Relationship between Corporate Governance and Firm Valuation in Nepal

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Abstract: In the context of growing corporate financial scandals and misconduct, the purpose of this study is to examine the relationship between various internal corporate governance measures and corporate valuation (Tobin Q) in Nepal. The study is descriptive and analytical in nature. Causal comparative research design especially multivariate regression models have been used. The method of estimation is Ordinary Least Square (OLS). Board size and independence, CEO duality and existence of audit committee as corporate governance variables and Tobin Q as performance variable for the valuation measure of 54 listed Nepalese firms over the period 2018/19 and 2019/20 have been used in the analysis. Result supports governance performance hypothesis. It shows a significant positive relationship between board size and firm value (Tobin Q). The study establishes the positive impact of CEO duality on firm valuation and concludes that independent directors are unable to play role in value creation. Finally, the role of audit committee is not significant in creating value. These results provide insights on the current regulatory provisions. The findings raise the questions over the role of our expert directors and audit committee. The need of larger board size has been established. Therefore, current regulations with respect to board size and independence; and CEO duality and audit committee need to be reassessed. Though few studies have examined role of corporate governance measures in corporate performance and valuation in Nepalese context, this study is new in its type in investigating the governance performance relationship taking recent dataset of Tobin Q as valuation measure. However, the study is based on limited internal corporate governance variables from a small sample size for only two year's data set. Hence, generalization should be made cautiously.

Keywords: Corporate governance, Tobin Q, board size and independence, CEO duality and audit committee.

1. General background

Corporate governance, as the system by which business corporations are operated, regulated, controlled and monitored, is about promoting corporate fairness, transparency and accountability (World Bank, 1999). It includes the relationships among stakeholders and is the set of processes, customs, policies, laws and institutions affecting the way a corporation (company) is directed, administered or controlled. The relationship between corporate governance and performance has been an area of research interest in the financial literature. It is important not only in formulating corporate plans but also for regulations as well. It is widely believed that good corporate governance helps in improving the value of the firm. Several literatures confirmed the direct relationship between two in both developing and developed countries (Black 2001: Klapper and Love 2004: Gompers et al. 2003: and Beiner and Schmid (2005)). However, there are differences in the nature, direction, magnitude and processes of operation of the relationship between developed and developing countries due to differences in their economic, social, regulatory framework and market behavior (Hermalin and Weisbach 1991:, Ahunwan 2003). It is important especially for developing countries to incorporate these differences into the analysis for an appropriate understanding of the role of corporate governance in influencing the corporate value and formulating regulatory framework. However, these differences have not been systematically discussed in the existing literature based on developing country like Nepal.

2. Literature review and research questions

Cadbury (1992) defines corporate governance as the mechanism used to discipline organizations. However, different people from different fields have come up with different interpretations that basically reflect their own perspectives. It indicates the policies and procedures applied by firms to attain fixed sets of objectives, corporate missions and visions with regard to stockholders, employees, customers, suppliers and different regulatory agencies and the community. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and others, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance (OECD 2004). Alternatively, it deals with the ways in which funds suppliers assure themselves getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply it in bad projects? How do suppliers of finance control managers? There are internal and external ways of

achieving this. Morin and Jarrell (2001) argue that corporate governance is a framework that controls and safeguards the interest of the relevant players in the market. Perfect corporate governance can strengthen intra-company control and can reduce opportunistic behaviors and lower the asymmetry of information, so it has a positive impact on the high quality of disclosed information (Li and Qi, 2008). Obviously good corporate governance practices are more essential in determining the cost of capital.

