

Impact of Corporate Governance on Profitability of Selected IT Companies

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Abstract

This article investigates the relationship between corporate governance and profitability of information technology (IT) companies listed on Bombay Stock Exchange (BSE). The sample was chosen via purposive sampling. The analysis is based on secondary data gathered throughout the ten years between 2011–12 and 2022–23. Methods of multiple regression were used to analyze the data. According to the findings of the research, institutional ownership in the IT companies has a considerable and positive impact on profitability. On the other hand, the study discovered that managerial ownership also has substantially improves profitability.

Keywords: Corporate Governance, Profitability, Information Technology companies.

Introduction

Corporate governance refers to the system of rules, practices, and processes through which a company is directed and controlled. It encompasses the relationships between a company's management, its board of directors, its shareholders, and other stakeholders. The primary objective of corporate governance is to ensure that a company operates in a fair, transparent, and accountable manner, while safeguarding the interests of its various stakeholders. It provides a framework for responsible decision-making, effective risk management, and ethical conduct within an organization. By establishing clear lines of authority, accountability, and responsibility, corporate governance helps prevent conflicts of interest, fraud, and other unethical practices.

Profitability refers to the ability of a company to generate profits and financial returns from its business operations. It is a critical measure of a company's success and sustainability, as it directly impacts its ability to

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grow, invest, and reward its stakeholders. Profitability is typically assessed through various financial ratios and metrics, such as net profit margin, return on investment (ROI), and earnings per share (EPS). Profitability is influenced by several factors, including revenue generation, cost management, efficiency, pricing strategies, and market dynamics.

Effective corporate governance promotes transparency in financial reporting, operations, and decision-making processes. Transparent and reliable financial information enhances investor confidence and attracts capital, which can positively impact a company's profitability.

Literature Review

According to Brown, A., Lee, C., & Garcia, M. (2019), meta-analysis brings together findings from multiple empirical studies to provide a more extensive and robust understanding of the link between corporate governance and firm profitability. It examines the moderating effects of industry, country-specific factors, and firm characteristics. The results of this study contribute to the theoretical perspective by providing insight into the influencing role of managerial behavior in the relationship between CG practices and firm performance in an emerging markets economy. Also, the study provides important managerial implications for the practice and is important for policy-makers seeking to improve corporate governance in the emerging market economy. According to Rahman, M., Uddin, M., & Chowdhury, T (2020) Their research shed light on the distinct challenges and opportunities faced by such companies and how specific governance factors impacted their profitability. Interestingly, the findings showed that the size of the audit committee and the frequency of its meetings had no significant relationship with profitability, as measured by return on equity. However, two other corporate governance aspects, namely audit committee independence and firm size, were found to have a considerable impact on profitability. These two factors played critical roles in determining the financial performance of firms in the context of emerging economies. According to Brigham and Houston (2014), when the firm's controlling shareholders grant management the authority to make decisions, a potential conflict of interest occurs. Ownership is the essential distinction between control (agent/manager) and ownership (principal/investor) in an agency relationship. Ownership, represented by investors, authorizes agents to manage owners' funds in the hope of principally enhancing investors' wealth and prosperity. To measure how well or poorly the management is competent to deal with their financial matters in this case, con-

