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CORPORATE GOVERNANCE AND FIRM PROFITABILITY IN AGRICULTURAL SECTOR: EVIDENCE FROM ASIAN COUNTRIES

Zeshan ANWAR[1], Bilal AZIZ[2], Kausar ABBAS[1]

[1]The University of Lahore, Lahore, Pakistan, Phone/Fax: +92-300-4990206; Phone/Fax: +92-312-9681500; E-mail: zeshananwar58@gmail.com, kausar.abbas@lbs.uol.edu.pk
[2]University of Engineering & Technology (UET), Lahore, Pakistan, Phone/Fax: +92-333-4385652; Email: biiilal@live.com

Corresponding author: zeshananwar58@gmail.com

Abstract

The objective of this research is to determine the relationship between corporate governance practices and firm profitability for the companies in agricultural sector of Asian countries for the period of 2008 to 2017 as agriculture is one of the most important sectors in these economies. The results demonstrate that the variables of board independence, ownership concentration, audit committee independence, leverage and sales growth have significant positive relationship with return on assets (ROA), whereas, the variables of quality of corporate governance, board size, CEO duality and firm size have significant negative association with return on assets (ROA). Moreover, the endogeneity of the board structure variable was investigated by applying the Two Stage Least Squares (2SLS) regression model. The results of the 2SLS regression model depicts that variables of board independence, audit committee independence and sales growth have significant positive association with return on assets (ROA), whereas, the variables of quality of corporate governance, leverage and firm size have significant negative relationship with return on assets (ROA).

Key words**:** *corporate governance, return on assets, agricultural sector, Asian countries, firm profitability*

INTRODUCTION

This paper studies association of governance practices and business profitability by incorporating a sample of companies from agricultural sector in Asian countries. There are several theories which point out association of governance practices with wealth of shareholders. Stewardship and agency theories recommend that governance is about maximization of shareholders wealth thus points out the link of governance with wealth of shareholders. The profitability is a fundamental factor of wealth creation. The debate regarding optimum capital structure also establishes the link of capital structure with profitability and wealth of shareholders. However, the association of governance practices with profitability has not been sufficiently investigated and several studies have pointed out the need for such kind of research.

This research empirically examines this issue by utilizing data of companies from agricultural sector in Asian countries as empirical studies regarding governance practices are comparatively lesser for Asian countries and there is a gap in existing literature for effect of governance systems on business performance in agricultural sector. These gaps in existing literature offer strong motivations to conduct this study as this study will bridge these gaps in empirical literature.

The study aimed at bridging this gap by investigating whether better governance practices could result in improving business performance by utilizing a sample of firms from agricultural sector in 20 Asian countries from Year 2008 to Year 2017. This research conduct analysis to determine relationship of governance systems variables with business profitability and controlling for variables of level of leverage, firm size, sales growth and volatility of stock prices for companies from agricultural sector.

The objective of this research is to determine whether Better Governance practices Results in increasing the Firm's Profitability.

The study on correlation of governance practices systems with business profitability

in Asian economies will facilitate investors, policy makers and managers to have improved insights of governance practices role in organizations. Each of these companies represents a unique economic situation. Moreover, as the companies included in the sample are taken from agricultural sector, therefore, findings of this research are extremely significant for policy makers and decision makers in agricultural sector.

The remaining research has been organized as follows: the literature review has been presented in section 2; research methods: research framework has been provided in section 3. The section 4 presents results for firm profitability and corporate governance practices, whereas, the section 5 provides conclusion and directions regarding future research.

Literature review

The corporate governance literature in developed and developing economies presented controversial results for correlation of corporate governance with financial performance of organizations [18]. Several studies analyzed relationship of corporate governance with business performance but findings are not conclusive.

Most of studies have supported positive association of governance practices with financial performance of companies e.g. [17] examined association of independent board composition with business performance for Bangladeshi companies and detected independent board directors improve firm value and performance.

