

Effect of Board Size and Promoter Ownership on Firm Value: A Study of Indian Companies

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Abstract: The purpose of this paper is to examine the effect of corporate board size and promoter ownership on firm value for selected Indian companies. The study analyses the corporate governance structure of 100 Indian firms listed on the Bombay Stock Exchange using multiple regression analysis. The empirical findings showed a positive relationship of board size and promoter ownership with firm value. The research has been limited to some selected Indian companies, with focus only on board size and promoter ownership as predictor variables.

Keywords: board size, promoter ownership, corporate governance.

1. INTRODUCTION

With the recent spate of corporate scandals and the subsequent interest in corporate governance, a plethora of corporate governance norms and standards have sprouted around the globe. The relation between characteristics of corporate boards and firm performance continues to be a fundamental issue in the corporate governance literature.

In recent years the attention and interest in corporate governance has grown exponentially especially with the major corporate collapses (e.g., Enron, WorldCom). The need for strong governance is evidenced by the various reforms and standards developed not only at the country level, but also at an international level. Corporate governance research has focused on developed economies (Daily, Dalton, & Cannella, 2003). However, limited research exists on the extent to which the corporate governance issues of developed economies are applicable to emerging economies. A major impetus for investigating the corporate governance of emerging economies such as India is the significant growth in the listing of companies from emerging economies on international stock exchanges. This development has been accompanied by a drive within emerging economies to attract more foreign direct investment as a means of promoting a country's long-term economic development. As such the focus on foreign investment development in India has necessitated a more transparent approach to corporate operations.

Considerable amount of research on corporate governance focuses on ownership structure and board characteristics of companies and linking these to their performance.

Corporate boards of directors have the fiduciary duty to ensure that the management acts in the interest of all shareholders. However, there is mounting evidence questioning the ability of boards of directors to mitigate agency problems in corporations. Therefore, many view boards of publicly traded firms to be relatively passive entities, often dominated by the managers whom they are charged with monitoring.

The present study attempts to investigate the effect of two corporate governance parameters on the firm value. The study is based on companies listed on the Bombay Stock Exchange (BSE) for the financial year 2013-2014 establishing a relationship of board size and promoter ownership with firm value.

2. THEORETICAL BACKGROUND AND HYPOTHESIS DEVELOPMENT

BOARD SIZE

Boards are considered as the institutions to mitigate the effects of agency problem existent in the organizations. As boards are considered to be large decision-making groups, size can affect the decision-making process and effectiveness of the board. Ideal size of the board has been an issue of debate over the years. There are extreme variations in board size across countries.

Boards of directors are representatives of the shareholders and other stakeholders of the company. A corporate board is delegated with the task of monitoring the performance, and activities of the top management to ensure that latter acts in the best interests of all the shareholders (Jensen and Meckling, 1976)

Fama (1980) and Fama and Jensen (1983), consider the board to be an important element of corporate governance and acknowledge the role of outside directors as monitors of management and providers of relevant complementary knowledge. According to this view, the 'inside directors/ i.e., the top managers of the corporation, provide valuable information about the corporation's activities, while 'outside directors' contribute both expertise and objectivity in evaluating the managers' decisions, thereby protecting the shareholders' wealth.

There is mixed evidence in the empirical literature linking board size to corporate performance. One group of researchers (Dalton *et al.*, 1998; Pearce & Zahra, 1992) predicts board size to have a positive association with firm performance. Proponents of this view argue that a larger board will have representation of people with diverse backgrounds, who bring knowledge and intellect to the board and thus improve the quality of strategic decisions. Size is thus assumed to be associated with the breadth of perspectives in the planning process.

The other view suggests that larger board would be less effective than smaller boards. As larger boards suffer from the problem of diffusion of responsibility or social loafing, wherein individual members of the board discount the likelihood that others will detect their poor contributions.

	Studies Approving	Studies Disapproving
Board size Having smaller board increases corporate performance	Jensen (1993); Yermack (1996); Eisenberg <i>et al.</i> (1998); Klein (1998); Felo <i>et al.</i> (2003); Uzun <i>et al.</i> (2004); Chiang (2005); Ghosh (2006)	Pfeffer (1972, 1973); Pfeffer and Salancik (1978); Alexander <i>et al.</i> (1993); Beasley (1996); Abbott <i>et al.</i> (2000); Beasley <i>et al.</i> (2000); Beasley and Salterio (2001); Adams and Mehran (2003); Uzun <i>et al.</i> (2004)

Eisenberg *et al.* (1998) examined the relationship between board size and financial performance. The study found a significant negative correlation between board size and profitability in a sample of small and midsize Finnish firms. Finding a board-size effect for a new and different class of firms affects the range of explanations for the board-size effect.

