RESEARCH

Board Structure, its Exposure and its Effect on IPO Grade: Stochastic Analysis from the Indian Equity Market

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ABSTRACT

In India an important experience in the form of IPO (Initial Public Offer) Grading took off in 2007. Rating of debt instruments is a universal practice, however Indian capital market regulator SEBI(Security Exchange Board of India), pioneered the concept of equity instrument rating. One of the criterion on which IPO bound companies, are evaluated is corporate governance. Composition of the board of directors, is an important aspect, on which corporate governance depends. In this research paper, it is explored whether number of directors in the board, experience and age profile of the board members, exposure of the independent directors in terms of board membership in other firms and also the proportion of the independent directors in the board have any bearing on the grade assigned to a IPO bound company. Results show, that out of these factors, two factors namely proportion of the independent directors and presence of directors with less than 5 years relevant experience do not have any statistically significant effect on the grade obtained by the companies. On the other hand companies with more board members, independent director with more exposures and higher age profile of the directors obtained better grades. However, counter intuitively companies with board members of less than five years of relevant experience obtained higher grades.

KEYWORDS: IPO Grading, Corporate Governance, Board Composition.

LITERATURE REVIEW

In most of the publicly listed companies, there is a clear division between the shareholders, the board of directors, and the management. Even then certain functions overlap between these three stake holder groups. It is important to appreciate that, why these distinctions between the three groups are necessary as far as possible.

"The corporate form of firm organization has obvious advantages for shareholders (suppliers of capital) and managers. Shareholders can participate in the gains from entrepreneurial ventures even though they lack management skills; managers can pursue profitable business opportunities even though they lack large personal wealth. Both parties benefit from this division of labor." (Fischel 1982). The problems generated by

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this "division of labor" also known as 'type one' of the agency problem, led to several researches (Berle & Means, 1932; Jensen & Meckling, 1976; Fama & Jensen, 1983). Some of the top management people and major shareholders find their place in the board of directors. In the case of many emerging countries (including India) promoters of businesses, themselves in many instances act as the top management and form significant part of the board of directors.

In order to have watchdogs in the board, so that processes remain transparent and material information is disseminated to all the shareholders in a timely and ethical manner, independent directors are appointed in the board. This is important to safeguard the interest of the non promoter shareholders (or in other words minority shareholders). The ethical behaviour and timely high quality information disclosures by a corporation and to be fair to all its stakeholders come under the umbrella term of corporate governance. Presence of adequate high quality independent directors in the board, is regarded as one of the corner stone's of the good corporate governance practice. Adhering to higher level of corporate governance, ensures efficient allocation of resources. Countries with higher governance standard shows, about twice Return On Asset(ROA) compared to the countries with lower standard (Claessens & Fan, 2002). In fact bad corporate governance can cause systematic crisis in an economy (Chakrabarti, 2005).

Similarly there are literature available on size of the board and its relationship with the functioning of the companies. Larger board leads to issues of coordination and communication, and it affects the boards functioning, resulting in poor performance of the companies (Lipton & Lorsch, 1992; Jensen, 1993).This view point was also empirically proved (Yermack,1996 ;Eisenberg et al.,1998).

From an investor's point of view, the decision to participate in the stock exchange requires the knowledge and awareness of the available financial instruments, an assessment of the risk-return trade off and an act of trust, that the overall system is fair (Guiso & Jappelli, 2004). Many prospective investors shy away from the stock market because they have limited knowledge of stocks, the working of the stock market, and asset pricing (Rooij, Lusardi and Alessie, 2007). The decision to invest in stocks requires not only an assessment of the risk-return, trade-off given the available data, but also an act of faith (trust) that the data in the possession of the investor's are reliable, and that the overall system is fair (Guiso, Sapienza and Zingales,2007).

INDIAN SCENARIO

Family continues to be one of the basic units of Indian society (Chokkar, 2009). Family owned enterprise is a phenomena which transcends national boundaries. According to some of the previous studies more than half of the businesses worldwide are family owned (Timmons & Spinelli,2007). In the Indian context the agency problem typically exists between the dominant or majority shareholders (in most of the cases promoter or promoter family) and the minority shareholders (i.e. type two of the agency problem). About 70% of Indian firms are family controlled (Piramal,1996). As seen in most of the

Asian countries like keiretsus in Japan and chaebols in South Korea, India is dominated by business groups. Scholars like Bebchuk, Kraakman, and Triantis (2000), Morck et al. (2000), argued that family run firms can have the type two of the agency problem. Also family businesses often have key executives from the extended family(Chokkar,2009), that aggravates this problem.

