

**Impact of Corporate Governance on Default Risk and  
Earnings Response Coefficient: An Exploratory study in  
Indian Context**

**ABSTRACT OF THE THESIS**

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## **ABSTRACT**

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### **INTRODUCTION:**

This study is an effort to explore the impact of corporate governance practices on default risk and earnings response coefficient of listed companies in India. Even though corporate governance has expanded and is getting noteworthy attention recently and much emphasis and discussions took place is still in process of getting more prominent place in organization to justify its importance. Regardless of these efforts and debates, the procedure of reconstruct and to strengthen corporate governance only appears and becomes unavoidable when the present practice fails to stop a major corporate scam. Corporations play a crucial role in ensuring fast-paced socio-economic growth and development of any country. India opened up its economy in 1991 which brought up the growth initiators viz. liberalization, privatization and globalization. With the advent of these events, Indian market became more reachable for domestic as well as foreign corporate which was vitally imperative for the growth and survival of the economy. On one hand, these events facilitated firms to have access of funds from the capital market but on the other hand, it also brought certain issues. Corporate scams were certainly one of those issues. Indian economy saw a number of scams since then, which brought about the issue of corporate governance into a realm for everyone to discuss. Some of the major scams included Harshad Mehta scam (1992), UTI scam (2001), Ketan Parekh scam (2001), Satyam Fraud case (2009), Speak Asia scam (2011) Reebok India scam (2012), National Spot Exchange Ltd. scam (2013), Saradha Group chit fund scam (2013), Sahara Group case (2014), Kingfisher money laundering case (2015), & Ricoh India accounting fraud (2016). Such scams forced the regulatory body to pay more focus on the impending requirements and efficacy for an appropriate analysis of companies' financial statements and to provide guidance to the investors in their financial decisions.

This is well accepted that companies with superior corporate governance system create trust and goodwill amongst the investors that enables them to procure funds at most reasonable costs. Investors always inclined to invest in a firm which is safe and transparent in all its transactions.

Even the best standards cannot prevent instances of major corporate misconducts. In India, the major characteristics of corporate governance norms and standards are imported from the jurisdiction of other developed countries. It is obvious that every country is different in terms of social, economic, cultural and legal environment and therefore there is a need to understand what norms work in Indian Scenario. Effective implementation can only be made possible when these international best standards and norms are developed and customized according to the unique issues of Indian system. There is a need to comprehend what makes the Indian scenario separate so as to build some practical suggestions on how to strengthen the Indian corporate governance within its own legal framework.

The concept of corporate governance is growing day by day and is not restricted to just protecting the interest of the shareholders but extended to attain the overall sustainability. The top management that is comprised of board of directors has the responsibility of the governance and is accountable overall. This research adds to the literature by highlighting the significant link between some corporate governance measures, default risk and earnings response coefficient. Therefore, this study theoretically and practically attempts to provide evidence for the existence of relationship between corporate governance, default risk and earnings response coefficient in India. It also analyses the impacts of different variables (factors) of corporate governance on default risk and earnings response coefficient.

## **CONCEPT OF CORPORATE GOVERNANCE, DEFAULT RISK AND EARNINGS RESPONSE:**

Corporate governance enables to govern a company by providing rules and norms which are required for the survival of firm and protection of the interests of its shareholders & stakeholders.

Sir Adrian Cadbury Committee, which was setup in May 1991 for corporate governance issues in U.K., defined corporate governance, “As the system by which companies are directed and controlled. The basic objective of corporate governance is to enhance and maximize shareholder value and protect the interest of other stakeholders.”

Keasey and Wright (1993) defined corporate governance as a framework for effective monitoring, regulation and control of companies which allows alternative internal and external mechanisms for achieving the laid down objectives. The internal mechanisms include the board composition, managerial ownership, and non- managerial shareholding including the institutional shareholding while external mechanisms include; the statutory audit, the market for corporate control and stock market evaluation of corporate performance.

According to Shleifer & Vishny (1997) “Corporate Governance deals with the ways in which the suppliers of finance to corporations assure themselves of getting a return on their investment.”

Craig (2005) stated that corporate governance depends upon the relative power of owners, managers and provider of capital. It entails the procedures, customs, laws and policies of different economies around the world. An important objective of corporate governance is to ensure accountability and transparency of those who are involved in the policy implementation of organizations through mechanisms that will reduce principal agent

conflict.