Corporate governance codes that serve as templates of achieving value to the shareholders have been developed by OECD and several countries. South Africa: King Report II, 2004, Brazil: CVM Code, 2003, UK: Combined Code, 2003 and Cadbury Code, 1992, France: Bouton Report, 2002, Russia: CG Code, 2002, Singapore: CG Committee, 2001, USA: SARBANES-OXLEY ACT 2002 and Commonwealth countries: Corporate Governance Guidelines (1999) are few names. In the context of Nepal, still there is no unified corporate governance code of conduct. However, Nepal Rastra Bank has recently issued Unified Directives, 2078 which laid down some rules for governance to banking and financial sectors that come under the jurisdiction of NRB. The voices for promoting corporate governance have been increasing. It is believed that good corporate governance reduces risk, stimulates performance, and improves access to capital markets, enhances the marketability of goods and services, improves leadership, demonstrates transparency and social accountability (CIPE, 2004). Corporate governance, as indicated by Gompers, Ishii, and Metrick (2003), Bebchuk et al. (2005), Cremers and Nair (2005), Brown and Caylor (2006), and Black et al. (2006), is a crucial factor to dictate firm value and performance. Some researchers have examined the relationship between the internal governance mechanisms and valuation and some have focused their studies on exploring the relationship between external governance mechanisms and various performance measures. This study also tries to investigate the relationship between internal governance variables and firm valuation. Drobetz et al. (2004) states a positive relationship between governance practice and firm valuation for German public firms and confirms that small board size is generally believed to improve the value of the firm. Eisenberg, Sundgren, and Wells (1998) report a clear negative relationship between board size and firm value. Lipton and Lorsch (1992) suggest an optimal board size between seven and nine directors. Yermack (1996) finds negative correlation between board size and profitability. Mak and Kusnadi (2005) report that small size boards are positively related to high firm value. Sanda et al. (2005) report that value of the firm is positively correlated with small, as opposed to large boards.

Table 1: Empirical evidences on the effect of board size on valuation

This table reports the findings of previous studies that examine the impact of board size on valuation. * denotes *Statistical significance at the 10% level or better.*

Author (year)	Sample (period)	Observations	Model	Tobin Q
Cheng (2008)	350 US firms 1984-1991	2,199	OLS	-*
Wintoki (2007)	>6,000 US firms 1991-2003	>16,000	OLS/FE/GMM	
Beiner et al. (2006)	109 Swiss firms 2002	109	OLS/IV	+*/+*
Adams & Mehran (2005)	35 US firms 1986-1999	472	FE/IV	+*/+
Lasfer (2004)	1,424 UK firms 1990-91/ 1996-97	1,798	OLS	-*
Loderer & Peyer (2002)	169 Swiss frims1980-1995	330	OLS	-*
Eisenberg et al. (1998)	879, Finish firms 1992-1994	879	OLS/IV	-*
Conyon & Peck (1998)	481 UK firms 1992-1995	1924	GMM	-*
Yermack (1996)	452 US firms 1984-1991	3,400	OLS/FE	-*/-*

Above table clearly shows the mixed relationship between board size and valuation. Another concern is about the relationship between board independence and performance. Following table shows the previous findings.

Table 2: Empirical evidences on board independence and Tobin Q

Study	Sample size	Focus of the study	Key findings
Bhagat and Black (2002)	934 large U.S firms	Board independence and performance	*No linkage between the proportion of outside directors and Tobin's Q,
Hermalin and Weisbach (1991)		Outside directors and Tobin Q	* No association between the proportion of outside directors and Tobin's Q.
Agarwal and Knoeber (1996)	383 large US firms, Forbes 800 (1987)	Performance and Control	*Tobin's Q decreases significantly with board outsiders, leverage, and corporate control activity. *Presence of non-executive directors is negatively linked with firm value.