[12] observed effect of board's activity, capital structure and ownership structure on business performance. The findings revealed that composition of board and investors having substantial voting power have positive relationship with business performance. [15] assessed relationship of governance practices with performance of Indonesian organizations and disclosed that all internal governance systems excluding size of board and audit committee along with managerial ownership have significantly positive influence on firms' performance.

[14] studied relationship of governance practices and financing strategies with performance of companies by utilizing data for 84 public firms on Tehran Stock Exchange for 2007-2011. The authors found that capital structure, financing decisions and corporate governance practices affect performance of businesses. Additionally, [19] assessed link among corporate governance practices, business performance, risk taking attitude and ownership structure of firm. The results demonstrated that improvement in governance practices has positive effect on performance and risk level of firm, whereas, governance practices has negative correlation with ownership concentration.

Some researchers have also found negative association of governance practices with business profitability e.g. [18] checked influence of CEO duality on organizational performance by utilizing sample of 204 firms in Istanbul from 2009 to 2010. The results found negative relation of CEO duality with firm performance. The stockholders will get higher return in businesses which have separate chairman and CEO.

Some researchers have also discovered neutral correlation of governance practices with firm performance e.g. [18] explored correlation of corporate governance with profitability and value of Turkish companies and found insignificant association of corporate governance with financial performance. [10] examined influence of governance practices on financial distress and performance of banks in UAE. The researcher discovered positive and significant relation of financial distress with corporate governance systems insignificant relation of corporate governance practices with performance level.

[20] investigated correlation of corporate governance practices with performance of insurance firms during 2005-2009 for Ghana. The results showed that independent audit committees have positive association with performance of insurance businesses in Ghana. [10] examined relation of independent audit committees with organizational performance for 106 financial listed companies in Amman for period of 2008-2009 and concluded that independent audit committees have significant effect on company performance. [1] described that

institutional ownership has significant impact on performance of Pakistani businesses. [3] demonstrated that a relationship exist between governance index and business performance in Indian economy.

We can also see from the literature review that few studies depicted a positive association of governance practices with firm performance, whereas, some other studies depicted a negative and insignificant correlation of corporate governance practices with firm performance. Moreover, there is dearth of literature which provides insights for association of governance practices with firm profitability in agricultural sector of Asian economies. Therefore, major purpose of this research is to bridge this research gap by investigating relationship of corporate governance practices with firm performance in agricultural sector of Asian economies for the period of 2008 to 2017 as regulatory authorities are trying to encourage better governance practices in agriculture sector of Asian countries. This study anticipates a positive correlation of changes in corporate governance practices with firm profitability measured through return on Assets (ROA) for firms from Asian countries.

Consequently, the hypothesis of this research is as follows:

H1: Better Corporate Governance Practices Results in Increasing the Return on Assets (ROA).

MATERIALS AND METHODS

This section presents the framework for this research. It also provides empirical models of this study. The methodology to determine association of corporate governance practices with firm performance for firms from agriculture sector in Asian countries has also discussed.

The Figure 1 presents conceptual framework of this research. The variables for corporate governance practices which past studies and regulators in Asian countries specified as significant principles are recorded on the left hand side. These variables include: Board Independence, Ownership Concentration, Audit Committee Independence, Quality of Corporate Governance, Board Size and CEO Duality. The proxy for firm profitability is specified on the righthand side which is return on assets (ROA). The return on assets has been computed as net income divided by total assets [5].

The effects of control variables on ROA have also controlled in the model and these variables include: Firm Leverage, Firm Size, Sales Growth and Firm's Systematic Risk. These variables are employed as the influencing factors in the relationship of corporate governance practices and firm performance.