Default risk can be defined as the risk that a lender takes on in the anticipation that a borrower will be incapable to make the obligatory payments on their debt obligation. Lenders and investors both are exposed to default risk in almost all types of credit extensions. A higher level of default risk leads to a higher mandatory return, consequently resulting into a higher interest rate. An Independent cash flow numeral that is near zero or negative could specify a higher default risk. Default risk can be evaluated by using FICO scores for customer credit and credit ratings for company and government debt issues. Rating agencies simplify credit ratings for companies and debt into either investment score or non-investment score. Whenever a lender gives credit to a borrower, there is a possibility that the loan amount will not be paid back. The dimension that looks at this probability is the default risk. Default risk not only covers individuals who borrow money, but also companies that issue bonds and due to financial restraints, fail to make interest payments on those bonds. Whenever a lender offers credit, quantifying the default risk of a borrower is vital as part of its risk administration strategy. Whenever an investor is assessing an investment, determining the financial well-being of a company is eminence in evaluating investment risk.

Easton and Zmijewski (1989) define ERC as the coefficient concerning the surprise component in new information in an accounting earnings declaration to irregular stock returns. It is hence a measure of the range to which new earnings information is capitalized in a stock price (Teoh and Wong, 1993). In proposition, ERC can be sustained as the slope coefficient in a regression of abnormal stock returns on unexpected earnings. Research on ERC has led to an improved appreciation of the nature of earnings information and the function of accounting information within the market's general information structure. Earnings-returns studies have a tendency to start with a valuation model that links dividend, cash flows or earnings, to value. Cho and Jung (1991), for example, recommend that all earnings-returns studies employ a valuation

model that discounts future dividends or cash flows. In elucidating ERC, it is presumed that accounting earnings are closely associated to future dividends. Hence, any unexpected earnings may source investors to revise their expectations of future dividends therefore leading to security price variations (Collins and Kothari, 1989; and Dhaliwal and Reynolds, 1994).

## **RELEVANCE OF THE STUDY**

The study is relevant from the perspective of academic, managers, regulators and policymakers. This study offers contribution to the existing body of literature on the relationship between corporate governance, default risk and earning response coefficient. To my knowledge and information, a very limited research has been conducted recently. The result may provide a good guideline for managers and stakeholders to understand whether their companies are exercising good corporate governance practices or not. Without empirically testing the effect of corporate governance norms it would be difficult to say that board characteristics or functions and audit committees have brought any significant change in the decision-making. Just as any change takes time, so too good corporate governance application will bring alteration in the system with time. India has adopted the best and most robust corporate governance norms from the other countries' jurisdiction. But just having best rules or regulations of the world could not bring the change in the corporate functioning and corporate misbehaviours. Listed companies are trying to comply with corporate governance norm which is very much evident from the outcomes of the checklist provided by SEBI. Compliance is the necessity in Indian environment but the purpose should not be just to complete the paper work. There are few old corporate that practice the corporate governance long before it became obligatory like Tata, Birla and Infosys. Though, recent cases of Tata and Infosys are examples that irrespective of having best norms of the world, there is something in which India is lagging which made us fail on effective decision making. Consequently, empirical studies are mandatory to understand what works in Indian system so

that proper and effective norms are enforced otherwise it would remain a box ticking exercise.

## **SCOPE OF THE STUDY**

This study tries to link the research gap through investigating the relationship between the board characteristics, audit committees and default risk rates. As board plays an important role in determination of financing mix of the companies. This study addressed the issues relating to some pertinent questions emerging within the domain of study problems.

The study seeks to answer the following questions:

- There are some queries in context of Indian companies like Corporate Governance has a positive or negative relationship with ERC & Default risk?
- Whether default risk & earning response coefficient are correlated or not?
- Does audit quality effect the association between default risk & ERC?
- Does audit quality expertise effect the association between default risk & ERC?
- Does audit committee independence effect the association between default risk & ERC?
- Does board independence effect the association between default risk & ERC?
- Does board shareholding effect the association between default risk & ERC?

## **SIGNIFICANCE OF THE STUDY**

The study is relevant from the academic, managers, regulators and policymakers' perspective. This study contributes to the existing body of literature on the relationship between corporate governance, default risk and earnings response in Indian context. To the best knowledge and information of the researcher, a very limited research has been conducted recently. The result may provide a good guideline for managers and stakeholders to understand whether their companies are practicing good corporate governance practices or not. Without empirically testing the effect of corporate governance norms it would be difficult to say that board and audit committee characteristics have brought any significant change in mitigating corporate scams, default rate or not. Just as any change takes time, so too good corporate governance implementation will bring change in the system with time. India has adopted the best and most robust corporate governance norms from the other countries' jurisdiction. But mere having best norms or regulations of the world could not bring the change in the corporate functioning and corporate misconduct. Listed companies are trying to comply with corporate governance norm which is evident from the outcomes of the checklist provided by SEBI. Compliance is the necessity in Indian environment but the purpose should not be just to complete the paper work. However, recent cases of Tata and Infosys are examples that irrespective of having best norms of the world, there is something in which India is lagging which made us fail on effective decision making. Therefore, empirical studies are required to understand what works in Indian system so that proper and effective norms are implemented otherwise it would remain a box ticking exercise.

