ISSN: 2583-7354

International Journal of Emerging Knowledge Studies

Publisher's Home Page: https://www.ijeks.com/

Fully Open Access Research Paper

# The Effect of Corporate Governance on Firm Profitability of Nifty50 Companies in India: A Longitudinal Perspective

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DOI: https://doi.org/10.70333/ijeks-03-08-006

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**Article Info:- Received** : 06 August 2024 **Accepted** : 25 October 2024 **Published** : 30 October 2024

Abstract

This research explores corporate governance's influence on the profitability of Indiancompanies listed on the Nifty50 index. The study employs panel data analysis from 2010 to 2022 to investigate the impact of various corporate governance variables, which include board size, board independence, and audit committee meetings, on the returns on assets and equity. The study also includes firm size as a control variable to ensure accurate results. The study indicates that corporate governance has animpact on returns on both assets and equity. The study reveals that increasing the board size does not necessarily lead to higher profitability. Instead, the findings suggest that smaller boards contribute to better firm profitability by promoting a collaborative decision-making environment that fosters diverse ideas. However, the study highlights the crucial relationship between a firm's profitability and board independence. Although audit committee meetings are essential for the effective functioning of a company, research has shown that such meetings may not significantly impact shareholder returns. Lastly, the firm size is the most significant contributor to firm profitability. These findings hold immense value for policymakers, researchers, managers, analysts, investors, and anyone keen on exploring emerging markets.

**Keywords:** *Corporate Governance, Firm's Profitability, Nifty50, Pooled OLS Regression, Random and Fixed Effect Models.*



## 1. INTRODUCTION

Corporate governance is recognized worldwide as essential to evaluating the strengths and functions of a company **(Crifo et al., 2019)**. The **Cadbury report (1992)** defined "corporate governance as codes of conduct for directing and controlling a company and its stakeholders" **(Gulzar et al., 2020)**. Corporate governance mechanisms are one of the most critical factors affecting the firm performance because the managers have their own interests, which sometimes differ from the shareholders' **(Al-Kake et al., 2019)**.

The firm's financial performance is the main factor determining its success. Good corporate governance can provide valuable information that helps achieve its goals and improve its overall performance in the firm

(Ahmed et al., 2020). Profitability is a measure of how well a company can generate income, and it is calculated by taking the income earned and subtracting all expenses (Husnain et al., 2021). The firm can inspire and strengthen the confidence of its investors, showing a commitment to higher growth and profits by implementing good corporate governance practices.

The issue of corporate governance is highly debated in India, especially after the exposure of corruption in companies like WorldCom and Enron in 2002 (Al-Kake et al., 2019). In addition, external corporate governance mechanisms and market forces are weak in the Indian capital market. Therefore, it is crucial to establish proper corporate governance structures through law (Kumar & Singh, 2012). To enforce this, SEBI has formed various committees, including Clause 49 in the listing agreement for Indian stock exchange companies, which sets out laws and regulations for proper corporate governance in India. This clause highlights the essentials for an audit committee and independent directors on the board (Kulkani & Maniam, 2014). The Companies Act (2013) is also a significant legislative milestone that has implemented stricter disclosure norms, mandated consolidated financial statements, and addressed related party transactions, all aimed at improving corporate governance practices and protecting stakeholder interests (Arora & Bodhanwala, 2018).

Corporate governance can influence a firm's profitability by providing fairness, transparency, and disclosures for stakeholders. Several studies (Kapoor & Goel, 2016; Kumar & Singh, 2020; Gulzar et al., 2020; Prusty & Al-Ahdal, 2018) have examined the potential relation between corporate governance and profitability in India, with diverse results. While some studies (Brown & Caylor, 2004; Eisenhofer & Levin, 2005; Gompers et al., 2003) have seen that good corporate governance improves profitability and long-term value for shareholders. However, some studies (Heracleous, 2001; Mukherjee & Ghosh, 2004; Chidambaram et al., 2006) discovered no noteworthy relation between corporate governance and financial performance. This study analyzes corporate governance variables such as the board, its independence, and the number of audit committee meetings on profitability measures for the top 50 companies listed on the National Stock Exchange of India.

