Responses	Mean	% Responding
Re.5	No RPTs brought to board or audit committee for approval in the last 3 years.[33]	69/175	0.39	59%
Re.6	Related party transactions are on arms-length terms	226/289	0.78	98%
RPT approval subindex				
Ra.1	Related-party transactions with *executives* approved by board or audit committee or shareholders	219/296	0.74	100%
Ra.2	Related party transactions with *executives* approved by audit committee or non-interested directors	97/296	0.33	100%
Ra.5	Shareholder approval of related party transactions with executives	37/296	0.13	100%
Ra.3	Related-party transactions with *controlling shareholder* approved by board or audit committee or shareholders	197/296	0.66	100%
Ra.4	Related party transactions with *controlling shareholder* approved by audit committee or non-interested directors	84/296	0.28	100%
Shareholder Rights Index				
Sh.1	Directors serve one year terms	26/296	0.09	100%
Sh.2	Firm allows voting by postal ballot	213/292	0.73	99%
Sh.3	Disputes between company and shareholders are subject to arbitration	20/266	0.08	90%
Sh.4	Company has policy against insider trading	273/295	0.93	99%
Sh.5	Board has one or more minority shareholder representatives	3/294	0.01	99%
Board Procedure Index				
Overall procedure subindex				
Pr.1	Average board meeting attendance rate ≥ 80%	174/296	0.59	100%
Pr.2	Firm has system to evaluate CEO	146/293	0.50	99%
Pr.3	Firm has system to evaluate other executives	243/293	0.83	99%
Pr.4	Firm has system to evaluate nonexecutive directors	74/292	0.25	99%
Pr.5	Firm has succession plan for CEO	84/288	0.29	97%
Pr.6	Firm has retirement age for nonexecutive directors	41/294	0.14	99%
Pr.7	Directors receive regular board training	39/294	0.13	99%
Pr.8	Firm has annual board meeting only for nonexecutives	46/292	0.16	99%
Pr.9	Board receives materials in advance	285/296	0.96	100%
Pr.10	Nonexecutives can hire own counsel and advisors	172/292	0.59	99%
Pr.11	Firm has code of ethics	269/296	0.91	100%
Audit committee procedure subindex				
Pa.2	Firm has bylaws governing audit committee	199/293	0.68	99%
Pa.3	Audit committee recommends the external auditor at the annual shareholder meeting.	191/293	0.65	99%
Pa.1	Independent members of audit committee meet separately at least once per year	212/292	0.73	99%

Within each index, we give equal weight to each element. Thus, to compute Disclosure Index, we sum all 13 elements, weighted equally, whether they are part of the Disclosure Substance Subindex or the Disclosure Reliability Subindex. We then normalize each index to mean = 0 and standard deviation = 1, and sum the normalized index scores to obtain an overall *ICGI* score. If a firm has a missing value for a particular element, we use its average score for the nonmissing values to compute each index.[34]

[33] Clause 49(I)(E)(2) requires significant RPTs to be approved by the audit committee.

[34] More specifically, if a firm has a missing value for a particular index, we compute the index value as (Σ(values on nonmissing elements) * (total no. of elements)/(no. of nonmissing elements)). For Board Independence subindex, three of the four elements require data on number of independent directors. This

Figure 1 provides a histogram showing the overall variation in governance practices in India.

Figure 1. Distribution of *ICGI*

Histogram shows fraction of firms with Indian Corporate Governance Index (ICGI) scores in indicated ranges. Sample = 296 private, non-bank Indian firms. Mean = 0 (by construction), median = 0.211; σ=2.71.