## **OBJECTIVES OF THE STUDY**

- To identify the key determinants of ERC.
- To examine the effect of Default Risk on the determinants of Earnings Response Coefficient.
- To examine the role of corporate governance in mitigating default risk.
- To examine the impact of Corporate Governance on Corporate Frauds (if any).

## **RESEARCH HYPOTHESES**

With the purpose of giving specific direction to investigation and based on the understanding of the subject from the available literature and research objectives, this study formulated the hypothesis and later tested with the data collected using appropriate statistical tools. Justification of these testable hypotheses is derived from previous studies discussed in details in the literature review sections. The formulated hypotheses were used as a basis for analysis and conclusion on the relationship among corporate governance variables, default risk factors and earnings response coefficient. To proffer useful answers to the research questions and realize the study objectives, the following hypotheses are stated:

H1: Holding other things sustained, default risk has a significant negative association with ERC.

H2: Holding other things persistent, effect of default risk on ERC diminishes in magnitude as audit quality increases.

H3: Holding other things persistent, the negative effects of DR on ERC diminish in magnitude as audit committee expertise increases.

H4: Holding other things constant, the negative effects of DR on ERC diminish in Magnitude

as audit committee interdependence increases.

H5: Holding other things constant, effects of DR on ERC diminish in Magnitude as board independence increases.

H6: Holding other things constant, the negative effects of DR on ERC diminish in magnitude as board shareholding increases.

## **RESEARCH DESIGN**

This research involves quantitative research techniques using panel data in the sense that it aims to draw out conclusions from the financial data gathered, summarized, and processed. The quantitative research instrument is developed from the models that other researchers had developed. This research is exploratory and explanatory in context and design.

**Sources of Data:** This study collected data from secondary sources. The required data related to financial statement and corporate governance variables were extracted from annual reports of the companies from their official websites and NIFTY 50 (National Stock Exchange) website. Other sources were journals; newspapers articles; books; reports provided by SEBI, RBI, MCA, and OECD etc.

**Population / Universe:** Firms listed on NIFTY 50 Sensex during 2012-2017.

**Sampling Technique:** Non-probability sampling (purposive sampling)

**Sample Size:** Total data was consisted of 300 observations (50 listed companies for six years). Panel data increases the sample size. The determination of sample size is the result of a compromise between the need for a large sample to obtain statistically significant results and the need for detailed information on default risk small sample. Thus, the final sample

was constituted of 300 observations.

50 companies\*6 years= 300 observations

**Structure of the Sample used in the study**

Number of annual observations per company	06
Number of companies	50
Number of observations	300

**Statistical tools and techniques used:** Panel data regression model & correlation

**Software used for data analysis:** MS-Excel and SPSS version 20.

**MODEL SPECIFICATION**

$$UR = ERC * (UX/P)$$

Thus, if ERC is determined by the n variables  $X_1, X_2 \dots X_n$ , then

$$UR = (X_1, X_2 \dots X_n) * (UX/P)$$

In this manner the coefficient of  $X_i * (UX/P)$  in a back slide of UR on  $\{X_i * (UX/P)\}$  can show the effect of  $X_i$  on ERC. Be that as it may, UX is probably going to be liable to huge estimation mistakes and along these lines, rather than an immediate relapse, switch relapse ought to be used as the technique for estimation (Collins and Kothari (1989) and the later research, e.g., That is, the impact of  $\{X_i\}$  is tried by a relapse in light of:

$$UX/P = [1/ (X_1, X_2, \dots ,X_n)]/UR$$

That is, the regression equation

$$UX/P = a_0 + a_1UR + a_2UR*X_1 + a_3UR*X_2 + \dots + a_{n+1}UR*X_n + \varepsilon$$

It is critical to take note of that in this shape, the test on the coefficients truly relates to the retrogressive of the ERC, the Return Response Coefficient (RRC). Appropriately, if the coefficient on UR\* Xi is seen to be gigantic and negative, that ought to show that Xi is decidedly identified with ERC.

To test the piece of beta, improvement, salary consistency and size, the back slide is continued running with just those components as the {Xi}. These factors at that point turn into the controls in the preliminary of the theories. Theory 1, the impact of default chance, is finished by including an extent of default risk to the set {Xi} and assessing the accompanying relapse condition:

$$UX/P = a_0 + a_1UR + a_2UR*DER + a_3UR*BETA + a_4UR*GROWTH + a_5UR*EPERS + a_6UR*SIZE + \varepsilon$$

Accordingly  $(a_2) \hat{>} 0$  also, would exhibit that default risk contrarily influences ERC while controlling for beta, improvement, wage productivity and size. Theories 2 to 6 are attempted by additionally including, therefore, the correspondence of UR\*DER with the extent of the relevant corporate Governance framework. Along these lines a backslide in the edge

$$UX/P = a_0 + a_1UR + a_2UR*DER + a_3UR*DER*CORPORATEGOVERNANCE + a_4UR*BETA + a_5UR*GROWTH + a_6UR*EPERS + a_7UR*SIZE + \varepsilon$$

Is assessed and  $a_3 < 0$  and basic would show that the corporate Governance variable mitigates the effect of default chance on ERC.