India's chosen path with regards to corporate governance is based on Anglo-Saxon model, thanks to the legacy of the British colonial rule. A contrasting model also exists in the developed world, i.e. the corporate governance model of Japan and Germany, where banks which put money into the business enforce checks and balances (Jackson and Moerke,2005). Post independence, the country's emphasis on socialism and government's increasing role in the economy led to the government becoming the predominant supplier of capital(both equity as well as debt, through nationalised banking, development financial institutions and insurance sectors). In that scenario, corporate governance of the companies deteriorated.

Indian economy opened up in the early 1990s, which is a very significant event in the history of the Indian capital market. Post this, there were attempts to increase the disclosure norms and align them to more advanced western economies. India's effort to undertake corporate governance reform passed through a number of different paths and intertwined with significant conflict between SEBI(Securities Exchange Board of India, the capital market regulator) and the MCA(Ministry of Company Affairs, then DCA or Department of Company Affairs) (Afsharipour,2009). A number of committees are set up with respect to this goal. Prominent among them are Bajaj committee (set up by industry body CII in 1995), Birla committee (constituted by SEBI in 1999), Murthy committee (constituted in 2002) and Naresh Chandra committee (appointed by DCA in 2002 to look into the audit and governance issues). Birla committee under the chairmanship of noted industrialist Mr. Kumar Mangalam Birla, submitted its report in the year 2000, based on these recommendations SEBI introduced clause 49 of the listing agreement, which all listed companies with Rs. Three crore or more as paid up share capital, or a net worth of Rs.25 crore, recorded any time in their history of existence, had to comply to, within three financial years, starting with 2000-2001.Bodies corporate like public and private sector banks, insurance companies etc. were kept out of these requirements.

As India chose to follow Anglo-Saxon model, there were many similarities with the Cadbury committee (constituted by the London Stock Exchange) recommendations as well Sarbanes and Oxley act enacted in the USA.

Some of the salient features of the clause are as follows:

With respect to the board of directors, fifty percent of the director's should be independent directors, if chairman is an executive director or thirty three percent if the chairman is also an independent director. Nominees of financial institutions, who are large stake holders in several companies, are treated as independent directors. The board must meet within three months of the previous meeting; any director at the most should be part of ten committees, and chair at the most five of them.

According to the clause, an independent director should be:

- At least twenty one (21) years in age
- Should own less than two percent (2%) of common share
- Should not have voting rights more than, what is available to two percent (2%) equivalent of the equity holder
- Should not be a vendor, customer, lesser or lessee of the company
- Should not be a partner or executive (at the time of the appointment and three years preceding to that) of the audit, legal or consulting firms, which have material association with the company.
- Is not an executive (or was not in preceding three years) of the company.
- Is not related to the promoters, members of the other board of directors, or executives one level below board of directors.

The other features were related to different committees of the board (like audit, remuneration etc.) and their structures etc.

The independent directors should bring to the table, relevant expertise and experience to advise the management on the future course to be taken. Since the independent directors are not expected to have any conflict of interest, their advise should strengthen the management and benefit all the shareholders, especially the non promoter shareholders (Weisbach, 1988; Lee, Rosenstein, and Wyatt, 1990; Warner, Watts, and Wruck, 1988). However, there are contrarian views, as well, like independent directors lack the adequate time, expertise, and wherewithal in terms of motivation to confront the path followed by the management(Zahra and Pearce, 1989). Also the independent directors may not understand the business model of the company, in its entirety as they may lack the relevant knowledge (Coughlan and Schmidt,1985).

Existing literature is available in the domain of independent directors and the information dissemination outcome. These research showed mixed outcome, for example some studies failed to establish adequate relationship between the number of independent directors in the board and timely reporting of financial data (Bushman et al., 2004 and Vafeas,2000).