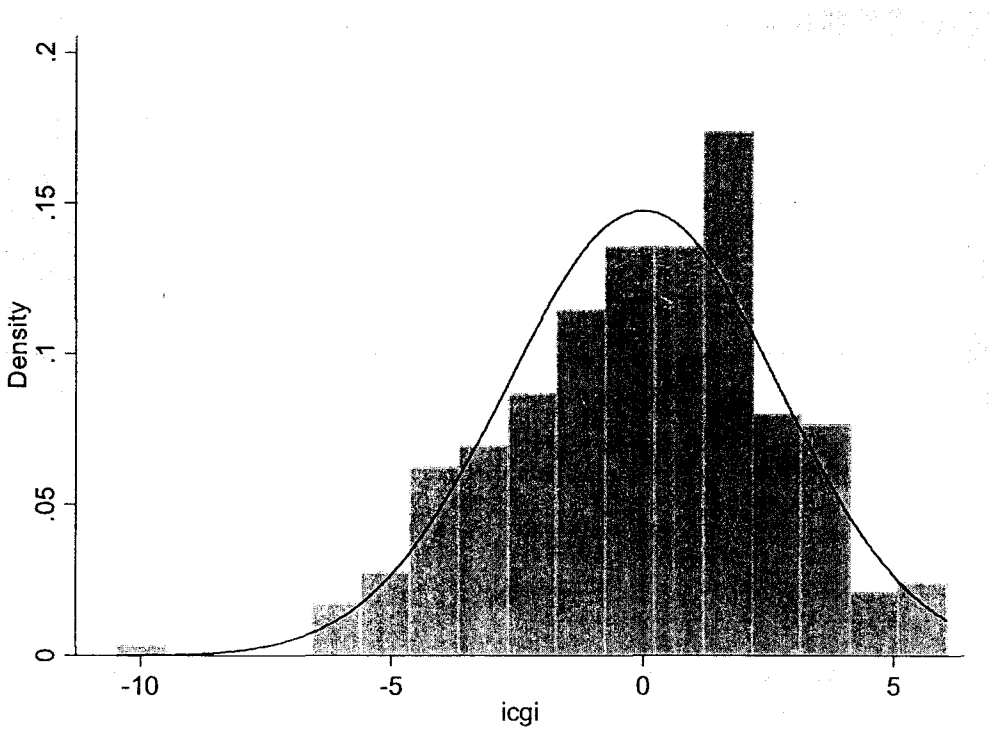


Table 22 provides further data on ICGI and its component indices and subindices. There is substantial spread on each index and subindex, and for ICGI as a whole. The mean (median) firm has "1" values for 27.47 (27.82) of the 49 elements. This firm aside, the distribution of ICGI scores is reasonably symmetric and close to normal. All other firms have nonnormalized (normalized) scores ranging from 9.2 (-10.46) to 38.4 (6.07) .

data is missing for 6 firms. We judged that multiplying these firms' scores on the remaining element (for CEO ≠ chairman) by 4 would over weight to this element, so multiplied by 2 instead. Five of these 6 firms had CEO ≠ chairman, so these firms received a 2 score for Board Independence, before normalizing.

Table 22. Descriptive Statistics for Governance Index Variables

Descriptive statistics for overall India Corporate Governance Index (*ICGI*), and components of *ICGI* (before normalizing), for 296 private, non-bank Indian firms which responded to the India CG Survey 2006.

	Mean	Stand. Dev.	Min.	Max.	Max possible
Board Structure Index	4.29	1.36	0	6	6
Board Independence	2.61	1.19	0	4	4
Board Committees	1.64	0.57	0	2	2
Disclosure Index	8.85	2.65	0	13	13
Disclosure Substance	6.20	2.41	0	9	9
Disclosure Reliability	2.65	0.89	0	4	4
Related Party Index	6.66	2.11	0	11	11
Level of Related Party Transactions	4.67	1.24	0	6	6
Transaction Approval	2.14	1.55	0	5	5
Shareholder Rights Index	2.23	0.81	0	4.8	5
Procedure Index	7.43	2.41	1	14	14
Board Procedure	5.37	1.95	0	11	11
Audit Committee Procedure	2.04	0.90	0	3	3
Non-normalized sum of ICGI components	27.47	4.83	9.0	38.4	49
ICGI (sum of normalized subindices)	0	2.71	-10.46	6.07	

Table 23 provides Pearson correlation coefficients between *ICGI* and its components. The inter-index correlations are generally positive but modest. This suggests that multi-collinearity amongst the subindices is probably minimal.

