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The relationship between corporate governance and the investment decision of small business firms in India

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Abstract

The purpose of this study is to examine the relationships between corporate governance and the investment decision of small business firms in India. This study also seeks to extend the findings of Ruiz-Porras and Lopez-Mateo [1]. Owners/the members of board of directors of small business firms from Punjab area of India were surveyed to discover their perceptions, feelings, and beliefs on the relationship between corporate governance and the investment decision of small business firms to invest in the real estate market. This study utilized survey

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research (a non-experimental field study design). Overall results show that the CEO tenure, the CEO duality, board size, total assets of the firm, and small business performance positively impact on the investment decision of the small business firms in India. The CEO duality, total assets, and firm performance positively impact on the investment decision of small business firms in the Indian service industry. The board size and the firm performance positively impact on the investment decision of small business firms in the Indian manufacturing industry. This study contributes to the literature on the relationship between corporate governance and the investment decision of small business firms. The study can be useful for real estate investors and investment advisors.

JEL classification numbers: G32
Keywords: CEO tenure, CEO duality, board size, firm performance, investments

1 Introduction

The purpose of this study is to examine the relationship between corporate governance and the investment decision of small business firms in India. The growth of small business firms depends on the investments and the good corporate governance is required to make sound investment decisions. Kajola [2, p.16] defines corporate governance as the system by which business corporations are directed and controlled.

According to Ruiz-Porras and Lopez-Mateo [1] corporate governance theory contributes to explain firms´ behavior and their decisions, like investment ones. Grabowski and Mueller [3] also suggest that the degree of the separation between ownership and control explains investment decisions. In addition, Gugler *et al.* [4] explain ownership structures systematically affect investment decisions of the firm.

The potential growth of the firm cannot be achieved without investments. One of the investment areas is real estate investment. The real estate investment is necessary to operate and to expand small business firms. Some economists believe that good corporate governance practices contribute to firm growth [5]. They also argue that good practices increase returns on equity and promote efficiency of the firm which is in the favor of all stakeholders. Thus, good corporate governance leads to economic growth by enhancing corporate decisions [1, p.19].

The improvement in the investment of the firm is necessary to achieve the overall corporate objectives, to keep the organizations in business, and to create a greater prospect for future opportunities. Modern firms are run by professional managers [agents] [6] who may not work in the favor of shareholders (principals). The principal-agent problem has a negative impact on future investment the firm. Corporate governance plays an important role in minimizing i) an agency problem and ii) agency costs. The board of directors minimizes agency problems and the agency costs by aligning managers' and shareholders' interests. The minimization of agency problems and the agency costs helps corporations to maximize the shareholders' wealth by exploring future investment opportunities.

This study examines the relationship between corporate governance and the investment decision of small business firms in India. Ruiz-Porras and Lopez-Mateo [1] has examined the relationship between the corporate governance and investment decision of the firm in Mexican manufacturing firms. This study seeks to extend the above study by analyzing data from Indian small business firms.

The literature cites a number of variables that are potentially associated with the investment decision of the firm. In this study, the selection of exploratory variables is based on the previous empirical work. The choice of proxy variables can be limited, however, due to data limitations. As a result, the set of proxy variables includes seven factors: The CEO tenure, the CEO duality, board size, total assets, small business performance, industry dummy, and investment

decision.

This study contributes to the literature on the relationship between corporate governance and investment decision the firm in at least two ways. First, it focuses on Indian small business firms while a very limited research has been conducted on such firms recently. Second, this study validates some of the findings of previous authors by testing the relationship between the CEO tenure, the CEO duality, board size, total assets, small business performance, industry dummy, and investment decision. Thus, this study adds substance to the existing theory developed by previous authors.

2 Literature Review

Corporate governance deals with the rights and responsibilities of a company's management, its board, shareholders and various stakeholders such as employees and customers. The corporate governance affects the investment decisions of the company. Therefore, good corporate governance is necessary to make sound investment decisions which, in turn, help firms to prosper in the domestic as well as in the global market.

Modern firms are managed under the direction of a board of directors. According to [2, p.17] the board of directors delegates responsibilities to the CEO and other management staff who manages day-to-day affairs of the firm. The directors, with their wealth of experience, provide leadership and direct the affairs of the business with high sense of integrity, commitment to the firm, its business plans, and long-term shareholder value.