This article is structured into three sections: The first section provides an overview and shares empirical studies related to the topic. The second section explains the methodology used. The final section includes the results, analysis, conclusions, and suggestions.

## 2. REVIEW OF LITERATURE

This section reviews previous studies to measure the relationship between corporate governance and a firm's profitability. However, most of these studies have concentrated on developed nations and specific aspects of corporate governance. The most relevant papers in this field are Kerere & Ausloos (2021), Puni & Anlesinya (2020), Al-Ahdal et al. (2020), Bhatt & Bhattacharya (2015), Gulzar et al. (2020), and Al-Matari et al. (2014). However, a closer examination of the existing literature suggests that more conclusive results are needed.

Previous studies suggest that essential corporate governance elements, such as the size of the board, its independence, and the number of audit committee meetings, impact firm performance. Recent studies by Kerere and Ausloos (2021) reveal that good corporate governance mechanisms can improve a company's financial performance. Additionally, Puni and Anlesinya (2020) found that having internal and external corporate board members can enhance financial performance. Moreover, a larger board size and frequent board meetings generally lead to positive financial performance. However, Al-Ahdal et al. (2020) discovered that an audit committee has little to no impact on a firm's performance measured by return on equity. After considering firm-specific aspects, Bhatt & Bhattacharya (2015) found that larger board sizes positively affect firm performance, while the number of independent directors on the board has no significant relationship with firm performance. A review of past studies on measuring corporate governance and firm performance found that two performance criteria were used: accounting-based measures and market value-based measures (Gulzar et al., 2020). Accounting-based measurements preferred for analyzing the correlation between corporate governance and firm performance are precious as they provide a tangible reflection of managerial decisions (Al-

Matari et al., 2014). Return on assets and return on equity, two commonly employed accounting metrics, are instrumental in assessing a firm's financial performance.

## 3. CONCEPTUAL FRAMEWORK AND HYPOTHESIS DEVELOPMENT

The literature identifies board size, independence, and audit committees as critical corporate governance factors. A conceptual framework introduced based on this review, as shown in Fig. 1:

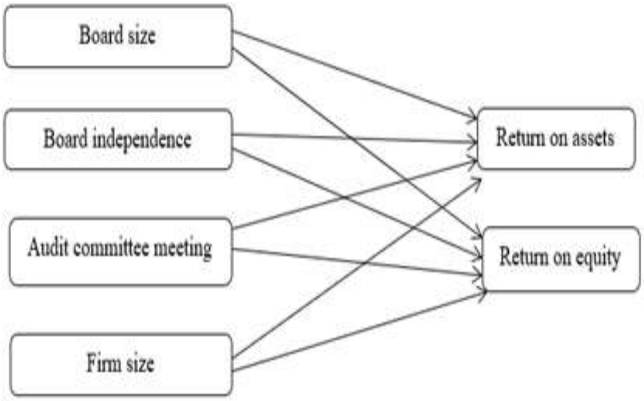


**Fig -1**: conceptual framework

The study, based on a literature reviewand conceptual framework, proposed the following primary and supporting alternative hypotheses to explore the impact of corporate governance on a firm's profitability.

H1: Corporate governance significantly affects the firm's profitability as measured by the return on assets and equity of Nifty50 companies.

### 3.1. Board size and firm's profitability

The "board size" refers to the number of directors on a corporate organization's board. Determining the ideal board size is crucial because the number and quality of directors can affect the board's functioning and, consequently, the organization's profitability (Daily et al., 2003; Ogbechie & Kouropoulos, 2010). Theoretically, it is often assumed that the board consists of many directors capable of producing financial statements reflecting the company's financial position. However, numerous empirical results did not support this theoretical assumption. Researchers have found two opposing viewpoints: Smaller boards are likely to facilitate efficient communication and coordination between the board and management (Jensen, 1993), while larger boards reduce information content and increase earnings management (Bradbury et al., 2006). Based on these findings, discussions, and theoretical assumptions, the study proposes the following hypothesis:

H1: Board size significantly affects the return on assets and return on equity of Nifty50 companies.