Table 23. Correlation Matrix for Corporate Governance Index and Subindices

Correlations among India Corporate Governance Index (*ICGI*) and its components, for 296 private, non-bank Indian firms which responded to the India CG Survey 2006. *, **, and *** indicate significance at 10%, 5%, and 1% levels. Statistically significant correlations (at 5% level or better) are shown in **boldface**.

	ICGI	*ICGI* - indicated index	Board Structure	Disclosure	Related Party	Shareholder Rights
ICGI	1					
Board Structure Index	**0.54*** **	**0.20*** **	1			
Disclosure Index	**0.56*** **	**0.22*** **	**0.21*** **	1		
Related Party Index	**0.53*** **	**0.19*** **	0.089	**0.15*** **	1	
Shareholder Rights Index	**0.46*** **	**0.10*** **	0.044	-0.043	0.060	1
Board Procedure Index	**0.61*** **	**0.29*** **	**0.12** **	**0.19*** **	**0.15** **	**0.18*** **

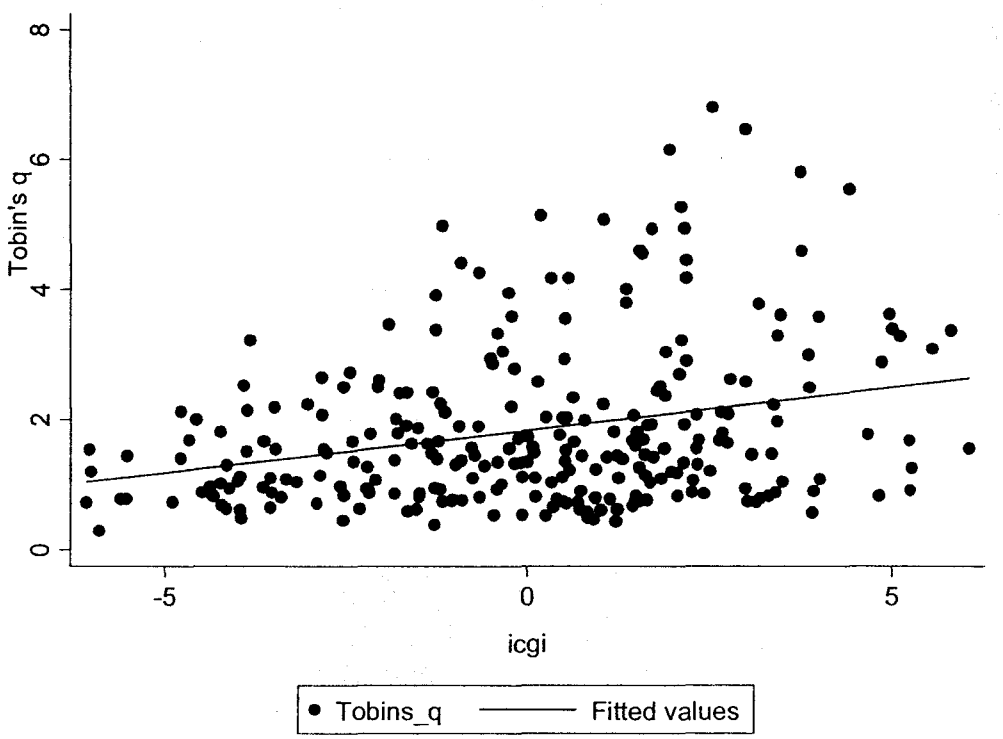
B. Simple Correlation Between Governance and Firm Value

We next assess the association between *ICGI* and its components, on one hand, and firms' market values, on the other. Figure 2 provides a scatter plot of *ICGI* values against Tobin's *q* values at year-end 2005 (shortly before we conducted the survey), plus a regression line from a simple regression of Tobin's *q* on *ICGI* plus a constant term. There is a visually apparent correlation between the two; the simple correlation is 0.26 ($t = 4.87$).