Kathuria and Dash (1999) examines the association between board size and corporate financial performance using data on 504 corporations belonging to 18 industries. The results suggest that the size of the board played an important role in influencing the financial performance of corporations. The analysis shows that the performance improves if the board size increases, but the contribution of an additional board member decreases as the size of the corporation increases. The results, however, fail to indicate any significant role of directors' equity ownership in influencing the performance.

Sarkar (2000) studied the role of large shareholders in monitoring company value from a developing and emerging economy. The study found support for the efficiency of the German/Japanese bank-bank model of governance, the results suggest that lending institutions start monitoring the company effectively once they have substantial equity holdings in the company and that this monitoring is reinforced by the extent of debt holdings by these institutions.

Beasley *et al.* (2000) empirically tests the prediction that the inclusion of larger proportions of outside members on the board of directors significantly reduces the likelihood of financial statement fraud. Results from logit regression analysis of 75 fraud and 75 no-fraud firms indicate that no-fraud firms have boards with significantly higher percentages of outside members than fraud firms; however, the presence of an audit committee does not significantly affect the likelihood of financial statement fraud. Additionally, as outside director ownership in the firm and outside director tenure on the board increase, and as the number of outside directorships in other firms held by outside director's decreases, the likelihood of financial statement fraud decreases.

Abbott *et al.* (2000) examined the role of the audit committee in mitigating the likelihood of fraud, with mixed results. The study extends prior research by replacing audit committee presence with a measure of audit committee independence and activity. This variable is expected to be a less noisy measure of audit committee monitoring because it allows for the possibility of an ineffective mandatory committee. The study found that firms with audit committees which are composed of independent directors and which meet at least twice per year are less likely to be sanctioned for fraudulent or misleading reporting.

Klein (2002) examined whether audit committee and board characteristics are related to earning management by the firm. A negative relation was found between audit committee independence and abnormal accruals. These results suggest that boards structured to be more independent of the CEO are more effective in monitoring the corporate financial accounting process.

Dwivedi and Jain (2005) investigated the relationship between corporate governance and firm performance. The sample of 340 large listed Indian firms for the period 1997-2001 spread across 24 industry groups. A simultaneous equation regression model for Tobin's Q, as a measure of firm performance was used. The analysis provides evidence that a higher proportion of foreign shareholding was associated with increase in market value of the firm. A Weak positive association was also found between board size and firm value.

Erickson (2005) examined the relation between board composition and firm value using publicly traded Canadian firms over the 1993-1997 periods. The results indicate that greater board independence does not have a positive influence on firm value and that poorly performing firms increase the proportion of outside directors in the subsequent period. The findings suggest that sound governance practices can enhance firm values in the countries with high ownership concentration even in the presence of strong minority shareholder protection.

Ghosh (2006) examined the association between financial performance and boards of non financial firms. Using data on 127 listed manufacturing firms in India for 2003 the findings indicate that, after controlling for various firm-specific factors, larger boards tend to have a dampening influence on firm performance, judged in terms of either accounting or market-based measures of performance. In terms of policy implications, the analysis suggests that compensation of the CEO has a significant effect on the performance of the firm

Boone et al (2007) found that (i) board size and independence increase as firms grow and diversify over time (ii) Board size – but not board independence reflects a trade-off between the firm specific benefits and costs of monitoring. (iii) Board independence was negatively related to the manager's influence and positively related to constraints on that influence.

Cheng (2008) studied that firms with larger boards have lower variability of corporate performance. The results indicate that board size was negatively associated with the variability of monthly stock returns, annual accounting, ROA. The results was consistent with the view that it takes more compromises for a larger board to reach at consensus , and consequently decision of larger boards are less extreme, leading to less variable corporate performance.

Link et al (2008) examined the development and determinants of board structure using a sample of 1000 firms from 1990 to 2004. The study found that corporate boards become smaller and more independent in 1990, although these trends do not apply equally to all firms. Small firms show a more dramatic increase in board independence board reversing the trend toward smaller board.

Uzun et al. (2004) examined how various characteristics of the board of directors and other governance features affected the occurrence of U.S. corporate fraud in the 1978–2001 periods. The findings suggest that board composition and the structure of a board's oversight committees are significantly correlated with the incidence of corporate fraud. In the sample, as the number of independent outside directors increased on a board and in the board's audit and compensation committees, the likelihood of corporate wrong doing decreased.