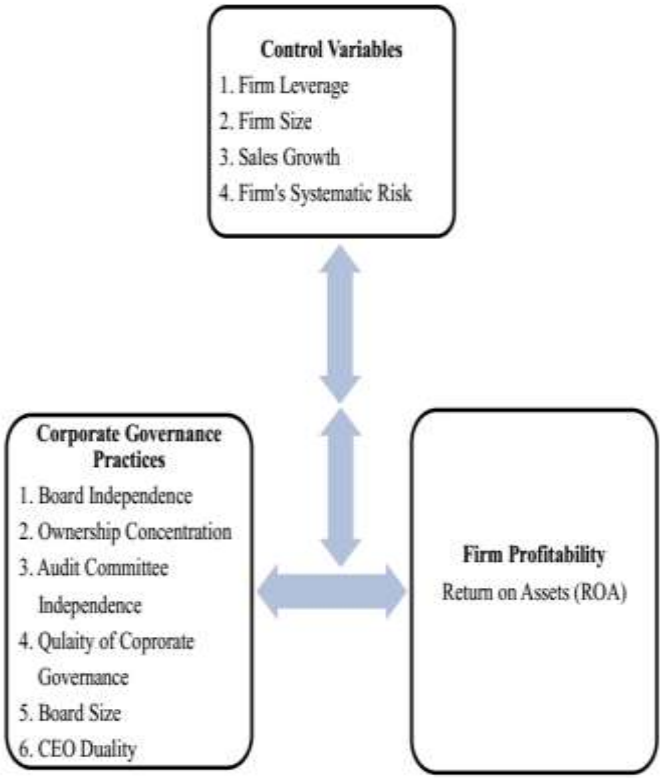

Fig. 1. Possible Relationship of attributes for Governance Practices and Firm's Profitability
Source: Adapted from the Corporate Governance Practices and Cost of Capital: Evidence from Asian Countries (p. 100), by Zeshan Anwar, 2017, PhD Dissertation, The University of Lahore, Pakistan.

Data and Selection of Sample

This research uses quantitative research technique, as the purpose is to find the relationship of certain factors of corporate governance practices with firm profitability for firms from agriculture sector in Asian economies. The hypothesis is developed based on results of prior studies in corporate governance area.

The sample of this research is selected from firms of agriculture sector in 20 Asian countries. The data covers the period of Year 2008 to Year 2017 and it excludes financial companies and the firms for which complete dataset is not available.

The required data is collected from annual reports of companies, stock exchanges of concerned countries and organization's web sites.

The final sample of 363 non-financial companies from agriculture sector is included in the dataset of this research as the representatives of companies from agricultural sector in Asian countries (Appendix I).

Variables

Dependent and independent (explanatory) variables utilized in this research are explained in following portion.

The dependent variable of firm profitability measured through return on assets (ROA) has been measured as dividing the net income after taxes with total assets [5].

The independent variables used in this research are factors described as components of governance practices by past studies (table 1).

These factors influence performance of the firm positively or negatively. Just like the measures of governance practices incorporated in previous research [5], this study will also include the variables of BI, OWN, AI, QCG, BSIZE and DUAL. Specifically, most of factors to be analyzed are variables of internal governance practices which effect firm's profitability as depicted by previous research. The approaches by which these factors are estimated in this research are described as follows:

Board Independence (BI) is percentage of outsider directors to total directors on the board (independent directors). An outsider director is a board member who is not included in team of executive managers and they are not employees of the firm and they don't have any other affiliation with the organization.

The outsider board directors are distinguished from insider directors who are currently serving or have previously served as the firm's executive managers.

Table 1. Explanation and Measurement of Variables

Variables	**Measurement Technique**
Dependent	
ROA	The net income divided by the total assets
Independent	
BI	Board Independence measured as independent directors divided with total directors
OWN	Ratio of Common Stock owned by five largest to total issued stock
AI	Measured as independent directors divided by total directors on audit committee
QCG	Quality of Corporate Governance calculated as: QCG = f (BS, OS and AI)
BSIZE	Board Size calculated as total board directors
DUAL	The firms with dual role of CEO are equal to one and zero, otherwise
SIZE	Natural logarithm of total assets
VOLA	One year volatility of firm stock prices
LEV	The ratio of total debt to total assets
SALESGROW	The log of sales growth rate

Source: Adapted from the Corporate Governance Practices and Cost of Capital: Evidence from Asian Countries (p. 116), by Zeshan Anwar, 2017, PhD Dissertation, The University of Lahore, Pakistan.