We have 277 firms with data on Tobin's *q*. In Figure 2 and throughout our regression analysis we identify observations as outliers and drop them, if a studentized residual from regressing Tobin's q on ICGI is greater than ±1.96. This procedure results in 10 outliers, and hence a sample of 267 firms.

Figure 2. ICGI (Indian Corporate Governance Index) and Tobin's *q*

Scatter plot of *ICGI* versus Tobin's *q* at year-end 2005. 31 observations are identified as outliers and dropped based on a studentized residual greater than ±1.96. Sample size = 265. Highest and lowest 5% of Tobin's *q* values are included in the regression but suppressed in the scatter plot for better visual presentation.



C. Association Between Governance and Market Value: Full Sample Results

In Table 24, we regress *ln*(Tobin's *q*) against *ICGI*. We limit the results to *ln*(Tobin's *q*) as a measure of performance, but obtain similar results with other measures of performance (e.g., Tobin's *q* (unreported), market-to-book; market-to-sales). We drop 11 firms with book value of common stock ≤ 0 from the regressions and drop outliers based on a studentized residual obtained by regressing the dependent variable on *ICGI*, greater than ±1.96. In unreported regressions we obtain similar results when we winsorize at 5% and 95%.[35]

[35] The number of firms with negative or zero book value of stock is 11 and the number of firms dropped due to the studentized residuals is between 17 and 20. There is overlap between these two groups of firms.

Many firm characteristics can potentially be associated with both Tobin's *q* and governance. We therefore include a broad array of control variables, to address the resulting potential for omitted variable bias. We use *ln*(assets) to control for the effect of firm size on Tobin's *q*. In unreported robustness checks, we obtain similar results if we instead use *ln*(sales). We include *ln*(years listed) as a proxy for firm age, because younger firms are likely to be faster-growing and perhaps more intangible asset-intensive, which can lead to higher Tobin's *q*. We include leverage (measured as debt/market value of common equity) because it can influence Tobin's *q* by providing tax benefits and reducing free cash flow problems.

We control for firms' growth prospects using geometric average sales growth over 2003-2005, for capital intensity using (PPE/sales, and for capital expenditures relative to the historical capital stock (capex/PPE). We control for intangible assets using (R&D expense)/sales and (advertising expense)/sales. Because export-oriented firms may be different than other firms in various, we control for exports/sales. We control for profitability measured by *EBDIT*/sales. Market share could affect both profitability and governance or product market constraints, we control for market share measures as fraction of sales of all BSE firms in the same 4-digit industry.

We include share turnover (traded shares as a percentage of public float) as a measure of liquidity, since share prices may be higher for firms with more easily traded shares. We include promoter ownership as a measure of insider ownership. We include fraction of foreign ownership because foreign investors are diversified and may be willing to pay higher prices than domestic investors, thus affecting Tobin's *q*, may pressure firms to improve their governance, or may invest in better governed firms (see, for example, Ferreira and Matos, 2007).

Since both board structure and Tobin's *q* may reflect industry factors, we include industry dummies (see Table 6). We include a business group dummy because firms that belong to a business group may have stronger political connections, access to financing, or be more diversified, which could affect Tobin's *q*. We include a cross-listing dummy, which can proxy for foreign investor interest, liquidity, and enhanced disclosure. We include a dummy variable for a firm's inclusion in the Morgan Stanley Capital International Index for East Asia (*MSCI* dummy) at year-end 2004, which may proxy for price pressure due to purchases by index funds, greater liquidity, and foreign investor interest.