The CEO supervises the operations of the firm in effective and ethical manners, and prepares the strategic plans, annual operating plans, and budgets for the board's approval [2]. Thus, the CEO plays an important role in the investment decision of the firm. The CEO tenure has a positive impact on the investment

decision of the firm. The investment decisions of the firm also improve when the CEO serves as a director of the board. In the small business firms, the larger board size (large number of directors) is in the favor of the firm because they provide i) help to make investment decisions and ii) financial support.

According to Kyereboah-Coleman [6] the nature of ownership of the firm constitutes a dimension of its governance structure. Therefore, institutional ownership influences the investment decision of the firm. The empirical studies on the relationship between corporate governance and the investment decision of the firm are as follows:

Bohren *et al.* [7] collected data from US manufacturing firms and found that i) good governance improves the efficiency of capital allocation within firms and ii) lax governance produces underinvestment rather than overinvestment.

Chang *et al.* [8] collected data from Taiwan and found that corporate governance mechanisms affect investment decisions of the firm.

Ruiz-Porras and Lopez-Mateo [1] collected data from Mexican manufacturing firms and found that the separation of ownership encourage investment decisions among the Mexican manufacturing firms. They also found a positive relationship between cash flows and the investment.

Aldrighi *et al.* [9] collected data from Brazil and found that ownership and control structures significantly affect the firm's investment decisions.

In summary, limited availability of literature review shows that the corporate governance positively impact on the investment decision of the firm.

3 Methods

3.1 Measurement

To remain consistent with previous studies, measures pertaining to:

i) The CEO tenure, the CEO duality, and board size were taken from

Kyereboah-Coleman [6],

ii) Small business performance were taken from Zehir *et al.* [10],

iii) Total assets were taken from Michaelas *et al.* [11], and

iv) Investment decision of small business firms were taken from Gill and Biger [12].

All the scale items were reworded and the reliability of these re-worded items was re-tested for construct validity. Respondents were asked to indicate their agreement with each item, using a five-point Likert scale ranging from "Strongly Disagree" to "Strongly Agree," related to small business performance variable. Respondents were asked to indicate their agreement with each item, using a five-point Likert scale ranging from "0%-5%%" to "76%-100%." related to "investment decision small business firms" variable.

The measurements of the independent and dependent variables are as follows:

The CEO tenure (Tenure) independent variable was measured by a single item that asked respondents to indicate the number of years they have been involved as a CEO of the company. Categorized alternative responses were: 0-4 Years, 5-9 Years, 10-30 Years, and 31 Years and Over.

The CEO duality (CD) independent variable was measured by a single item that asked respondents to indicate if he or she serves chairperson of the board in the company. Categorized alternative responses were: 1) Yes and 0) No.

Board size (BS) independent variable was measured by a single item that asked respondents to describe number of directors (decision makers) they have in their companies. Categorized alternative responses were: i) 1-3 directors and ii) 4 and more directors.

Total assets (TA) independent variable was measured by a single item that asked respondents to describe if total assets of their companies increased within last three years. Categorized alternative responses were: 1) Yes and 0) No.

Small business performance (SBP) independent variable is operationalized as the

extent to which owners/the members of board of directors of the small business firms perceive that the net profit margin and return on assets have improved over the last three years. Zehir *et al.* [10] used the seven-item tolerance-of-freedom scale which measures the "small business growth" variable. In the present study only two items were selected to measure the "SBP" variable. Scale items were reworded and the reliability of these re-worded items was re-tested.

The Cronbach alpha on the responses of the 29 small business owners who participated in the pre-test of the above scale items was 0.84. All three items were included in the final questionnaire.

Investment decision of small business firms (ID) is operationalized as "the proportion of small business firms' total portfolio" that is allocated in the real estate market to earn higher rate of return and to diversify risk. Gill and Biger [12] used three items to measure "investment decision of investors" variable. Based on that study, two items were selected to measure the "ID" variable. Scale items were reworded and the reliability of these re-worded items was re-tested.

We calculated a Cronbach's alpha of .84 on the responses of the 29 respondents who participated in the pre-test of the above scale items. These two items were included in the final questionnaire.

3.2 Sampling Frame, Questionnaire Distribution, and Collection

The current study consisted of the population of Indian owners/the members of board of directors of small business firms. Indian owners/the members of board of directors of small business firms living in Punjab (Ludhiana, Malerkotla, Raikot, Banga, Hoshiar Pur, Kaputhala, Phagwara, Jalandhar, and Sahid Bhagat Singh Nagar) area of India were chosen as a sampling frame.