### 3.2. Board independence and firm's profitability

The concept of "board independence" pertains to the extent to which non-executive directors on a company's board are free from any influence or control by the company's executives. It is the proportion of independent non-executive directors to the total number of directors on a company's board (Uadiale, 2010). These are directors who do not hold any management positions within the company. According to Clifford & Evans, (1997), an independent non-executive director is not affiliated with the firm in any way except for their role as a director. A recent study (Said et al., 2019) found a strong relationship between corporate performance and having independent directors on the board. However, (Pareek et al., 2019) discovered that board independence has an adverse impact on companies' disclosure of environmental performance. (Siladi, 2006) contends that having additional non-executive directors on the board can reduce the perceived conflict between shareholders and managers. Additionally, Baysinger & Butler, (1985) suggest that outside directors bring superior performance benefits to the firm due to their independent perspective on management. Based on these findings, the study proposes the following hypothesis:

H1: Board Independence significantly affects the return on assets and return on equity of Nifty50 companies.

### 3.3. Audit committee meetings and firm's Profitability

A well-structured audit committee is essential to ensure reliable and high-quality corporate performance as it oversees the financial reporting process and audits the financial statements. Audit committee meetings play a significant role in Monitoring firm activities and protecting shareholders' rights from managers (Al-Kake et al., 2019). The Blue and Ribbon

Committee Report (BRC) recommends that India's laws mandate audit committees to convene at least four times a year, with no more than a four-month gap between meetings. According to **Mishra and Malhotra (2016)**, an audit committee should comprise at least three independent directors, half of whom possess financial literacy. The significance of an audit committee is positively associated with the frequency of meetings **(Kalbers & Fogarty, 1998)**. Conversely, **(Collier & Gregory, 1999)** discovered a negative correlation between the number of meetings and the presence of executive members on audit committees. Based on these findings, our study proposes the following hypothesis:

H1: Audit committee meetings have a significant effect on the return on assets and equity of Nifty50 companies.

## 4. METHODOLOGY

### 4.1. Variables under study

**Table 1:** Measurements of dependent and independent variables

| Variables | Measurement |
|---|---|
| **Dependent Variables** | |
| Return on Assets (ROA) | Net income as a percentage of total assets at the end of the financial year. |
| Return on Equity (ROE) | Net profit as a percentage of total equity at the end of the financial year. |
| **Independent Variables** | |
| Board Size (BS) | The aggregate number of directors serving on the board |
| Board Independence (BI) | The total number of directors who serve as independent board members. |
| Audit Committee Meetings (ACM) | The total meetings the Audit Committee conducts within a specific fiscal year. |
| **Control variable** | |
| Firm size (FSIZE) | The total assets are defined as the natural logarithm |

### 4.2. Data and sample

The Nifty 50 companies in this study were selected using the purposive sampling technique over thirteen years from 2010 to 2022. Later, six financial sector companies were excluded from the study due to their peculiar features. Additionally, two companies had to be removed from consideration due to a lack of available data. Ultimately, the final sample size consisted of 42 companies chosen for analysis. The study relied on secondary data sourced from the PROWESS database as well as the annual and corporate governance reports of selected companies.

### 4.3. Multicollinearity test

The study used the variance inflator factor (VIF) technique to detect the multicollinearity problem. The variable is multi-collinear with others in the model when its VIF is greater than ten, and its 1/VIF is less than the significance level **(Brooks & Tsolacos, 2010)**. As a result, this study has no evidence of a multicollinearity problem because VIF is less than ten, and 1/VIF is greater than the significance level (0.05) for all variables.

### 4.4. Model estimation

The study employed panel data methodology to explore the influence of corporate governance on profitability. The sample consisted of a balanced panel, with 546 observations utilized in the estimated models. The study utilized pooled and panel models to analyze data from 42 firms over 13 years. The study used STATA software for the statistical analyses.

The Breusch-Pagan/Cook-Weisberg test is a helpful tool in determining if a data set is homoscedastic or heteroscedastic. The study employed this test to examine the null hypothesis with heteroscedasticity at a significance level of less than 0.05 **(Gulzar et al., 2020)**.