sider the organization's appraisal of its financial success. Shareholders of the corporation strive for a high firm value because it denotes significant shareholder wealth. Enhancing the value of a company is a crucial goal as the good value of a company could result in large capitalist wealth. Tomar S. and Bino A. (2012) explored the connection between corporate governance and bank performance. They discovered that ownership structure and board composition significantly affect bank performance, while board size has no bearing on bank performance. A.K.A. Devi K.K., C.V. Maheswari (2015). A study comparing the financial results of two leading pharmaceutical companies, Cipla Ltd. and Aurobindo Pharma Ltd., was published in 2015 under the title "A Study on Comparative Analysis on Financial Performance of Cipla Ltd. and Aurobindo Pharma Ltd." Ratio analysis was used to compare the two businesses' financial health. Based on the data, Cipla Ltd. was determined to have greater financial performance than Aurobindo Pharma Ltd. Wei-Xuan Li, Clara Chia-Sheng Chen, and Joseph J. French (2012) whether or if more liquidity leads to stronger corporate governance, and whether or not the latter leads to a higher value for Russian businesses. Liquidity metrics and good corporate governance were shown to have a positive causal link in the research. Furthermore, it provided empirical evidence for the beneficial effect good corporate governance has on stock price. The findings have important monetary implications. For instance, the research showed that an increase in openness and disclosure of 0.34% indicates a drop in zero return days of 10%, which in turn increases business value by 9.6%. The results of this study illuminate the significance of liquidity in enhancing corporate governance and value. Mengling Zhou, Kexin Li and Zhongfei Chen (2021). The authors found that the negative relationship between corporate governance quality and financial leverage is stronger for state-owned enterprises (SOEs) compared to non-state-owned enterprises (NSOEs). This finding suggests that SOEs may face more agency problems due to their unique ownership structure and may therefore benefit more from better corporate governance practices. According to Isik and Soykan (2013), concentrated ownership causes agency difficulties between significant shareholders and lesser stakeholders such as managers, employees, creditors, and outside investors. They found that concentrating significant shares of the business helps to boost firm profitability to a certain level and decreases firm performance when that level is surpassed.

Objectives of the Study

1. To find the impact of Institutional ownership on profitability.

2. To find the impact of Managerial ownership on profitability.

Research Methodology

The research is based on secondary data acquired during the previous 12 years between 2011-12 and 2022-23. The selected IT companies are included in BSE 200 index as these companies are financially stable and have a significant impact on the Indian economy. Also, Availability of data is also an important consideration when selecting companies for study. The selected companies are as follows:

- Tata Consultancy Services
- Astral Poly Technik Ltd.
- L&T Technology Services Ltd.
- Larsen & Toubro Infotech Ltd.
- Endurance Technologies Ltd.
- HCL Technologies Ltd.
- Wipro Ltd.
- Infosys Ltd
- Tech Mahindra
- Larsen & Toubro Infotech Ltd
- Mindtree Ltd
- Info Edge (India) Ltd.

Research Hypothesis

H1: There is no significant impact of Managerial ownership on profitability.

H01: There is a significant impact of Managerial ownership on profitability.

H2: There is no significant impact of Institutional ownership on profitability.

H02: There is a significant impact of Institutionall ownership on profitability.

Variables of study

The following variables are taken into study for measuring the impact of corporate governance (CG) on profitability:

- a) **Managerial Ownership**

Managerial ownership is taking those shares of the company into account that are held by directors and their dependents following the financial year.

b) Institutional Ownership

This measures the number of a company's shares held by pension funds, insurance companies, investment firms, private entities, or other large organizations that administer other stakeholders' portions.

c) Return on equity

Return on equity (ROE) indicates how well a firm handles the money that shareholders have given to it. The ROE ratio shows how well an executive team uses capital assets to generate net income for shareholders.

$$\text{ROE (\%)} = \text{Net Income} / \text{Shareholders' Equity} \times 100$$

Data Analysis Techniques

According to Hair et al., the simultaneous equation can be employed in conjunction with path analysis estimation approaches if the problem's formulation incorporates factors of a tiered connection.

Path Analysis

Arrows are used in the route diagram to indicate the connection between the constructions. The straight arrows represent the direct relationship between the constructs. The route coefficient compares the coefficients of the indirect and direct effects or is a normalized regression coefficient.

In this work, route diagrams were transformed into structural equations as under:

$$Y_1 = \beta_1 X_1 + \beta_2 X_2 + \epsilon_1$$

Note:

Y_1 = *Return on Equity (ROE)*

X_1 = *Managerial Ownership (MO)* X_2 = *Institutional Ownership (IO)*

β = *Regression Coefficient standardized*

ε = Error of term

Result

Research Model

In order to examine the model as a whole and make the route analysis more realistic for this study’s simultaneous testing, the multiple regression data analysis methodology is used for testing

The Classical Assumption Test

Several theoretically necessary assumptions form the foundation of regression analysis. The monitoring or evaluation in this area aims to validate the objectivity and reliability of the regression model in order to make the appropriate statistical judgments. The hypotheses tested included residual normality, multicollinearity, and heteroscedasticity.