In regression (1), the only independent variables are *ICGI* and industry dummy variables. We then steadily add additional control variables in regressions (2)-(4). The coefficient on *ICGI* declines somewhat as we add controls, but remains economically meaningful with full controls (coefficient = .0343; t = 2.70). This implies that a one standard deviation (2.71 point) increase in *ICGI* predicts an 0.093 increase in *ln*(Tobin's *q*), or about a 17% increase in share price for a firm with median Tobin's *q* (1.54)and median debt/total assets (0.66).[36]

Most of the control variables have signs consistent with theory or with other research, or are insignificant. Larger firms have lower Tobin's *q*. Firms which are intangible

[36] Tobin's *q* = (debt/assets) + (market value of equity/assets). A shock to share price affects only the second term: Let T be the fractional increase in Tobin's q and S be the fractional share price increase. S = {[New (market equity/assets)]/[Old (market equity/assets)] -1} = {[New q - (debt/assets)]/[Old q - (debt /assets)] - 1} = {[(Old q)*(1+T) - (debt/assets)]/[Old q - (debt /assets)] - 1}. This equation can be solved for S if we know debt/assets, old *q*, and the fractional change T.

asset intensive, proxied by advertising/sales and R&D/sales, have higher Tobin's *q*. More profitable firms have higher Tobin's *q*, as do firms with higher inside ownership, higher foreign ownership, and cross listed firms. In unreported regressions, we add interactions between ICGI and the significant control variables; none of the interaction terms are significant.

Table 24. *OLS* for Corporate Governance Index with Different Control Variables

Ordinary least squares regressions of ln(Tobin's *q*), ln(market/book), and ln(market/sales) on Corporate Governance Index (*ICGI*) and control variables. We drop 11 firms with book value of common stock ≤ 0 and also identify as outliers and drop 20 observations, based on a studentized residual obtained by regressing the dependent variable on *ICGI*, greater than ±1.96. *, **, and *** indicate significance levels at 10%, 5%, and 1% levels. *t*-values, based on White's heteroskedasticity-consistent standard errors, are reported in parentheses. Significant results (at 5% or better) are shown in **boldface**.

Dependent variable		***Ln*(Tobin's *q*)**		***Ln*(market/book)**	***Ln*(market/sales)**
	(1)	(2)	(3)	(4)	(5)
Overall Index (*ICGI*)	**0.0574*** (4.26)**	**0.0558*** (4.02)**	**0.0343*** (2.70)**	**0.0352** (2.11)**	0.0343* (1.80)
Ln(assets)		-0.00235 (-0.076)	**-0.0939*** (-2.72)**	**-0.0925** (-2.13)**	-0.0766 (-1.38)
Ln(years listed)		0.0518 (0.94)	0.0672 (1.23)	0.120* (1.78)	0.0898 (1.16)
Debt/Equity		-0.0387 (-1.34)	-0.00631 (-0.27)	**0.0935*** (3.15)**	-0.0395 (-0.69)
Sales Growth		**0.0502** (2.29)**	0.0348* (1.69)	0.0351 (1.64)	0.0403 (1.09)
R&D/Sales			**5.929*** (3.40)**	**5.195*** (2.89)**	**10.32*** (3.03)**
Advertising/Sales			**4.961** (2.41)**	**5.586*** (2.79)**	4.778** (1.96)
Exports/Sales			0.0957 (1.25)	0.0578 (0.58)	0.230* (1.70)
PPE/Sales			-0.113* (-1.82)	-0.0565 (-0.58)	0.0468 (0.44)
Capex/PPE			-0.00003 (-0.081)	-0.00011 (-0.30)	-0.00061 (-1.14)
EBDIT/Sales			**1.197*** (3.81)**	**0.801** (2.21)**	**2.726*** (5.97)**
Market Share			1.171 (1.39)	2.153** (2.46)	-0.434 (-0.37)
Share Turnover			2.790* (1.91)	1.368 (0.78)	**5.614*** (2.81)**
Foreign Ownership			**0.012*** (3.76)**	**0.012*** (3.44)**	**0.018*** (4.60)**
Promoter Ownership			**0.004** (2.06)**	0.005* (1.94)	**0.008*** (2.75)**
Business Group Dummy			-0.0697 (-0.81)	0.0696 (0.66)	-0.0896 (-0.76)
Cross Listing Dummy			**0.277** (2.06)**	0.245 (1.31)	0.316* (1.82)
MSCI Dummy			0.275 (1.29)	0.176 (0.73)	0.348 (1.63)
Intercept Term	Yes	Yes	Yes	Yes	Yes
Industry Dummies	Yes	Yes	Yes	Yes	Yes
Sample Size	257	251	248	253	257
Adjusted R^2	0.149	0.151	0.326	0.210	0.536

D. Subsample Results

We also divide the sample into various subsamples, and then rerun the "full controls specification" from Table 24, regression (3). Table 25 reports selected results. We found no consistently significant difference in the coefficient in ICGI for subsamples divided based on high versus low growth, manufacturing versus non-manufacturing, and business group versus non-group firms.