Table 3: Empirical evidences on CEO duality and performance

Study	Sample size	Focus of the study	Key findings
Song et al. (2006)	3,589 Chinese firms	CEO duality and performance i.e. ROE, ROA, Tobin Q	*Duality firms outperform non-duality firms when state ownership is high and Non-duality firms outperform duality firms when state ownership is low.
Bai et al. (2004)	2,905 firms	CEO duality and Valuation as Tobin Q	*Non-duality firms outperform duality firms.
Dalton et al. (1999)	228 firms	CEO duality and Market and accounting measures	*No significant relationship
Brickley et al. (1997)	661 large US firms	CEO duality and ROI, stock returns	*Duality is an optimal leadership structure. *The cost of separation is larger.
Baliga et al. (1996)	181 industrial firms1986-91	CEO duality and ROE, Stock returns	*Market is indifferent to changes in duality structure.
Rechner and Dalton (1991)	141firms1978-1983	CEO duality and ROI, profit margin	*Non-duality firms outperform duality firms.
Donaldson and Davis (1991)	321 firms	CEO duality ,ROE and Stock returns	*Duality firms outperform non-duality firms.

Majority of the literatures shows the negative relationship between duality and performance. However, the table shows the mixed results. Based on the literature discussed above, this research seeks to answer the questions like: is there a link between corporate governance and company performance? Does a good governance practice boost value for Nepalese listed companies? Specifically, do board size and independence, CEO duality and audit committee affect value of Nepalese firms? It aims to assess the status of governance practice and links governance to the valuation. In Nepalese context, a study conducted by Ranjana Rijal and Surya Bahadur G.C. (2010) reveals stronger corporate governance practices leads to lower financial leverage and lower agency conflicts. However, the number of corporate governance studies in Nepalese context is very limited. Hence, this study intends to highlight on the impact of selected corporate governance measures on the firm valuation in Nepalese context. The study is based on the following theoretical framework.

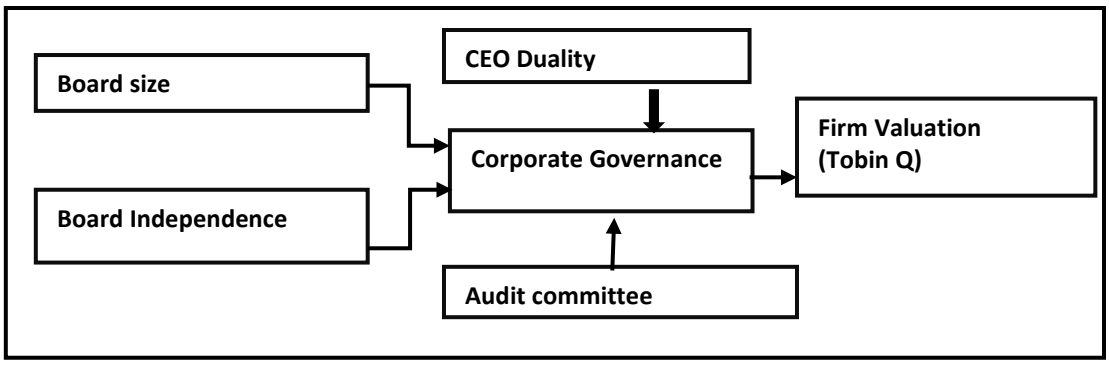

Figure 1: Theoretical framework

The Figure 1 assumes that corporate governance is affected by CEO duality, board independence and size and existence of audit committee. The literature supports the proposition that presence of more independent directors on the board leads to better governance, which in turn would positively impact the performance. Likewise, presence of audit committee for effective corporate governance can have impact on performance. It has been shown in the figure that firm's performance is measured through Tobin Q. The main objective of this study is to analyze and empirically investigate the relationship between corporate governance and value of the firm in Nepal. Specifically to examine the relationship between corporate governance measures (board size, board independence, CEO duality and audit committee) and value of the firm, to identify which governance measures have more influence on the firm valuation in Nepal and to discuss the implications of the findings and make policy recommendations.

3. Hypotheses

H_1: The size of the board is negatively related to value of the firm, **H_2:** Independent directors have a positive relationship with value of the firm, **H_3:** The separation of CEO and Board chair positions has a positive relationship with value of the firm, H4: The audit committee has a positive relationship with value of the firm.