The above discussion clearly lays down a platform to propose that board size may have positive or negative association with firm value. The vast literature on the impact of board size on firm performance, predominately foresees that board size is either negatively or positively associated with firm performance.

3. PROMOTER OWNERSHIP AND FIRM PERFORMANCE

Promoter's, in general sense, is/are a person or a group of persons, who is/are involved in the incorporation and organization of a corporation. Promoters are an important part of companies in Indian business context, as most of the companies are of family origin. However, they do not have statutory recognition in the Indian Companies Act, 1956 as the term "Promoter" is not defined therein. The term, however, finds a place in SEBI's Disclosure and Investor Protection Guidelines, 2000 (DIP Guidelines) and Substantial Acquisition of Shares and Takeover Regulations, 1997 (Takeover Code). According to these SEBI regulations, "Promoter or Promoter Group" exercise sufficient control over the company by virtue of their shareholding and management rights.

Ownership:

Demsetz and Villalonga (1985) investigated the relation between the ownership structure and the performance of corporations if ownership is made multi-dimensional and also is treated as an endogenous variable. The sample used in this study is a 223-firm random subsample of the sample in the original Demsetz and Lehn study for the period 1976–1980. The study found no statistically significant relation between ownership structure and firm performance. This finding was consistent with the views that diffuse ownership, while it may exacerbate some agency problems, also yields compensating advantages that generally offset such problems. Consequently, for data that reflect market-mediated ownership structures, no systematic relation between ownership structure and firm performance is to be expected.

Demsetz and Lehn (1985) studied the structure of corporate ownership varies systematically in ways that are consistent with value maximization. The sample consists of 511 firms from major sectors of the U.S. economy, including regulated utilities and financial institutions. Ordinary least Squares (OLS) regression was used. The study showed no significant relationship between ownership concentration and accounting profit rate, and especially no significant positive relationship.

Cho, M.-H. (1998) examined the relation among ownership structure, investment, and corporate value, focusing on whether ownership structure affects investment. The final sample contains 326 firms. Ordinary least squares regression results suggest that ownership structure affects investment and, therefore, corporate value. However, simultaneous regression results indicate that the endogeneity of ownership may affect these inferences, suggesting that investment affects corporate value which, in turn, affects ownership structure. The evidence showed that corporate value affects ownership structure, but not vice versa. These findings raise questions regarding the assumption that ownership structure is exogenously determined, and bring into question the results in studies that treat ownership structure as exogenous.

La Porta et al (1999) examined laws governing investor protection, the quality of enforcement of laws, and ownership concentration in 49 countries around the world. The findings showed that common law countries give both shareholder and creditors the strongest protection, and French civil-law countries the weakest protection. German civil-law country and Scandinavian countries generally fall in the middle. The study found a strong negative correlation between concentration of ownership, as measured by the combined stake of three largest shareholders, and the quality of legal protection of investor.

Khanna and Palepu (2000) analyzed the performance of affiliates of diversified Indian business groups relative to unaffiliated firms. The study found that Univariate comparisons show that firms affiliated with the most diversified business groups outperform unaffiliated firms using Tobin's q as a performance measure. univariate comparisons also suggest a quadratic relationship between firm performance (using ROA and Tobin's q measures) and affiliated group diversification. Multivariate regression analysis (using ROA and Tobin's q measures) reveals that, as group diversification increases, the performance of group-affiliates first declines relative to that of unaffiliated firms, until the group reaches a threshold diversification level. Beyond this threshold, marginal increases in group diversification result in incremental performance improvements

Claessens et al. (2002) studied the incentive and entrenchment effects of large ownership. The data for 1,301 publicly traded corporations in eight East Asian economies, the study found that firm value increases with the cash flow ownership of largest shareholder, consistent with a positive incentive effect. But firm value falls when the control rights of largest shareholder exceed its cash flow ownership, consistent with entrenchment effect.

Selarka (2005) examined the interaction between the ownership structure and firm value. The study found a significant curvilinear relationship between the firm value and the fraction of voting rights owned by insiders. The curve slope downward until insider ownership reaches approximately between 45 percent and 63 percent, then slopes upward. Empirical results on ownership concentration by minority block holders do not support the monitoring hypothesis of these investors. Furthermore, the coordinated behaviour of the largest two minority block holders has an increasing (decreasing) impact on firm value when the collective control is located in the lower (higher) range. The coordination problem worsens if the largest two are private corporate bodies.