The variable of ownership concentration (OWN) as considered in this research is percentage of stocks owned by top five stockholders to total issued stock in a firm.

An independent audit committee is also an important variable for better governance practices. The variable of Audit Committee Independent (AI) calculated as ratio of independent directors to total directors in committee.

This research also employs an index for determining quality of governance practices. In this study, following the work of [13] and [2], variable for Quality of Corporate Governance (QCG) will be calculated through following equation (Appendix II):

$$\mathbf{QCG = f (BI, AI, OWN, DUAL)} \quad \mathbf{(1)}$$

where BI = board independence, AI = audit committee independence, OWN = Ownership Concentration and DUAL = CEO Duality.

The above equation shows the theoretical framework for measurement of governance.

These factors will be used independently as a proxy for governance practices and also collectively for calculating governance scores for each organization.

The board size (BSIZE) is also a significant variable for governance activities in a company and is represented as total board directors and calculated as total board directors. Separation of board chairman and CEO is also critical component of governance practices in firm and it has major influence on business performance and capital cost. This research represents CEO and board chairman separation as CEO Duality (DUAL) and it takes value of one if chairman and CEO are same and value of zero if CEO and chairman are different persons.

The control variables which are having predictive power regarding an organization's profitability as shown by the empirical literature are also included in the regression models for controlling their predictive influences. These variables include Firm Size, Volatility, Leverage and Sales Growth. The explanation and measurement of dependent variables, independent variables and control variables has been provided in the Table 1.

Research Methodology

For analyzing the stated hypotheses, this research will estimate panel data regression equation. This regression equation will be estimated with Pooled OLS Regression Model, Fixed Effects and Random Effects Models; then Hausman Test will be used to identify whether Fixed or Random Effects Model would be applicable for the specific regression equation. In case test statistic will be rejected, it means that the fixed effects technique will fits data better as compared to random effects technique and therefore, fixed effects models should be preferred. Secondly, the regression diagnostics would be estimated for checking the problems of Auto Correlation/Serial Correlation and Heteroskedsticity. Thirdly, in case the problems of serial correlation or heteroskedasticity would be detected from the regression diagnostics then it implies that the Fixed Effect or Random Effects Regression Models would provide spurious regression results. Therefore, to overcome this problem, Panels Corrected Standard Errors (PCSE) Regression Model would be employed to estimate the regression equations. Fourthly, the Two Stage Least Squares (2SLS) Model would be employed to check endogeneity problem of the independent variables.

The base regression model for testing relationship of corporate governance practices with firm's profitability is stated below.

$$ROA_{i,t} = \beta0 + \beta1\ BI + \beta2\ OWN + \beta3\ AI + \beta4\ QCG + \beta5\ BSIZE + \beta6\ DUAL + \beta7\ LEV + \beta8\ SIZE + \beta9\ SALESGROW + \beta10\ VOL + Ut$$

RESULTS AND DISCUSSIONS

As the literature describes that most of the time the panel data suffers with the problems of autocorrelation / serial correlation and heteroskedasticity and in this case, the results of fixed effect or random effects regression models may provide spurious regression results. Therefore, the regression diagnostics tests have been used to check problems of heteroskedasticity and serial correlation in panel dataset used in this study for analysis.

The Wooldridge test of autocorrelation in panel data has been used for checking the presence of auto correlation / serial correlation in data used in this study and results describes that the probability value of F statistics is 0.0000, so we would reject null hypothesis of absence of first order autocorrelation and accept the alternative hypothesis of presence of first order autocorrelation in dataset. So, we concluded that the dataset used in this study incorporates the problem of autocorrelation / serial correlation.

In order to verify presence of heteroskedasticity problem, the Modified Wald Test for groupwise heteroskedasticity has been utilized and findings demonstrates that probability value of Chi2 is 0.0000, so we would reject null hypothesis that panel data does not have the problem of heteroskedasticity against the alternative hypothesis that the panel data does have the problem of heteroskedasticity. So, we can conclude that the dataset used in this study suffers with the problem of heteroskedasticity.