4. Data and methodology

The study first measures the governance variables as explanatory variables and then firms' value (Tobin Q) as dependent variable. Finally, it links governance and valuation. This study uses descriptive and causal comparative research designs to deal the issues raised. Selected corporate governance variables and Tobin Q of 54 firms with a total of 108 observations for the year 2018/19 and 2019/20 have been used for testing the relationship. The required data come from annual trading report of Nepal stock exchange, SEBO/N, banking and financial statistics publication of the Nepal Rastra Bank and annual reports of the firms. The sample includes 12 commercial banks, 4 manufacturing and processing companies, 3 hotels, 3 hydropower, 2 trading, 15 insurance, 6 finance companies and 9 development banks. The overall sample includes 23.28 percent of the population. Since the stock market trading and disclosures practice of financial sector is dominating in Nepal, the sample is also dominated by financial firms. Statistical tools like average, standard deviation, correlation, regressions and t- tests, F-test have been used to analyze the data. Data are processed through the Statistical Packages for Social Science (SPSS) version 13.0. The method of estimation is Ordinary Least Squares (OLS).

4.1 The empirical model

In order to test the hypotheses, the econometric model used in the study (which is in line with what is mostly found in the literature) is specified as:

$$Q_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 BIND_{it} + \beta_3 CEOD_{it} + \beta_4 BAC_{it} + \varepsilon_{it} \quad ----------(1)$$

Where, Q: is the dependent variable (Tobin Q); BS: Board size; BIND: Board independence measured as the proportion of independent directors in the board; CEOD; CEO duality which means dual role of a same person as Chief executive Officer and BOD member; BAC Board audit committee are the explanatory variables; β_0 is constant term $\beta_1, \beta_2, \beta_{3,} and \beta_4$ are coefficients of explanatory variables; ε_t is the error term assumed to have zero mean and independent across time period. First, descriptive statistics of the variables and then correlation analysis will be presented. Finally, various specifications of regression models are used to show the combined effects of selected independent variables on firms' value. F test is used to see the significance of the model. Multicollinearity test which IS carried out to assess the degree of correlation among the explanatory variables. Besides, VIF values will be looked into.

As used by Himmelberg et al (1999), Palia (2001) and Bhagat et al. (2002), Tobin's Q as the ratio of the market value of assets (equity and debt) to the replacement value of assets will be used as a main dependent variable. It is defined as market value of assets divided by book value of assets where market value of assets is the sum of market value of equity plus book value of debts. Market equity indicates to the total market value of firm's common stock outstanding (in million Rs), calculated as year-end market price per share multiplied by the number of common stock outstanding. Board size is measured as the total numbers of directors in the board of the company. BIND is measured as the proportion of independent directors on the board**.** CEOD takes the value 0 if same person occupies the post of the chairman and the chief executive officer otherwise 1. BAC takes the value 1 if there is audit committee otherwise 0.

5. Presentation and analysis of data

5.1 Descriptive statistics

The descriptive statistics of all variables have been shown in Table 4 which reveals that the value of Tobin Q of the sampled firms ranges from minimum 0.260 to maximum 17.350 with mean value 2.057 and standard deviation of 2.145 respectively. This wider fluctuation indicates that the sample includes both high and low value firms. The average board size is7.38 with a standard deviation of 1.483 and it ranges from 5 to 11 in members. The average proportion of independent directors on the board is 0.052 with standard deviation 0.068. The proportion of independent directors ranges from zero to 18.2 percent only. This indicates that Nepalese companies appoint minimum number of independent directors just to fulfill the policy guidelines. The result also indicates that 68% firms have separate persons occupying the post of the chief executive and the board chair, while 32% have the same person occupying the two posts. A majority of the firms (88%) have audit committee.

Table 4: Descriptive statistics

This table provides the descriptive statistics of all governance variables and performance variables.. The sample includes 54 firms listed in Nepal Stock Exchange (NEPSE).