We find weak evidence that governance is associated with firm value for smaller (non-BSE 500) firms. The coefficient on *ICGI* is negative for BSE-500 firms, but positive and marginally significant for non-BSE-500 firms. The unexpected negative coefficient for the BSE 500 firms is sensitive to choice of subsample. If we further divide the BSE 500 into BSE 200 (large firms) and BSE 201-500 (medium firms), *ICGI* takes a positive coefficient for both subsamples, and is significant (coeff. = 0.107, $t = 2.47$) for BSE-200 firms.

We find evidence that *ICGI* is more strongly associated with firm value for more profitable firms, and for higher Tobin's *q* firms. This is broadly consistent with an Australian study by Hutchinson and Gul (2004), which reports evidence that governance is more important for firms with high growth opportunites. However, if we use a different specification, in which we add an interaction between *ROA* and *ICGI* to a full-sample regression similar to our "full controls specification" from Table 24, the interaction term is small and insignificant.

Table 25. *OLS* Results for Subsamples

Ordinary least squares regressions of *ln*(Tobin's *q*) on *ICGI* for subsamples. Control variables and sample are the same as in *Table 24*, regression (3), except as indicated. *, **, and *** indicate significance levels at 10%, 5%, and 1% levels. *t*-values, based on White's heteroskedasticity-consistent standard errors, are reported in parentheses. Significant results (at 5% or better) are shown in **boldface**.

	Dependent variable	*Ln*(Tobin's *q*)				*Ln*(Market/Book)
		Sample Size	*ICGI*	Other Controls	Adjusted R^2	*ICGI*
1	Entire Sample	248	**0.034*** (2.70)**	Yes	0.326	**0.035** (2.11)**
2	BSE 500	94	-0.003 (-0.13)	Yes	0.458	-0.034 (-1.07)
3	Non-BSE 500	153	0.028* (1.76)	Yes	0.270	0.037* (1.82)
4	More profitable firms (Return on assets > 15%)	125	**0.053*** (3.12)**	Yes	0.348	**0.042* (1.82)**
5	Less profitable firms (Return on assets < 15%)	123	0.010 (0.55)	Yes	0.176	0.019 (0.78)
6	High Ln(Tobin's *q*)	124	**0.029** (2.15)**	Yes	0.235	0.010 (0.56)
7	Low Ln(Tobin's *q*)	125	0.002 (0.18)	Yes	0.210	0.022 (1.13)

E. Subindex Results

We next examine which subindices are associated with *ln*(Tobin's *q*). Most subindices are correlated with each other, albeit only moderately (see Table 23). We include

all five subindices as separate independent variables, in a regression otherwise similar to our "full controls" specification (Table 24, regression (3)). In robustness checks, we obtain similar results for each subindex by itself.

Table 26, regression (1) shows full sample results. Shareholder Rights Index is positively and significantly associated with Tobin's *q*. The coefficients on Board Structure and Disclosure are positive and likely contribute to the overall assocation between *ICGI* and Tobin's *q*, but the coefficients on Board Procedure and Related Party Transactions are close to zero.