This research relies upon firm-specific accounting and market data for a period from 2012 to 2017. Given the for the most part short time span for which sensible data is available, time arrangement research (which takes after an organization's change after some time) isn't doable for this research. Also, Collins and Kothari (1989) suggest that cross-sectional research is more suitable for an ERC think about in light of the fact that the ERC differs cross-sectionally withholding period return interims. Likewise, Easton and Harris (1991) propose that because of the variety of the ERC crosswise over eras, cross-sectional, as opposed to time arrangement investigation is more legitimate. The data for the individual associations are thus joined to lead tests both on a pooled explanation behind the whole multiyear time length (2002-2007) and on a well ordered introduce.

## **FINDINGS OF THE STUDY**

This research looks at the effect of corporate Governance on the default risk and ERC while controlling for the setup determinants of ERC — beta, growth, earnings persistence and size. Aim of undertaking this research was to test whether CG mitigates the effect of DR on ERC while controlling for established determinants of ERC.

- Using regression this study confirms that Beta is negatively related to ERC whereas, its other determinants such as growth, earnings persistence & size are positively related to ERC.
- Default risk was found to be negatively related to ERC hence confirming that beta is only a partial measure of risk pertinent to ERC.
- CG as indicated by audit quality, audit committee expertise, audit committee independence and board independence, board shareholding mitigates the negative effect of DR on ERC.

- Significant correlation was found among some pairs of several variables. Highest correlation occurs between board independence and audit committee independence. This is to be expected as AC is a subset of the full board.
- The correlation coefficient for board independence with board shareholding was also found to be significantly high.
- Negative relationship between DER (debt-equity-ratio) and Audit Quality, AC expertise and board independence suggest that a significant relationship exists between DR and CG.
- The outcomes likewise give confirm that default risk in emerging economies has a significant negative effect on ERC. Along these lines, the results support Hypothesis 1. These finding are consistent with those of prior studies conducted in developed economies and developing markets.

## **RECOMMENDATIONS**

Based on the analysis and findings of the present study the following recommendations are given:

- Corporate governance norms are becoming stricter day by day in India but there is a need to analyze these norms and rules scientifically before implementing it.
- This study suggests the need for robust research in the field of corporate governance research that would support policy formulation in order to make the corporate governance reforms more effective for the Indian conditions.
- Efforts should be made to make improvement in the quality of corporate governance attributes.

- There is a need to inculcate and adopt good corporate governance practices.

## **CONTRIBUTIONS OF THE STUDY**

- This study contributes to the body of knowledge and filling the gap by illuminating the significant link between some corporate governance measures, default risk and earnings response coefficient in Indian context.
- This study contributes to the literature on the factors that improve the debt management and its association with corporate governance.
- The findings may be useful for financial managers, investors, financial management consultants, and other stakeholders in order to ensure soundness in the management system of the firms.
- This study provides good opportunity for academics and practitioners to understand the role of corporate governance principles for economies especially transiting economies like India. It focuses on Indian firms while very limited research has been conducted recently. This study validates the findings of previous authors by testing the relationships between corporate governance attributes and audit committee characteristics. Thus, this study adds substance to the existing theory developed by previous authors. The usefulness of boards in India will therefore have a significant impact on the state of corporate governance at firm level and also in the country. Thereby, alleviating bankruptcy and lessen the financial scams.
- In addition to providing support to existing theories, this study has empirically contributed knowledge. From these findings, firms should understand that improving good corporate governance is a significant tool to achieve financial sustainability,

good financial performance and market value of the firm.

- The findings of the study would give insights and add on empirical evidence in the areas of corporate governance, default risk and earnings response coefficient for future academic research. Therefore, this study provides a direction for further studies in this and related directions.
- It will help policy makers to design proper strategies regarding how corporate governance could be followed and regulatory authorities for enacting laws by evaluating the current governance practices and to make the appropriate amendments, if required.

## **DIRECTIONS FOR FUTURE RESEARCH**

No research in any subject is complete in itself. Several extensions to this study are possible. This study might be extended in various aspects:

- The time period was six years from 2012-2017. In order to be more accurate, this time period might be extended more than 6 years. Also, other index consisting of large number of companies can be included to form large sample size which will help in making more generalized conclusions.
- Future research could use primary data along with secondary data to have more reliable results.
- Future studies could explore these effects in small, medium and public sector companies.
- Future studies could include and analyze other corporate governance variables along with more control variables to study their impact on default risk and earnings response coefficient.