Variables	**Tobin Q**	**BS**	**BIND**	**CEOD**	**BAC**
Mean	2.057	7.380	0.052	0.676	0.880
St. Dev.	2.145	1.483	0.068	0.470	0.327
Minimum	0.260	5.000	0.000	0.000	0.000
Maximum	17.350	11.000	0.182	1.000	1.000

5.2 Correlation analysis

This study uses several corporate governance variables that can have influence on valuation. The study considers Tobin Q as performance variable. Therefore, it is reasonable to expect some sort of relationship among the pairs of variables used in the study. This section exhibits the relationship among pairs of variables. Specifically, Pearson bivariate correlation coefficients with statistical significance are summarized in Table 5.

Table 5: Correlation matrix

This table shows the bivariate Pearson Correlation Coefficients between different pairs of variables.. Significance at the 5 percent and 1 percent levels are indicated by * and ** respectively.

Variables	Tobin Q	BS	BIND	CEOD	BAC
Tobin Q	1.000				
BS	0.264**	1.000			
BIND	-0.083	0.147	1.000		
CEOD	-0.242*	-0.117	-0.081	1.000	
BAC	-0.059	-0.040	-0.009	0.352**	1.000

Table 5 depicts the magnitude and direction of the correlation coefficients between variables. As table shows, Tobin Q is positively related with board size. The relationship is statistically significant at 1 percent level which does not support the priori expectation which is interesting result. Tobin Q has a negative relationship with independent directors and positive with CEO duality which is against the priori. The significant negative coefficient between CEOD dummy and Tobin Q indicates that valuation is positively affected by CEO duality (As value 1 has been assigned to non-duality and 0 to duality). However, no relationship is noticed between the audit committee and firm value.

The above table also reveals stronger positive relationship between value and board size as suggested by the highest coefficient of 0.264. Out of correlation coefficients among the explanatory variables, the highest correlation of 0.352 is observed between CEOD and BAC. Out of total 10 pairs of correlation coefficients, only 3 pairs (2 pairs positively and 1 pair negatively) are found significant. Out of 6 pairs of explanatory variables, more than 83 percent pairs are uncorrelated. In conclusion, the above correlation matrix shows that firms with larger board size with CEO duality tend to be more valuable.

5.3 Regression analysis

In order to test the statistical significance of the result, various regression models have also been specified. These regression models further confirm the relationship between dependent and explanatory variables. Hence, this section depicts the regression results of the different models and analyses the relationship of Tobin Q, with the four corporate governance variables for cross sectional data set of Nepalese listed firms. During these courses, the study also checks the validity of the model through statistical test of significance such as t-test, F-test, coefficient of determination (R^2) and other checks. In an attempt to test whether selected corporate governance variables capture the variation in firm value as measured by Tobin Q, simple and multiple regressions have been performed. The parameters estimates of different specifications of the model have been shown in Table 6 where specifications I and II represents simple linear regression result of Tobin Q on board size and CEO duality respectively. Finally, specification III shows the multiple regression results where Tobin Q has been regressed on board size, board independence, CEO duality and audit committee.

Table 6: Regression Results of Board size, Board independence, CEO duality and Audit committee on Tobin Q for 54 sample firms during 2018/19 through 2019/20 with 108 observations.

$$Q_{it} = \beta_0 + \beta_1 BS_{it} + \beta_2 BIND_{it} + \beta_3 CEOD_{it} + \beta_4 BAC_{it} + \varepsilon_t$$

This table shows regression results of Tobin Q on explanatory variables based on pooled cross sectional data of 54 firms listed in NEPSE with 108 observations for the year 2018/19 and 2019/20. Both dependent variable and independent variables are measured at mid-July end of year t. The figures in the parentheses are t-values and (*) and (**) indicates that the result is significant at 5 and 1 percent level. P-values are presented below the t-value in bold and italicized form.