Malik and Nehra (2014) studied the new expectations and key challenges for the governance practices to mitigate the conflicts between the shareholders in the wake of corporate governance reforms. The majority of the findings from the review showed that the various board attributes are significantly (whether positive or negative) associated with the performance. However, board provenience and the board interlocks variables are least studied variables in the review but these two can make significant contribution to the existing literature if studied more in future research. Moreover, the impact of remuneration of directors on firm's performance is studied, but it is not broadly studied inversely.

Researching the effect of promoter ownership on corporate performance may be of utmost important in the period of financial distress. They are the persons, who are in a position to take any important strategic decision to drive the performance. Therefore, high promoter ownership in such a period may enhance the firm performance. This leads to development of the hypothesis that promoter ownership is positively associated with firm value. Further, above certain ownership, promoters may exert significant control over firm and drive the decision-making in the company, thereby increasing firm value.

H2. Promoter ownership exhibits positive relationship with firm performance.

Objectives of the study:

The present study revolves around the following two major objectives.

- To examine the effect of corporate board size on firm value
- To examine the effect of promoter ownership on firm value

4. RESEARCH DESIGN

Sample size and period of study:

The sample to be used in this study includes firms listed on the Bombay Stock Exchange (BSE) of India during the financial year 2013-14. The sample includes all firms of the BSE 100 index except the banking firms and CPSEs. Therefore the final sample consists of 65 companies after eliminating the banking firms, CPSEs and firms with missing data.

Data sources:

The data on board size and promoter ownership sources were sourced from the annual reports of sample companies.

The financial and market data will be obtained from corporate database (PROWESS) database maintained by the Centre for Monitoring Indian Economy (CMIE). The data thus obtained was used in calculating and measuring the different variables used as control variable in the model.

Statistical Tool used: Multiple Regression analysis

MODEL:

The model for our study is represented by the following equation:

$$\text{Tobin's } Q = b_0 + b_1 \text{BSize} + b_2 \text{PrOwn} + b_3 \text{LAge} + b_4 \text{LSize} + b_5 \text{Lev} + b_6 \text{SGrowth} + e$$

5. VARIABLES

Dependent Variable:

Various financial measures for firm performance are used by researches. These measures can be grouped into two broad classes: *the accounting-based measures (such as PBIT, PAT/Sales, EVA, etc.) and the market-based measures (such as market capitalization, MVA, Tobin's Q, etc.)* Three parameters were initially considered for our analysis: Tobin's Q, return on assets (ROA), return on equity (ROE). However, in the final analysis the study considered only Tobin's Q, as the problem of heteroskedasticity was encountered with other variables.

Performance variables:

Tobin's Q will be used for assessing the firm performance

Variables of interest:

Two variables will be used board size (B Size) and promoter ownership (Pr Own) to empirically find out their net effect on firm performance.

Control variables:

Different control variables such as firm age (LAge), firm size (LSize), leverage (Lev) and sales growth (SGrowth) will be included in the study.

The two principal control variables we use are **Sales and Age**. **Sale** is a proxy for the size of a firm. Size of a firm can

Variables	Measurement
Tobin's Q	Tobin's Q, measured as market value of equity plus book value of short-term and long-term debt divided by total assets
Board Size	The number of director on the board of a firm
Promoter holding	Percentage of total equity ownership of promoter group in the company
Firm age,	Measured as the logarithm of the number of years since the establishment of a firm
Size	Measured as the natural logarithm of total assets
Firm leverage,	Measured as the ratio of long term debt to the total assets
Sales growth,	Measured as total sales of the current year minus total sales in the previous year divided by total sales in the previous year

have a significant influence on firm performance and a proxy for firm size is used in almost all studies explaining firm performance. **Age** is also considered to be an important determinant of firm performance. Older firms are more experienced, receive the benefits of learning and are associated with first mover advantages. However, older firms are also arguably prone to inertia and are less flexible in their ability to adapt to competitive pressures.

6. RESULTS AND DISCUSSIONS

Table 1 Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation
Board size	65	1.61	2.89	2.3720	.28627
Age	65	2.0794	4.6821	3.598073	.6270980
Promoters shares	65	16.9695	21.7496	19.679969	1.2488770
Sales growth	65	-.5835	11.3198	.375524	1.6220626
LEVERAGE	65	.0000	.6440	.188350	.1820268
SIZE	65	10.0918	15.1177	12.118207	1.0393653
tobins Q	65	.0624	.9215	.458062	.1769845
Valid N (listwise)	65				

The summary of descriptive characteristics of dependent and independent variables are presented in Table. The results show that the average (std deviation) board size is 2.3829

(.29293). The promoter ownership shows variation with minimum and maximum value being 16.9695 and 21.7496 respectively, with average value (std deviation) of 19.679969 (1.2488770). The leverage ratio for sample companies is 18.83 percent, entailing the fact that firms (in the sample) rely on more on equity capital and other sources of fund, rather than debt.