The Hausman test is used to select between fixed or random effect models by comparing the null hypothesis, which confirms the fixed effect model estimate **(Gujarati & Porter, 2004)**. The hypotheses for the test are:

H0 = Probability > 0.05, the Random effect model is appropriate.
H1 = Probability < 0.05, Fixed effect model is appropriate.

Based on the empirical research **(Al-Najjar, 2010)**, the following panel data model equation can be defined:

$$Y_{it} = \alpha + \beta X_{it} + \varepsilon_{it} \text{ (Pooled model)}$$
$$Y_{it} = \alpha i + \beta X_{it} + \varepsilon_{it} \text{ (Fixed effect model)}$$
$$Y_{it} = \alpha_i + \beta X_{it} + (\varepsilon_{it} + \mu_i) \text{ (Random effect model)}$$

Here *Yit* means,

ROA = Net income as a percentage of total assets at the end of the financial year.

ROE = Net profit as a percentage of total equity at the end of the financial year.

The reason for using the percentage of profitability as a dependent variable is to reduce any firm size effect in the models.

The intercept represented by "αi" is consistent over time and specific to each cross-sectional unit. The variable "i" represents the attribute of the equation for each cross-sectional unit, while "t" specifies the time series dimension. It is assumed that there is a random error term with a normal distribution, represented by β. The independent variables for firm i at time t are represented by the column vector Xit, which includes the following variables:

*X1 (BS)* = the aggregate number of directors serving on the board.
*X2 (BI)* = the total number of directors who serve as independent board members.
*X3 (ACM)* = the total meetings the Audit Committee conducts within a specific fiscal year.
*X4 (FSIZE)* = the total assets defined as the natural logarithm.

## 5. EMPIRICAL ANALYSIS AND DISCUSSION

### 5.1. Descriptive statistics for all variables

Table 2 represents the statistics used to describe the variables chosen for the study. The dependent variable has a larger degree of variation if the standard deviation value is higher than the mean value. Here, the dependent variables are ROA and ROE. The average return on assets (ROA) is 11.40, ranging from -19.30 to 77.90, with a standard deviation of 10.20. The average return on equity (ROE) is 1527, with a range of -1366 to 13215 and a standard deviation of around 1963. Table 2 concludes that the ROE has a greater variation than the ROA, as the standard deviation for ROE is larger than its mean. These findings support the notion that ROE can be a more reliable indicator of a firm's profitability than ROA, as it provides a better indication of how much profit investors can expect to receive and allows them to assess their investment risk more accurately.

**Table 2: Summary of Descriptive statistics**

| Variable | N | Mean | S.D. | C.V. | Mini. | Maxi. |
|---|---|---|---|---|---|---|
| **ROA** | 546 | 11.40 | 10.20 | 0.89 | -19.30 | 77.60 |
| **ROE** | 546 | 1527 | 1963 | 1.29 | -1366 | 13215 |
| **BS** | 546 | 11.50 | 2.67 | 0.23 | 4 | 22 |
| **BI** | 546 | 6.25 | 1.78 | 0.28 | 1 | 11 |
| **ACM** | 546 | 6.20 | 2.22 | 0.36 | 1 | 19 |
| **FSIZE** | 546 | 10.30 | 1.41 | 0.14 | 6.32 | 13.80 |

Source: Authors' compilation

Table 2 shows the Coefficient of Variation (CV) values for the variables, which can help assess their consistency. The CV is calculated by dividing the standard deviation by the mean. A lower CV value indicates greater variable consistency, while a higher value suggests the opposite. Among all the variables, FSIZE has the lowest CV value of 0.14, making it the most consistent. On the other hand, ROE has the highest CV value of 1.29, indicating that it is the least consistent variable.

According to a 13-year study of 42 firms encompassing 546 observations, the average number of directors on a board is approximately 11, with a range between 4 to 22. The average board independence is six directors, with seven

annual audit committee meetings. These statistics show that firms followed corporate governance regulations. The control variable of the study is the firm size.

### 5.2. Correlation matrix

Table 3 represents the correlation matrix. It helps to identify whether multicollinearity poses any problem in the empirical analysis.