The Normality Test: This normality test assesses the dispersion of the confounding variables in the regression model to determine if they are proportionally divided. If the significance level is greater than 0.05, then values are randomly divided.

Table 1: The Normality Test Result on 1st and 2nd regression models

Model 1	Model 2
0.059	0.055

For Regression Model 1, the results demonstrated a significant value of 0.59, whereas, for Regression Model 2, the evidence suggests a value of $0.055 > 0.05$. This demonstrates that the knowledge for regressions 1 and 2 is divided evenly.

The Multicollinearity Test. This test checks that if there is a relationship among different independent variables of the study. Multicollinearity does not exist when the tolerance amount (VIF Value) is between 1 to 10.

Table 2: The Multicollinearity Test Result on 1st and 2nd regression

1 st Regression	Tolerance Amount	VIF Value	2 nd Regression	Tolerance Value	VIF Value
MO	0.392	3.08	MO	0.685	3.130

IO	0.392	3.08	IO	0.682	3.133
			ROE	0.692	3.121

Models 1 and 2 are unaffected by the multicollinearity problem with the regression, according to the results of the Multicollinearity Test. As the VIF value of each predictor was less than 10.

The heteroscedasticity Test: This test examines to see whether there is a difference between the residuals of one observation and the other. If the residual has the even variance as the observed data, it is homoscedastic; if not, it is heteroscedastic. A robust regression model either exhibits homoscedasticity or is not heteroscedastic. Heteroscedasticity is present in the scatter plot of this study as under.

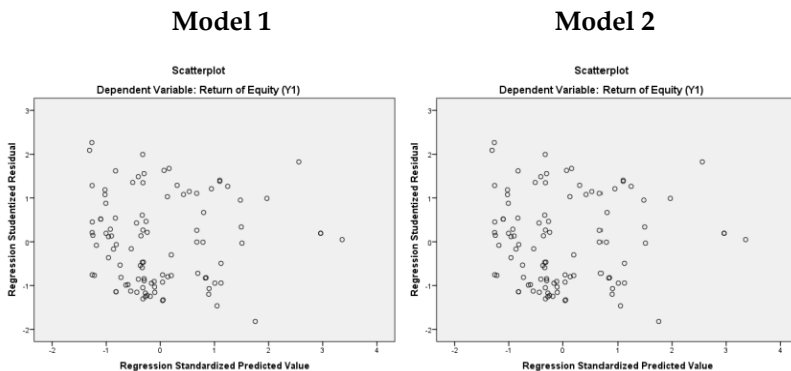


Figure 1a and 1b: The Heteroskedasticity Test Result on 1st and 2nd regression models

The above Scatter Plot Graph shows that there is no clear pattern since the dots are distributed unevenly above and below the 0 axes on the Y axis. It could be said that both regression models have no heteroscedasticity.

Hypothesis Test Results and Inference

H1: There is no significant impact of Managerial ownership on profitability.

Table 3: Empirical results obtained by employing Fixed Effect Model

Dependent Variable: ROE				
Method: Panel EGLS (Cross-section fixed effects)				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
Managerial Ownership	0.198496	0.056514	3.512354	0.001
C	12.96094	1.062912	12.1938	0.000
	Effects Specification			
Cross-section fixed (dummy variables)				
R-squared	0.77558	Mean dependent var		-0.21331
Adjusted R-squared	0.68353	S.D. dependent var		1.804441
S.E. of regression	1.630473	Akaike info criterion		3.922079
Sum squared resid	3054.552	Schwarz criterion		4.508155
Log likelihood	-2394.51	Hannan-Quinn criter.		4.14201
F-statistic	2.99376	Durbin-Watson stat		2.003517
Prob(F-statistic)	0.00000			

Above Table 3 shows the effect of managerial ownership on return on equity (ROE), using a model with cross-section fixed effects. The results show a positive and statistically significant relationship between managerial ownership and ROE (coefficient = 0.1985, $p = 0.001$), indicating that increased managerial ownership is associated with higher ROE. The constant term is also significant, with a large positive value. The model has a strong fit, as indicated by an R-squared of 0.776

and an adjusted R-squared of 0.683, meaning it explains a substantial portion of the variance in ROE. The F-statistic confirms the overall model significance ($p = 0.000$), and the Durbin-Watson statistic of 2.00 suggests no major autocorrelation issues. Overall, the model demonstrates that managerial ownership is a significant predictor of ROE.