3.3 Sampling Method, Sampling Issues, and Possible Planned Solutions

Punjab (Ludhiana, Malerkotla, Raikot, Banga, Hoshiar Pur, Kaputhala, Phagwara, Jalandhar, and Sahid Bhagat Singh Nagar) area of India was chosen as the research site to collect data. Given that the population is "abstract" (e.g., it was not possible to obtain a list of all members of the focal population) [13, p.101], a non-probability (purposive) sample was obtained. In a purposive sample, participants are screened for inclusion based on criteria associated with members of the focal population. The focal population was comprised of owners/the members of board of directors of small business firms in the Punjab area of India. The survey did not need to be translated into Punjabi or Hindi for the Indian participants since almost all owners/the members of board of directors of small business firms can read and write English. Researchers were also available for translation. The instruction sheet indicated that participants could contact the researchers by telephone and/or email regarding any questions or concerns they might have about the research.

To avoid sampling bias, data collection team was asked to only choose participants that represent the target population. Non-Indian small business firms were excluded.

To achieve a convenience sample, an exhaustive list of Indian owners'/the members of board of directors' names and telephone numbers were created to distribute surveys and to conduct telephone interviews. Survey questionnaire bundles coupled with an instruction sheet were provided to the surveyors for distribution.

The sample included approximately 800 research participants encompassing Indian owners/the members of board of directors of small business firms. A total of 209 surveys were completed over the telephone (approximately 10% of the surveys were completed over the telephone), through personal visits, and received by mail. Two of the surveys were non-usable. The response rate was roughly

26.12%. The remaining cases were assumed to be similar to the selected research participants.

3.4 Issues Related to Confidentiality of the Research Participants

All individuals who were approached were ensured that their names will not be disclosed and confidentiality will be strictly maintained. In addition all subjects were requested not to disclose their names on the questionnaire. Since the research was based on the survey questionnaire small business owners were not forced to respond to each specific question.

All subjects were provided with stamped envelopes and confidentiality was ensured. There was no obligation for the subjects to answer our questions over the telephone and in person. Before any telephone interview the person was asked for willingness to participate and of course no one was forced to participate.

Owners'/the members of board of directors' Consent Letter specifically indicated that by completing the survey, subjects have consented to participate in the study. Any information that was obtained in connection with this study and that can be identified with subjects will remain confidential and will be disclosed only with subjects' permission or as required by law.

4 Analysis and Results

Measures of central tendency, variance, skewness, and kurtosis were calculated on responses to all of the items. Skewness measures for all of the items were within the range of: +0.995 to +1.067, which is considered to be a good range for most research that requires using statistics appropriate to normal distributions. Therefore, we used statistics that assume scalar values and

symmetric distributions to test our hypotheses.

We began our analysis by factor analyzing responses to the 4 items that described the respondents' feelings about their small business performance and investment decision. The principle components analysis (a cluster analysis tool designed to capture the variance in a dataset in terms of principle components) with number of factors set to 2 and a varimax rotation explained 90.47% of the variance in the original scores (see Table 1). As can be seen in Table 2, all the items loaded on the expected factors.

Table 1: Total Variance Explained – Rotation Sums of Square Loadings

Total Variance Explained			
	Rotation Sums of Squared Loadings		
Component	Total	% of Variance	Cumulative %
1	1.868	46.695	46.695
2	1.751	43.773	90.468

Extraction Method: Principal Component Analysis.

The question subsets were analyzed in order to enable the calculation of the weighted factor scores. In terms of these weighted factor score items: two SBP and two ID, loaded approximately equally.

Table 2: Rotated Component Matrix [a]

	Component	
Small Business Performance (SBP)	1	2
SBP1) The net profit margin of my company has gone up over last three years.	0.208	**0.909**
SBP2) The return on assets of my company has gone up over last three years.	0.159	**0.923**
Investment Decision of Investors (ID)		
What proportion of your total individual portfolio (e.g., personal savings, business, etc.) do you allocate in real estate market to…?		
IDI1) Obtain higher rate of return?	**0.943**	0.211
IDI2) Diversify risk?	**0.953**	0.169

Notes: [a]Extraction Method: Principal Component Analysis
Rotation Method: Varimax with Kaiser Normalization
Rotation converged in 3 iterations
Cronbach Alpha on the clusters of items: SBP 0.854; and ID 0.931.