**Table 3: Correlation matrix**

| Variables | ROA | ROE | BS | BI | ACM | FSIZE |
|---|---|---|---|---|---|---|
| **ROA** | 1.0000 | | | | | |
| **ROE** | 0.3748** (0.0000) | 1.0000 | | | | |
| **BS** | -0.0657 (0.1251) | -0.0845* (0. 0484) | 1.0000 | | | |
| **BI** | 0.0719 (0.0933) | 0.0676 (0.1145) | 0.7060** (0.0000) | 1.0000 | | |
| **ACM** | 0.0494 (0.2492) | -0.1036* (0.0154) | 0.2040** (0.0000) | 0.0097 (0.8219) | 1.0000 | |
| **FSIZE** | -0.2936** (0.0000) | -0.0400 (0.3508) | 0.2882** (0.0000) | 0.0813 (0.0578) | 0.4317** (0.0000) | 1.0000 |

Source: Authors' compilation

Note: ** At a significance level of 0.01 (two-tailed),
* At a significance level of 0.05 (two-tailed)

According to (Hair & Anderson, 2006), if the correlation between all explanatory variables is below 0.80, there is no presence of multicollinearity. The correlation matrix reveals that the strongest link, with a coefficient of 0.7060, exists between Board size and Board Independence. Conversely, the weakest correlation, with a coefficient of 0.0097, is observed between Board Independence and Audit Committee Meetings. Consequently, there is no problem of multicollinearity.

According to Table 3, the firm's profitability depends on its corporate governance attributes. Board size and Audit Committee Meetings negatively correlated with return on equity. Return on assets and return on equity have a positive correlation; while return on assets and firm size have a negative correlation. Furthermore, a positive correlation exists between Board size, Board Independence, Audit Committee Meetings, and firm size. There is a direct relationship between the size of a firm and the frequency of Audit Committee Meetings.

### 5.3. Panel Regression Analysis

Table 4 provides a summary of the Breusch-Pagan test results. The chi-squared values derived from the test for the ROA and ROE models are 52.11 and 62.47, respectively, at a 5% level. This suggests that the pooled regression is not suitable for these models. As per the test results, the possible models are panel data with fixed or random effects.

The study employed the Hausman specification test to ascertain the appropriate model, either fixed-effect or random-effect, for the ROA and ROE models. The chi-squared p-value for the ROA model was not significant, indicating that the random-effect model is suitable. The R-square statistic for the random effect model remained unchanged at 5.52%, demonstrating that the explanatory variables accurately reflect the ROA model. Conversely, the chi-squared p-value was significant for the ROE model, indicating the suitable fixed-effect model. Evaluating the explanatory variables' capacity to represent the ROE model caused a slight increase in the R-square for the fixed effect model, from 25.72% to 25.97%.

**Table 4: Panel Regression Analysis**

| Variables | ROA Model | | | ROE Model | | |
|---|---|---|---|---|---|---|
| | Pooled OLS | Fixed effect | Random effect | Pooled OLS | Fixed effect | Random effect |
| BS | -.5979064* (0.010) | -0.5211592* (0.015) | -0.5237211* (0.011) | -187.9435* (0.000) | -118.5638* (0.005) | -146.8503* (0.000) |
| BI | 1.204026* (0.000) | 0.624824* (0.021) | 0.6470366* (0.015) | 270.261* (0.000) | 217.8541* (0.000) | 233.045* (0.000) |
| ACM | 1.096368 (0.000) | 0.3168977* (0.032) | 0.3521513* (0.016) | -64.972 (0.120) | -10.97183 (0.703) | -18.71586 (0.520) |
| FSIZE | -2.676146* (0.000) | -1.84035* (0.000) | -1.894276* (0.000) | 63.48014 (0.346) | 990.9627* (0.000) | 841.4005* (0.000) |
| Cons | 31.47066* (0.000) | 30.4345* (0.000) | 30.6618* (0.000) | 1750.604* (0.008) | -8604.504* (0.000) | -6785.973* (0.000) |
| Observation | 546 | 546 | 546 | 546 | 546 | 546 |
| R, Square (%) | 14.53% | 5.52% | 5.52% | 25.97% | 25.97% | 25.72% |
| Number of Panels | 42 | 42 | 42 | 42 | 42 | 42 |
| Breusch-Pagan/Cook-Weisberg test | 52.11 (0.0000) | | | 62.47 (0.0000) | | |
| Hausman test | 4.23 (0.3756) | | | 82.57 (0.0000) | | |