The weak results for Board Structure Index contrasts with the multi-country results in Dahya, Dimitrov and McConnell (2008) and the results for Korea in Black and Kim (2008). Both papers find that board structure is associated with higher firm market value. Moreover, Black and Khanna (2007) and Dharmapala and Khanna (2008) find evidence of positive investor reaction to the Clause 49 reforms, in which board independence was a central aspect. In unreported robustness checks, we vary subdivide Board Structure Index into Board Independence and Board Committee subindices. Board Independence subindex is not significant; Board Committee subindex is positive and marginally significant (coefficient = 0.062, $t = 1.75$). We also vary the definition of Board Independence subindex, with similar results.[37]

Why might board independence not be associated with market value for Indian firms, when it is so associated in other studies? One possibility is that India's requirements for board independence are sufficiently strict so that overcompliance (which provides the only variation we can test) does not predict firm value. If we divide the sample into BSE-500 and non-BSE-500 firms, we find weak evidence of a positive association between board structure and firm value for non-BSE-500 firms. This is broadly consistent with the results in Table 25 for all of ICGI, but there is no obvious reason why board structure levels above legal minima should be important for smaller firms, but not for larger firms.

The only subindex which is significant by itself for the full sample is Shareholder Rights. Shareholders rights also seems to drive the overall association between ICGI and firm value for the subsample of more profitable firms; board structure and shareholder rights together drive the association between *ICGI* and firm value for non-BSE-500 firms -- each is marginally significant for this subsample.

[37] We tested the following measures of board independence: (i) proportion of independent directors, (ii) proportion of independent directors minus proportion of inside directors and (iii) dummhy variable, which equals 1 if the firm has more independent than inside directors, 0 otherwise. Board independence was not significant under any of the alternatives.

Table 26. *OLS* Results for Subindices

Ordinary least squares regressions of *ln*(Tobin's *q*) on *ICGI* and each subindex. Control variables and sample are the same as in Table 24, regression (3). Regressions are similar to Table 24, except that we replace *ICGI* with the five subindices, as separate variables. *, **, and *** respectively indicate significance levels at 10%, 5%, and 1% levels. *t*-values, based on White's heteroskedasticity-consistent standard errors, are reported in parentheses. Adjusted R^2 varies from 0.323 to [to come]. Significant results (at 5% level or better) are shown in boldface. Studentized residuals>±1.96 are dropped. Normalized indices are used.

Dependent variable		***Ln*(Tobin's *q*)**				
Sample	Sample size	Board Structure Subindex	Disclosure Subindex	Related Party Subindex	Shareholder Rights Subindex	Board Procedure Subindex
(1) All firms	248	0.045	0.062	-0.001	**0.069****	-0.001
		(1.27)	(1.52)	(0.021)	**(2.08)**	(-0.026)
(2) BSE 500 firms	94	-0.020	0.049	-0.032	0.034	-0.026
		(-0.28)	(0.64)	(-0.53)	(0.50)	(-0.30)
(3) non-BSE 500 firms	153	0.075*	0.002	0.036	0.058*	-0.026
		(1.94)	(1.94)	(0.83)	(1.75)	(-0.59)
(4) More profitable firms (ROA>15%)	125	0.019	0.035	0.014	**0.135****	0.049
		(0.34)	(0.47)	(0.22)	**(2.30)**	(0.78)
(5) High Ln(Tobin's q)	124	-0.007	0.070	0.029	0.049	0.014
		(-0.15)	(1.43)	(0.60)	(1.24)	(0.31)

E. Endogeneity Concerns

Tables 25 and 26 provide evidence that firm-level governance is associated with higher *ln*(Tobin's *q*). We cannot assess causation because we have only cross-sectional data. For emerging markets, little is known about the extent to which reverse causation (with better performance leading to better governance) or "optimal differences," in which governance optimally differs across firms, make cross-sectional results unreliable in assessing causation (Arcot and Bruno, 2006). Black and Kim (2007) find only weak evidence of reverse causation in Korea. Black, Jang and Kim (2006) report that firm characteristics, other than firm size, are weak predictors of the governance choices of Korean firms, which suggests that optimal differences may not be a large concern.

In India as well, if governance were sensitive to a firm's circumstances, we might expect financial and ownership characteristics to predict governance. In unreported regressions, we assess whether the control variables we use in Tables 25 and 26 predict firms' governance choices. For the full sample, *ln*(assets), sales growth, and profitability predict higher *ICGI* scores. At the same time, regardless of which independent variables we use, adjusted R^2 values are negative (and become more so as we add more control variables we use). This suggests that in India, much like Korea, firm-level governance often reflects idiosyncratic firm choice This makes it more likely that our cross-sectional results may be decent guides to causation.