Therefore, the fixed effects or random effects regression models may not be suitable in this scenario as they may provide spurious regression results.

There is a problematic situation as common techniques of panel analysis are incapable of handling both cross sectional dependence and serial correlation simultaneously. [4] reported that 'Panel Corrected Standard Error' (PCSE) model provides considerably better results for handling both problems. So, based on the literature, the PCSE regression model has been also employed to establish correlation of cost of debt with governance variables along with control variables and the results have been reported in table 2.

Table 2. Panels Corrected Standard Errors (PCSE) Regression Model

Panel-corrected		
ROA	**Coef.**	**Std. Err.**
BI	4.338*****	2.227
OWN	2.528*****	1.361
AI	1.052******	1.136
QCG	-.526*******	.187
BSIZE	-.071	.074
Dual	-1.106	.777
LEV	2.990*****	1.602
SIZE	-1.331*******	.257
SALESGROW	.404	.246
VOLA	-.053	.681
_cons	20.161	3.370
Rho	.613	
*****Significant at p-value <1%, **Significant at p-value <5%, *Significant at p-value <10%**		

Source: Adapted from the Corporate Governance Practices and Cost of Capital: Evidence from Asian Countries (p. 184), by Zeshan Anwar, 2017, PhD Dissertation, The University of Lahore, Pakistan.

The results have indicated that variable of board independence, audit committee independence and ownership concentration have positive and significant impact on return on assets (ROA) for companies in agricultural sector of Asian economies which mean that higher board independence and more ownership concentration would result in increased return on assets. The control variable of leverage also has positive and significant correlation with return on assets. These finding are same to the results of previous studies, for example [6]; [7]; [9]; [11]; [16] and [21].

The results also depicts that the variables of quality of corporate governance has negative and significant correlation with return on assets in Asian countries. The control variable of firm size also has negative and significant association with return on investment which means that the companies in agricultural sector of Asian countries have lesser return on assets. Moreover, the variables of board size, CEO duality, sales growth and volatility of stock prices have insignificant impact on return on assets.

For checking the problem of endogeneity of board independence, the 2SLS model has been applied and variable of board independence has been considered as endogenous variable based on the literature, whereas, the variables of board size and CEO duality have been considered as instrumental variables. The results of the 2SLS regression model have been presented in table 3.

Table 3. The Two Stage Least Squares (2SLS) Regression Model

2SLS Regression Model		
ROA	Coef.	Std. Err.
BI	20.007***	3.569
OWN	1.072	.774
AI	.304**	.956
QCG	-.826***	.305
LEV	-2.033***	.780
SIZE	-1.016***	.076
SALESGROW	1.197***	.240
VOLA	-.352	.309
_cons	13.562	1.346
Instrumented: BI		
Instruments: OWN AI QCG LEV SIZE SALESGROW VOLA Dual BSIZE		
*****Significant at p-value <1%, **Significant at p-value <5%, *Significant at p-value <10%**		

Source: Adapted from the Corporate Governance Practices and Cost of Capital: Evidence from Asian Countries (p. 186), by Zeshan Anwar, 2017, PhD Dissertation, The University of Lahore, Pakistan.

The results demonstrate that the variables of BI and AI has positive and significant impact on ROA which means that more independent boards would result in higher return on assets. The control variable of sales growth also has positive and significant correlation with ROA

which means that the firms having higher sales growth would also have higher ROA. The results are similar to the findings of [6].

The findings also demonstrate that the variable of QCG has negative and significant impact on ROA for firms in agricultural sector of Asian economies. The control variables of leverage and firms size also have negative and significant correlation with return on assets which means that the firms having higher leverage ratio and larger size would have lesser return on assets. Moreover, the variables of ownership concentration and volatility of stock prices have insignificant influence on return on assets.