Previous research also showed, that independent directors presence in the board, may not yield intended results as the management led by the Chief Executive Officer (CEO) block certain critical information to the board (Lee et al.,1992, Jensen,1993)

However in spite of these shortcomings, there are many positive outcomes noticed due to presence of independent directors in the board, as far as corporate governance is concerned. For example companies with more independent directors, recognize bad news in their financial reporting earlier(Ahmed and Duelman,2007). Certain studies concentrating on the emerging economies showed that, greater representation of independent directors in the board increased the quality of financial data disclosures (Peasnell et al., 2000;

Klein, 2002; Davidson et al., 2005). Where as in certain studies it is found that accounting quality has a positive correlation with the proportion of independent directors in the board (Petra, 2007). Also there is existing literature on addition of new independent directors in the board, following poor financial performance (Hermalin & Weisbach,1988).

IPO GRADING

SEBI introduced IPO grading, as a pioneering concept on voluntary basis in April, 2006. It was optional till 30th.April,2007. Grading of fixed-income instruments, is a universally accepted feature. However Indian Equity Market Regulator, Security Exchange Board of India(SEBI) is credited with, coining a new concept, i.e. grading of equity instruments.

Credit rating agencies (CRAs) like CRISIL, CARE, ICRA, India Rating & Research (earlier FITCH India) and Brickwork Rating, which are registered with SEBI, are entrusted with the job of IPO grading. The rating scale used is 1 to 5, with 1 being the worst, and 5 being the best. There were many weak as well as fraudulent issues hitting the market. The number of such issues hit the roof, whenever the stock market performance is extra ordinary. Some dubious companies also want to bask in the glory of well performing equity market.

IPO GRADING FRAMEWORK

Grade / scale	Grading Définition
5/5	Strong Fundamentals
4/5	Above Average Fundamentals
3/5	Average Fundamentals
2/5	Below Average Fundamentals
1/5	Poor Fundamentals

Table 1: IPO Grading Scale

According to the SEBI guidelines, Credit Rating Agencies (CRAs) are supposed to analyse companies, for the purpose of grading on the following parameters:

a. Business Prospects and Competitive Position

   i. Industry Prospects

   ii. Company Prospects

b. Financial Position

c. Management Quality

d. Corporate Governance Practices

e. Compliance and Litigation History

f. New Projects-Risks and Prospects

The costs of the Grading are to be borne by the IPO bound firm. Therefore there is likely to be conflict of interest between the rating agency(which is supposed to grade the IPO) and the equity issuing firm, which is bearing the costs of this grading process. However there is a reputational stake for the rating agencies in the long term.

OBJECTIVE OF THE RESEARCH

In the literature review it is observed that, Indian economy is dominated by the family run business enterprises, and also Indian society is closely linked family oriented society. In this scenario, there is a possibility that, even listed companies can have inexperienced people in the board by virtue of their closeness to or membership of the promoter family. However these will lead to poor corporate governance standards and the likely disregard of the minority shareholder's interests. As a result companies with inexperienced people in the board should receive lower grade from the Credit Rating Agencies (CRAs). As in family managed businesses corporate governance is important as that puts system in place, which takes into account competing interest of all the owners, in the decision making process (Gordon and Nicholson,2008). Also there can be a tendency to nominate independent directors, based on their proximity to the promoter group, irrespective of their competencies and exposure to other companies. Number of directors in the board and the proportion of independent directors, should be the other important factors, to consider, as they have significant impact on the timely and transparent dissemination of the financial data in the public domain as well as financial performance of the concerned firm.

For our analysis we have taken all the IPO bound corporate entities in the same footing, irrespective of their different structures (for example, companies formed under the companies act and body corporate like banks etc.), and all are termed as companies.

NULL HYPOTHESES

Null Hypothesis 1: The number of members in the board of directors (i.e. board size) influence the grade obtained by an IPO bound company.

Null Hypothesis 2: The number of independent directors in the board influence the grade obtained by an IPO bound company.

Null Hypothesis 3: Whether majority of the independent directors have any other board membership influence the grade obtained by an

IPO bound company.

Null hypothesis 4: Whether there is any member of the board who is 30 years or less in age influences the grade obtained by an IPO bound company.

Null Hypothesis 5: Whether there is any member of the board has less than 5 years relevant experience influences the grade obtained by an IPO bound company.