Table 3 provides the Pearson correlation for the variables used in the regression model. As shown in Table 4, investment decision of small business firms (ID) is positively correlated with tenure (the CEO tenure), the CEO duality (CD), total assets (TA), and small business performance (SBP) in the service and manufacturing industries of India.

Table 3: Pearson Bivariate Correlation Analysis

Entire Sample (N = 207)							
	ID	Tenure	CD	BS	TA	SBP	Industry
ID	1	0.211**	0.240**	0.123	0.283**	0.386**	0.056
Tenure		1	-0.045	0.127	0.166*	0.170*	0.063
CD			1	-0.149*	0.225**	0.268**	0.025
BS				1	-0.087	-0.047	0.230**
TA					1	0.326**	-0.048
SBP						1	0.048
Industry							1

Service Industry (N = 140)						
	ID	Tenure	CD	BS	TA	SBP
ID	1	0.176*	0.227**	0.094	0.279**	0.365**
Tenure		1	-0.080	0.111	0.202*	0.118
CD			1	-0.108	0.128	0.172*
BS				1	0.003	-0.012
TA					1	0.184*
SBP						1

Manufacturing Industry (N = 67)						
	ID	Tenure	CD	BS	TA	SBP
ID	1	0.298*	0.276*	0.164	0.316**	0.444**
Tenure		1	0.032	0.134	0.107	0.301*
CD			1	-0.239	0.423**	0.521**
BS				1	-0.169	-0.139
TA					1	0.669**
SBP						1

**Correlation is significant at the 0.01 level (2-tailed)
*Correlation is significant at the 0.05 level (2-tailed)
ID = Investment decision of small business firms
Tenure = The CEO tenure
CD = The CEO duality
BS = Board size
TA = Total assets
SBP = Small business performance

4.1 Testing of Hypotheses

Overall, positive relationships between i) tenure and ID, ii) CD and ID, iii) BS and ID, iv) TA and ID, v) SBP and ID were found (see Table 4); that is, the CEO tenure, the CEO duality, board size, total assets, and small business performance are the predictors of investment decision of small business firms in India.

A non-significant relationship between industry and ID were found.

In the service industry, positive relationships between i) CD and ID, ii) TA and ID, and iii) SBP and ID were found (see Table 4); that is, the CEO duality, total assets, and small business performance are the predictors of investment decision of small business firms in the Indian service industry.

Non-significant relationships between i) Tenure and ID and ii) BS and ID were found (see Table 4); that is, the CEO tenure and the board size are not the predictor of investment decision of small business firms in the Indian service industry.

In the manufacturing industry, positive relationships between i) BS and ID and ii) SBP and ID were found (see Table 4); that is, the board size and small business performance are the predictors of investment decision of small business firms in the Indian manufacturing industry.

Non-significant relationships between i) Tenure and ID, ii) CD and ID, iii) and TA and ID were found (see Table 4); that is, the CEO tenure, the CEO duality, and total assets are not the predictors of investment decision of small business firms in the Indian manufacturing industry.

Table 4: Regression Coefficients [a, b, c]

Entire Sample (N = 207)

R^2 = 0.234; SEE = 0.888; F = 10.21; ANOVA's Test Sig. = 0.000

Regression Equation: ID = -1.342 + 0.016 Tenure + 0.405 CD + 0.169 BS + 0.426 TA + 0.280 SBP + 0.002 Industry

	Unstandardized Coefficients		Standardized Coefficients [c]			Collinearity Statistics	
	B	Std. Error	Beta	t	Sig.	Tolerance	VIF
(Constan)	-1.342	0.292		-4.605	0.000		
Tenure	0.016	0.008	0.126	1.956	0.052	0.926	1.079
CD	0.405	0.167	0.160	2.430	0.016	0.879	1.137
BS	0.169	0.070	0.157	2.415	0.017	0.907	1.102
TA	0.426	0.193	0.148	2.210	0.028	0.849	1.177
SBP	0.280	0.068	0.280	4.136	0.000	0.833	1.200
Industry	0.002	0.136	0.001	0.017	0.986	0.937	1.068

Service Industry Sample (N = 140)

R^2 = 0.225; SEE = 0.954; F = 7.76; ANOVA's Test Sig. = 0.000

Regression Equation: ID = -1.463 + 0.014 Tenure + 0.459 CD + 0.158 BS + 0.573 TA + 0.293 SBP