Source: Authors' compilation

Note: * At a significance level of 0.05 (two-tailed)

## 6. RESULTS AND DISCUSSION

Table 4 presents the outcomes of the empirically estimated model using random effect regression for the ROA model and fixed-effect regression for the ROE model.

The findings support the hypothesis by showing a significant negative relationship between the size of the board and the firm's profitability, as measured by both ROA and ROE, with a 5% significance level. This result aligns with previous research **(Jensen, 1993)**. However, the results contradict the argument **(Dalton et al. 1998)** that larger boards enhance a firm's profitability by increasing the pool of expertise. Further, study results suggest that small boards contribute to better firm profitability by promoting a collaborative decision-making environment that fosters diverse ideas and improves profitability. In the Indian context, having a smaller board may be more helpful.

On the other hand, according to the model's results, a positive correlation exists between board independence and a firm's profitability. It is essential to have an independent board consisting of non-executive directors who are not part of the company. This finding is consistent with the study **(Said et al., 2019)**. However, it contradicts the study **(Syriopoulos & Tsatsaronis, 2011)**, which argued that there is no link between board independence and firm success.

According to the study's findings, there is a strong and positive correlation between the frequency of audit committee meetings and the return on assets (ROA) but an insignificant association with the ROE. The research also indicates that these meetings tend to substantially impact accounting metrics related to the ROA than those associated with the ROE. This result aligns with prior research **(Jensen, 1993)**, which suggested that audit committee meetings can improve a company's overall performance, particularly concerning its ROA.

However, Firm size is the most significant contributor to firm profitability, with a positive effect on return on equity and an inverse effect on return on assets. This result implies that larger firms generate more profit for their equity shareholders but may need to use their assets

more efficiently, resulting in decreased return on assets. Conversely, smaller firms may struggle to generate as much profit for their equity shareholders but may use their assets more efficiently, resulting in a higher return on assets.

## 7. SUMMARY AND CONCLUSION

Effective corporate governance practices can influence a firm's profitability by ensuring fairness, transparency, and disclosure for all its investors. Previous research conducted by **(Kapoor & Goel, 2016; Kumar & Singh, 2020; Gulzar et al., 2020)** has delved into the potential correlation between corporate governance and profitability in India, with diverse results. This study seeks to examine the influence of corporate governance on the profitability of Nifty50 firms, employing panel data analysis from 2010 to 2022. The results imply a compelling association between corporate governance and a firm's profitability.

According to the research, corporate governance significantly influences the firm's profitability, and the quality of corporate governance impacts both returns on assets and equity. The study indicated that board size does not necessarily correlate with increased profitability, as smaller boards were found to perform better in profitability for Indian firms. However, the study discovered a strong correlation between board independence and a firm's profitability, emphasizing its importance in success. Moreover, the study found no meaningful relationship between audit committee meetings and shareholder returns. Lastly, the firm size was observed to be the most significant contributor to firm profitability, with an inverse effect on return on equity and a positive effect on return on assets. These findings are important for policymakers, researchers, managers, analysts, investors, and anyone interested in emerging markets.

This study has limitations that require attention and could be the basis of future research. The study relied on secondary data. Therefore, conducting further research using primary data and with a larger sample size would be beneficial. Additionally, analyzing the correlation between corporate governance and firm profitability could be improved by considering a more complete range of internal and external corporate governance practices.

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**Cite this article as:** Jigarkumar L. Vaghela and Chetana R. Marvadi., (2024). The Effect of Corporate Governance on Firm Profitability of Nifty50 Companies in India: A Longitudinal Perspective, International Journal of Emerging Knowledge Studies. 3(10), pp.742-751. https://doi.org/10.70333/ijeks-03-08-006