In order to test the endogeneity for variable of board independence, the Durbin and Wu-Hausman tests have been applied and based on the p-value of Durbin and Wu-Hausman test statistics of 0.0002 and 0.0002 respectively, we reject null hypothesis that variables are exogenous and accept the alternate hypothesis that variables are not exogenous. We conclude that the problem of endogeneity does exist in regression model and board independence is the endogenous variable in this model, therefore, 2SLS regression model is best for estimation.

After verifying the endogeneity of the variables, the test for the First Stage Regression Summary Statistics has been employed to determine whether the instrumental variables are weak or not and results showed that Minimum eigenvalue statistic is 197.176; this value needs to be compared with critical values at 10%, 15%, 20% and 25%. The minimum eigenvalue is greater than all the critical values, so we would reject null hypothesis that instruments are weak and accept alternative hypothesis that the instrumental variables are not weak.

After determining the endogeneity of board independence; the test of Overidentifying restrictions has been used and s the p-value statistics for the both Sargan Test and Basmann Test are 0.1692 and 0.1694 respectively, so we cannot reject null hypothesis that instruments set are valid and model is correctly specified. So, we conclude that the instrumental variable included in this model namely board size and CEO duality are both valid instruments and 2SLS regression model which has been employed for the analysis in this study is correctly specified.

CONCLUSIONS

The results depict that the variables of board independence, audit committee independence and sales growth have positive and significant association with ROA, whereas, the variables of QCG, leverage and firm size have negative and significant correlation with ROA. The corporate governance practices are very important for all firms as it strengthens trust of investors, creditors and all stakeholders regarding organizational activities. These practices are even more important for firms in agricultural sector as large number of shareholders and stakeholders have involvement in these organizations. The findings of this study suggested that better corporate governance practices result in higher performance for Asian firms in agricultural sector. These results justify most of the past research and corporate governance theories in general and agency cost theory in particular regarding role of corporate governance activities in lowering agency cost and improving firm performance. These findings are significant as sample considered in this study comprises of firms from agricultural sector in Asian countries; therefore it is important for policy makers of these firms to further improve and develop their corporate governance activities as they would gain the benefits of increased profitability. It would results in further development and growth of these firms as investors and creditors are more interested to invest in those firms where corporate governance structures are better. Moreover, the size and share capital of these firms is quite large; therefore, the results of this study are also very important for investors and creditors around the world as they can forecast the performance of these firms based on their corporate governance systems. Furthermore, better governance practices consider interests of all stakeholders including efforts for improving lives and welfare of labor/workers/employees which ultimately

leads towards social welfare of the society as a whole.

The future research could concentrate on extending this study in various directions. Some of these directions are identified as follow:

(i)Firstly, the future researchers could clarify this association for firms in other sectors.

(ii)Secondly, separate analysis of each country should be conducted in future research.

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Appendix I: Firms Included in Final Sample from Agricultural Sector of Asian Countries

Region	Country	Firms Included in Final Sample
East Asia	China	51
	Japan	126
	South Korea	37
	Taiwan	19
	Hong Kong	25
South Asia	India	25
	Pakistan	2
Central Asia	Kazakhstan	1
ASEAN	Thailand	10
	Vietnam	1
	Malaysia	7
	Singapore	10
	Indonesia	3
	Philippines	7
Eurasia	Russia	20
Middle East	Saudi Arabia	10
	Israel	2
	Qatar	2
	UAE	4
	Kuwait	1
Total Sample		**363**

Appendix II: Scoring Criteria and their Weights for QCG

1. **Number of INEDs in Board of Directors: (Weight 25%)**

Range	Score
0%----------20%	1
21%-------- 40%	2
41%---------60%	3
61%---------80%	4
81% and above	5

2. **No. Of INEDs in Audit Committee: (Weight 25%)**

Range	Score
0%----------20%	1
21%-------- 40%	2
41%---------60%	3
61%---------80%	4
81% and above	5

3. **Ownership Concentration: (Weight 25%)**

Range	Score
0%----------20%	5
21%-------- 40%	4
41%---------60%	3
61%---------80%	2
81% and above	1

4. **CEO Duality: (Weight 25%)**

Value of 0	2
Value of 1	1