ALTERNATIVE HYPOTHESES

Alternative Hypothesis 1: The number of members in the board of directors (i.e. board size) do not influence the grade obtained by an IPO bound company.

Alternative Hypothesis 2: The number of independent directors in the board do not influence the grade obtained by an IPO bound company.

Alternative Hypothesis 3: Whether majority of the independent directors have any other board membership does not influence the grade obtained by an IPO bound company.

Alternative Hypothesis 4: Whether there is any member of the board, 30 years or less in age, does not influences the grade obtained by an IPO bound company.

Alternative Hypothesis 5: Whether there is any member of the board has less than 5 years relevant experience does not influence the grade obtained by an IPO bound company.

RESEARCH METHODOLOGY

SPSS 16.0 is used as a software package for the analysis. Red Herring Prospectus (RHP) of all the companies were analyzed threadbare to find the relevant data. In total 171 companies which accessed the primary market between May,2007(post IPO grading was made mandatory) and May,2013 are taken into account. If any company is graded by two credit rating agencies, the higher grade is considered for the purpose of analysis. There are 21 companies with grade 1,52 companies with grade 2, 64 companies with grade 3,29 companies with grade 4 and 5 companies with grade 5 in this research.

Dummy variables are used for presence of directors with less than 5 years experience (1 for yes and 0 for no), less than 30 years in age (1 for yes and 0 for no) and majority of the independent directors have no other board membership (1 for yes and 0 for no).The number of board members and the number of independent directors are taken as the absolute number.

Discriminant regression analysis is used to analyze the data, where the dependent variable is a ordinal data (the grade obtained by the various IPO bound companies) and the independent variables are the number of board members and the number of independent directors as well as the dummy variables, for the presence of directors with less than 5 years experience, less than 30 years in age majority of the independent directors have no other board membership.

EMPIRICAL RESULTS AND ANALYSIS

Standardized Canonical Discriminant Function Coefficients

	Function
	1
less_than_30	1.185
lees_than_5_yrs_exp	-.876
board size	-.608
Majority 0f independent directors no other board membership	.316
%of independent directors	.003

Eigen values

Function	Eigen value	% of Variance	Cumulative %	Canonical Correlation
1	.245 [a]	100.0	100.0	.444

a. First 1 canonical discriminant functions were used in the analysis.

Wilks' Lambda

Test of Function(s)	Wilks' Lambda	Chi-square	df	Sig.
1	.803	15.033	5	.010

Tests of Equality of Group Means

	Wilks' Lambda	F	df1	df2	Sig.
Presence of directors with less_than_30 years in age	.914	3.871	4	165	.005
Presence of directors with lees_than_5 years of relevant experience	.969	1.303	4	165	.271
board size	.826	8.705	4	165	.000
Maj ind dir no board membership	.955	1.962	4	165	.103
%of ind dir	.963	1.586	4	165	.180

From the SPSS output of the discriminant analysis, it is clear that the model is statistically significant. Moreover, it is quite apparent that out of the five factors, three factors i.e. age of the directors (whether any director in the board is less than 30 years in age), exposure of the independent directors (whether majority of the independent directors have any other board membership)and the board size have significant effect on the grade obtained by a company at 10% level of significance. So null hypothesis is rejected in these cases. Whereas for two factors, i.e. the proportion of independent directors in the board and the presence of directors with less than 5 years of relevant experience, do not have any significant effect on the grade obtained by a IPO bound company. In case of these two variables, we failed to reject the null hypothesis.

Out of the four factors having significant effect, only the director's experience has an inverse relationship with the grade. That means, higher graded companies are more likely to have board members with less than five years relevant experience. Which is a significant finding.

CONCLUSIONS

The study clearly shows that, companies which put more experienced people in the board, perceived to have better corporate governance standard and are awarded higher grade. Similarly having well known personalities, having exposure to other companies as part of their boards, increases grade of the IPO bound companies. This shows that, companies which have independent directors from their close circles, without relevant experience and expertise, show bad corporate governance practices and is awarded lower grade. More number of directors also have a positive bearing on the corporate governance practice of the board, as the decision making process becomes more broad based, resulting in the higher grade for the companies, which is a contribution to the literature.

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