Table 1.1 Correlation

	Board Size	Promoter ownership	Sales growth	Size	Leverage	Age
Board Size	1					
Promoter ownership	-.157	1				
Sales growth	-.295*	.212	1			
Size	-.141	.440**	.168	1		
Leverage	-.223	.219	.131	.409**	1	
Age	.120	-.163	-.031	-.116	-.147	1

The analysis of results begins with the presentation of Pearson's correlation matrix. Results of Table showed that all the correlations are within the acceptable range of 0.01-0.775. The degree of correlation between independent variables is either low or moderate, suggesting absence of multicollinearity between these variables. In addition, the colinearity diagnostic statistics, tolerance (TOL) and variance-inflated factor (VIF) support the Pearson's correlations, and provide no proof of multicollinearity in the regression model. The analysis of Table II (correlation matrix) reflects that the board size is positively correlated with sales growth, similarly size and promoter ownership and size and leverage.

Table 1.1.1 Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.679 ^a	.461	.405	.1365245	2.213

a. Predictors: (Constant), SIZE, Age, Sales growth, board size, LEVERAGE, Promoters shares

b. Dependent Variable: tobins Q

The table shows the multiple linear regression model summary and overall fit statistics. The study find that the adjusted R² of the model is .405 with the R² = .461 that means that the

Linear regression explains 46.1% of the variance in the data. The Durbin – Watson d=2.213 which is between the two critical values of 1.5<d<2.5 and therefore can assume that there is no first order linear auto-correlation in the multiple linear regression data.

Table 1.2 ANOVA^a

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	.924	6	.154	8.259	.000 ^b
	Residual	1.081	58	.019		
	Total	2.005	64			

a. Dependent Variable: tobins Q

b. Predictors: (Constant), SIZE, Age, Sales growth, board size, LEVERAGE, Promoters shares

The next table is the F-test, the linear regression's F-test has the null hypothesis that there is no linear relationship between the variable. The F- test is highly significant, thus it is assumed that there is a linear relationship between the variables in the model.

Table 1.2.1 Coefficient

Model	Unstandardized Coefficients		Standardized Coefficients	t	sig	Collinearity statistics	
	B	Std. Error	Beta			VIF	Tolerance
Constant	.532	.370		1.439	.155		
Board size	.007	.064	.012	.114	.910	.869	1.151
Age	.053	.028	.186	1.888	.064	.953	1.049
Promoter shares	.002	.16	.012	.112	.911	.772	1.295
Sales growth	-.008	.11	.075	.730	.468	.880	1.137
Leverage	.718	.105	.738	6.835	.000	.797	1.255
Size	-.037	.020	.217	-1.882	.065	.701	1.426

The findings of Table illustrate result for the entire sample and give a positive association between board size and firm value. In line with many international studies, board size is positively correlated with firm value (though not significant) reflected by positive coefficient of BSize (b1 =.012) in the model, giving support to H1. Promoter ownership was found to be positively correlated (b2 =.012) with firm performance in our model (Table V) giving support to the H2. The results support the fact that high promoter ownership in a company help them to take important decisions and drive its performance during financial distress period. This table also checks for multicollinearity in the multiple linear regression model. Tolerance should be >.1(or VIF<10) for all variables.

7. CONCLUSION

The study explores the relationship of board size and promoter ownership on firm value for a sample of firms listed on the Bombay Stock Exchange of India. The study found a significant positive association of promoter ownership and board size with firm performance. The regression results suggest that firms with high ownership concentration of promoters have high market valuations (Tobin's Q). Higher ownership gives the promoter enough incentive and control to monitor and enhance firm value. The study contributes to existing literature on corporate governance on board size and insider ownership. The outcome of research gives firm support to the agency theory, that high ownership has more alignment effect resulting in reduced agency cost.

8. LIMITATION AND DIRECTION FOR FUTURE RESEARCH

The current research is subject to some major limitations. First, the study has used only a small sample of BSE 100 firms. Second, the important aspect left out in our study pertains to board composition and other ownership patterns that may also have affect on firm performance.

The current study also opens up avenues for future research ideas. The analysis using primary data can give better insights. Further research should be carried out using other governance parameters and ownership structure. Larger sample sizes can be used to reach at accurate results. Pursuing a longitudinal study including the variables like percentage of non-executive and independent directors on the board, which may have affected the board dynamics can give better understanding.

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