Model	Intercept	BS	BIND	CEOD	BAC	F	R^2
I	-.759 (-.744) ***.458***	.264 (2.816**) ***.006***				7.928**	.070
II	2.803 (7.930**) ***.000***			-.242 (-2.569*) ***.012***		6.602*	.059
III	.065 (0.056) ***.956***	.258 (2.771**) ***.007***	-.140 (-1.505) ***.135***	-.235 (-2.376*) ***.019***	. 032 (.329) ***.743***	4.006**	.135

Table 6 shows the results of the simple and multiple regressions. In specification I, the simple regression result shows a positive relationship between Tobin Q and board size. The coefficient of board size is significant at 1 percent level. This relationship is confirmed to that of observed in the correlation analysis. The F-statistics, 7.928 is statistically significant at 1 percent level. Hence, the first hypothesis that size of the board is negatively related to value of the firm cannot be accepted. This finding supports the findings by Beiner et al. (2006), Zahra and Pearce (1989), Kiel and Nicholson (2003), Adams and Mehran (2005), Dalton et al. (1999) but contradicts with the findings of Yermack (1996), Eisenberg et al. (1998) and Singh and Davidson (2003). The explanatory power of the model is 7 percent. In Specification II, the coefficient of CEO duality on Tobin Q is negative and significant at 5 percent level which confirms the result of correlation analysis. This ultimately indicates that CEO duality is useful in value creation. This surprising finding is also against the priori hypothesis that the separation of CEO and Board chair positions has a positive relationship with value of the firm. Similarly, in equation III, where all selected variables have been included in the model provides important insights into the regression results. Out of four governance variables, board size and CEO duality are found important in valuation. As shown by insignificant coefficients, board independence and audit committee have no role in valuation. The sign of board size is constantly positive and its coefficient is significant. Similarly the coefficient of CEO duality remains negative and maintains the previous relationship. This finding supports the previous findings of Donaldson and Davis (1991), Brickley et al. (1997) and contradicts the findings of Rechner and Dalton (1991), Bai et al. (2004). The variance inflation factors (VIFs) of all explanatory variables in specification III are 1.103, 1.103, 1.103, and 1.141 respectively for board size, board independence, CEO duality and audit committee. These values are less than 10. Hence, it can be viewed that the model is free from multicollinearity. Taking overall, the explanatory powers of specifications III is about 14 percent. The coefficient of board size is slightly higher than that of CEO duality which indicates that board size has more influence in valuation.

6. Conclusions

This study examined the relationship between corporate governance mechanisms and value of the firm. The study supports the governance performance relations. The result reveals a positive and significant relationship between Tobin Q and board size which is in support of the resource dependency theory of corporate governance. This supports the findings by Adams and Mehran (2005), Beiner et al. (2006), Zahra and Pearce (1989), Kiel and Nicholson (2003), and Dalton et al. (1999) but contradicts with the findings of Yermack (1996), Eisenberg et al. (1998) and Singh and Davidson (2003). Similarly, this study establishes the positive impact of CEO duality on valuation and concludes that duality firms outperform non duality firms which supports the previous findings of Donaldson and Davis (1991), Brickley et al. (1997) and contradicts the findings of Rechner and Dalton (1991), Bai et al. (2004), Brown and Caylor (2004) and Yermack (1996) etc. The study also concludes that independent directors have no role in value creation which supports the Hermalin and Weisbach (1991), Bhagat and Black (2002) findings. Finally, audit committee is not significant in value creation. These results have the implication that regulatory agencies should encourage firms to increase reasonable board size. Unlike the findings in developed countries, the results show no significant evidence to support the idea that outside

director help promote firm performance. This suggests the need for the regulatory authorities to reassess the procedures for the appointment of outside directors. Corporate governance should not be practiced just to fulfill the regulations. Similarly, the findings on the audit committee's role to create value suggest that the regulatory bodies should make new provisions about the chairman of the audit committee. Therefore, re-evaluation of these requirements with respect to board independence and duality is needed.

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