	Unstandardized Coefficients		Standardized Coefficients [c]			Collinearity Statistics	
	B	Std. Error	Beta	t	Sig.	Tolerance	VIF
(Constan)	-1.463	0.397		-3.687	0.000		
Tenure	0.014	0.010	0.108	1.369	0.173	0.928	1.077
CD	0.459	0.208	0.173	2.206	0.029	0.937	1.067
BS	0.158	0.117	0.104	1.351	0.179	0.978	1.023
TA	0.573	0.251	0.181	2.282	0.024	0.920	1.087
SBP	0.293	0.079	0.290	3.689	0.000	0.934	1.071

Manufacturing Industry Sample (N = 140)

R^2 = 0.283; SEE = 0.752; F = 4.81; ANOVA's Test Sig. = 0.000

Regression Equation: ID = -1.052 + 0.018 Tenure + 0.295 CD + 0.159 BS + 0.170 TA + 0.300 SBP

	Unstandardized Coefficients		Standardized Coefficients [c]			Collinearity Statistics	
	B	Std. Error	Beta	t	Sig.	Tolerance	VIF
(Constan)	-1.052	0.504		-2.089	0.041		
Tenure	0.018	0.013	0.162	1.384	0.171	0.855	1.170
CD	0.295	0.289	0.134	1.020	0.312	0.685	1.459
BS	0.159	0.079	0.229	2.020	0.048	0.914	1.094
TA	0.170	0.339	0.075	0.502	0.617	0.535	1.871
SBP	0.300	0.162	0.307	1.854	0.069	0.428	2.336

[a] Dependent Variable: ID

[b] Independent Variables: Tenure, CD, BS, TA, SBP, and Industry

[c] Linear Regression through the Origin

SEE = Standard Error of the Estimate
ID = Investment decision of small business firms
Tenure = The CEO tenure
CD = The CEO duality
BS = Board size
TA = Total assets
SBP = Small business performance

Note that:

● A test for multicollinearity was performed. All the variance inflation factor (VIF) coefficients are less than 3 and tolerance coefficients are greater than 0.40.

● 23.4% ($R^2 = 0.134$) of the variance in the degree of ID can be explained by the degree of Industry, CD, Tenure, TA, BS, and SBP in India.

● 22.5% ($R^2 = 0.225$) of the variance in the degree of ID can be explained by the degree of SBP, BS, Tenure, CD, and TA in the Indian service industry.

● 28.3% ($R^2 = 0.283$) of the variance in the degree of ID can be explained by the degree of SBP, BS, Tenure, CD, and TA in the Indian manufacturing industry.

As shown in Table 5, analysis of variance (ANOVA) tests are also significant at 0.000.

5 Discussion, Implications, and Future Research

5.1 Discussion

The main purpose of this study was to examine the perceived relationships between corporate governance and the investment decision of small business firms in India. This was done by surveying a sample of owners/the members of board of directors of small business firms from the Punjab area of India.

The overall results show that investment decision of small business firms is positively related to the CEO tenure, the CEO duality, board size, total assets, and firm performance. In the service industry, investment decision of small business firms is positively related to the CEO duality, total assets, and firm performance. In the manufacturing industry, investment decision of small business firms is positively related to the board size and firm performance. The findings of this study support the findings of:

i) Bohren *et al.* [7] who found that good governance mechanisms improve the efficiency of capital allocation within firms and that lax governance produces underinvestment rather than overinvestment.

ii) Chang *et al.* [8] who found that corporate governance mechanisms affect investment decisions of the firm.

iii) Ruiz-Porras and Lopez-Mateo [1] who found that the separation of ownership encourages investment decisions and cash flows positively impact on the investment of the firm.

iv) Aldrighi *et al.* [9] who found that ownership and control structures significantly affect the firm's investment decisions.

In conclusion, the CEO tenure, the CEO duality, board size, total assets, and small business performance positively influence the investment decision of small business firms in India.

5.2 Limitations

The present study asks for responses from fixed format, set-questions survey tools, which could direct questions to the exclusion of providing additional input. Maturation of participants can also affect the survey response rate. Maturation of participants, in the context of this research, means that some of the research participants may be on holidays. However, a short study period (four weeks) limited any negative effects from maturation.

5.3 Future Research

The present study is limited to perceptions. The relations found may suffer from common factor bias, as the questions were parts of the same data collection instrument. Future research is needed to test the relation of perceived investment decision of small business firms to actual investment in the real estate market through longitudinal data. Other variables such as firm age, ECO age, number meetings, etc., should also be used in the future study.

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