VI. Conclusion

Our survey of Indian corporate governance practices reveals a number of things. First, it provides a detailed descriptive account of the governance practices of a broad array of Indian firms. For example, a large number of responding firms appeared to meet the

board independence requirements with many having separate CEOs and Board Chairs. Moreover, the majority of firms have a board member with financial or accounting expertise and boards in general seem to be composed of people from varying backgrounds (e.g., academia, legal profession, finance, government officials). Further, virtually all firms have audit committees, but only 67% had the audit committee recommend the reappointment of the auditor and roughly half the firms received non-audit services from the audit firm. When we move away from board composition and process we find a mixed bag. Related party transactions are quite common at Indian firms, yet the approval requirements for them are fairly weak. On disclosure, roughly 67% of firms provide annual reports on their websites, which leaves room for improvement. Further, executive compensation appears to be fairly modest by US standards, although firms' responses were not very complete on this. Regardless, CEOs at Indian firms face only a small risk of dismissal. In addition, voting by shareholders is not very active and postal ballots still do not appear to be available at roughly 25% of firms. Finally, government enforcement is only rarely utilized (although it could still be effective) and most firms have adopted a number of governance provisions only in the last decade or so.

Our paper's second contribution is to the literature on corporate governance indices and the connection between governance and firm value. We build a broad Indian Corporate Governance Index (*ICGI*) and examine the association between *ICGI* and firm market value. We find a positive and statistically significant association between *ICGI* and firm market value in India. This is consistent with prior research in other countries and in cross-country studies. The association is more significant for more profitable firms and firms with higher growth opportunities. A subindex for shareholder rights is individually significant, but subindices for board structure, disclosure, board procedure, and related party transactions are not significant. The non-results for board structure contrast to other recent studies, and suggest that India's legal requirements are sufficiently strict so that overcompliance does not produce valuation gains.

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Appendix A: Summary of Clause 49

Characteristic	Clause 49
Director Independence	• Requirement – 50% independent directors if Chairman is executive director or 33% if Chairman is a nonexecutive. • Definition – no material pecuniary relationship with company, not related to Board or one level below Board and no prior relationship with the Company for the last 3 years. • Nominee Directors of Financial Institutions - considered independent..
Board Requirements & Limitations	• Meet 4 times a year (maximum 3 months between meetings) • Limits on number of committees a director can be on (10), but only 5 for which director can be Chair of committee. • Code of Conduct (Ethics) required.
Audit Committee Composition	• At least 3 directors (two-thirds must be independent). • All financially literate. • At least one having accounting or financial management experience.
Audit Committee Role & Powers	• minimum 4 meetings/year (gap between meetings not exceed 4 months). • broad role – review statutory and internal auditors as well as internal audit function, obtain outside legal or other professional advise, and review whistleblower program if one exists amongst other things.
Disclosures	• Related party transactions, • Accounting treatments and departures, • Risk management, • Annual report include discussion of internal controls adequacy, significant trends, risks, and opportunities, • Proceeds from offerings, • Compensation for directors (including nonexecutives and obtain shareholders' approval), • Details of compliance history for last 3 years. • Corporate governance reports (and disclose adoption, if any, of mandatory and non-mandatory requirements).
Certifications	• CEO & CFO: ▪ financial statements ▪ effectiveness of internal controls ▪ inform audit committee of any significant changes in the above. • Auditor or Company Secretary: ▪ Compliance with corporate governance
Subsidiary Companies	• At least one Independent director of Holding Company should sit as a director on Board of material non-listed Indian subsidiary. • Significant transactions report to Holding Company Board (along with subsidiary board's minutes).
Other	Recommendations: • Whistleblower policy is optional • Independent directors loses status as "independent" if served 9 years at company • Training board members • Evaluate nonexecutive board performance.