H2: There is no significant impact of institutional ownership on profitability.

Table 4: Empirical results obtained by employing Fixed Effect Model

Dependent Variable: ROE				
Method: Panel EGLS (Cross-section fixed effects)				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
Institutional Ownership	0.308146	0.008555	-0.95214	0.034
C	2.373271	0.160908	14.74924	0.000
	Effects Specification			
Cross-section fixed (dummy variables)				
R-squared	0.66818	Mean dependent var		1.166057
Adjusted R-squared	0.626011	S.D. dependent var		0.403612
S.E. of regression	0.246828	Akaike info criterion		0.14621
Sum squared resid	70.00165	Schwarz criterion		0.732286
Log likelihood	52.25602	Hannan-Quinn criter.		0.366141
F-statistic	15.84702	Durbin-Watson stat		1.93815
Prob(F-statistic)	0.00000			

In table 4, panel regression analysis explores the impact of institutional ownership on return on equity (ROE) with cross-section fixed effects. The findings indicate a positive and statistically significant relationship between institutional ownership and ROE, with a coefficient of 0.308 ($p =$

0.034), suggesting that higher institutional ownership is associated with increased ROE. The constant term is also highly significant ($p = 0.000$), with a coefficient of 2.373. The model shows good explanatory power, as reflected by an R-squared of 0.668 and an adjusted R-squared of 0.626, suggesting it explains over 60% of the variance in ROE. The F-statistic (15.847, $p = 0.000$) further supports the model's overall significance, and the Durbin-Watson statistic of 1.94 indicates no major issues with autocorrelation. In sum, the analysis confirms that institutional ownership is a significant factor influencing ROE

Conclusion

The panel regression analysis demonstrates that both managerial and institutional ownership positively impact return on equity (ROE). For managerial ownership, the significant positive coefficient of 0.1985 ($p = 0.001$) indicates that as managers hold larger stakes in the firm, ROE tends to increase, possibly because managers with ownership stakes are more motivated to enhance firm performance. Similarly, institutional ownership shows a positive effect on ROE, with a coefficient of 0.308 ($p = 0.034$). This relationship could be due to institutional investors often bringing greater oversight and governance, which can drive better financial outcomes.

Both models exhibit good explanatory power: the R-squared values are 0.776 for managerial ownership and 0.668 for institutional ownership, indicating that they explain a substantial portion of ROE's variability. Additionally, the F-statistics in both models ($p = 0.000$) confirm the overall significance, affirming that these ownership structures are strong predictors of ROE. These findings highlight that higher managerial and institutional ownership not only align interests with shareholders but also enhance firm performance, making these ownership forms essential in effective corporate governance and profitability strategy.

Suggestions

On the basis of the present study, some suggestions can be made as follows:

- Managerial and institutional ownership might not have a simple linear effect on ROE. Testing for non-linear relationships (e.g., squared terms or threshold effects) could reveal if certain levels of ownership are more impactful.

- Lagged variables could capture potential delayed effects of managerial and institutional ownership on ROE, as ownership changes may take time to influence performance. Including lagged managerial ownership could strengthen the model.
- Industry or firm-specific variables (like firm size, leverage, or market conditions) could play an essential role in ROE. Including these controls could clarify the direct effect of managerial and institutional ownership by accounting for other influential factors.
- Managerial and institutional ownership's effect on ROE might differ by industry or firm size. Segmenting the data by industry or conducting a multi-group analysis could highlight these variations.
- Ensure a balanced and diverse board with independent members who can objectively evaluate managerial decisions, aligning them with profitability and ROE growth.
- Foster relationships with long-term investors by highlighting the firm's commitment to sustainable growth and profitability.
- Offer loyalty rewards for institutional investors who hold shares over extended periods, increasing their stake and potentially creating a more stable shareholder base.
- Design compensation packages that tie managers' stock holdings to long-term metrics like return on equity (ROE), earnings growth, or cash flow improvements rather than short-term metrics.
- Implement vesting schedules that extend over multiple years to encourage managers to focus on sustainable growth, helping boost profitability.

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