# CORPORATE GOVERNANCE AND ORGANIZATIONAL PERFORMANCE IN NEPALESE FIRMS: AN EMPIRICAL INVESTIGATION

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## ABSTRACT

*This study explores the corporate governance landscape within Nepal, a developing nation experiencing industrial transformation. It aims to elucidate the current corporate governance system, examine the correlation between governance scores and firm performance (measured by Return on Assets), and investigate the unique characteristics of corporate governance in Nepal compared to other countries. Utilizing a sample of 37 publicly listed companies, the research employs a Composite Governance Score, developed based on the OECD Principles of Corporate Governance, and utilizes multiple regression models to assess the impact of corporate governance on firm performance. Higher governance scores in financial companies likely stem from stricter regulations and disclosure rules enforced by the central bank. The study found a strong positive link between good corporate governance and better firm performance. The findings contribute to the limited empirical research on corporate governance in Nepal, providing valuable insights for policymakers, investors, and corporate leaders.*

**KEYWORDS:** *Corporate Governance, Nepal, Developing Economies, Firm Performance, Governance Scores, Oecd Principles.*

## 1. INTRODUCTION

The global significance of corporate governance has intensified since the 1990s, triggered by a series of prominent corporate scandals worldwide (Ward, 1997). These events necessitated a critical reassessment of governmental oversight in protecting shareholder interests. The corporate scandals of the early 2000s, exemplified by the enactment of the Sarbanes-Oxley Act, further emphasized the importance of robust corporate governance frameworks. Consequently, United Nations member states have actively pursued the strengthening of regulatory frameworks to restore investor confidence and enhance corporate transparency and accountability. Wasdani et al. (2021) emphasized the fundamental nature of corporate governance in the effective management and operational success of an organization. The establishment of sound corporate governance is now widely recognized as pivotal for maintaining investor confidence and fostering superior performance, leading to the global dissemination of governance norms and standards (Salmon, 1993). Effective corporate governance involves selecting highly capable managers and ensuring their accountability to investors (Adams & Mehran, 2005). Agrawal and Knoeber (1996) describe corporate governance as a dual control mechanism for organizations.

Similar to many developing nations, Nepal's economy, while predominantly agrarian, is undergoing a transition towards industrial development. Nepal possesses a small but active capital market, attracting a significant number of retail investors. New issuers frequently enter the market, often resulting in oversubscribed initial public offerings. Banks and other financial institutions, mandated to list by the Nepal Rasta Bank (NRB), constitute the majority of market capitalization and trading volume. While some companies initially listed for now-defunct tax benefits, others continue to list to raise capital. Key legislation governing Nepal's capital markets includes the Company Act 2006 and the Securities Act 2007, both based on common law. The Securities and Exchange Board (SEBON) acts as the capital market regulator, while enforcement of the Company Act falls to the Office of the Company Registrar (OCR), with disputes adjudicated by the related Company Board. The state-owned Nepal Stock Exchange (NEPSE) operates largely autonomously.

In Nepal, a key component of ongoing financial sector reforms involves empowering the Nepal Rastra Bank (NRB) to oversee corporate governance standards, particularly within the dominant banking and financial sector. The NRB's strategic positioning on the boards of both the Securities Board of Nepal (SEBON) and the Nepal Stock Exchange (NEPSE) provides it with significant resources and independence to act as a central corporate governance regulator. Complementing this, the Institute of Chartered Accountants of Nepal (ICAN) is responsible for developing accounting and auditing standards. Further legal frameworks have been established to enhance and accelerate these reforms, although their effectiveness hinges on successful implementation.

Corporate governance encompasses the policies and procedures organizations employ to achieve specific objectives and their broader missions and visions, considering the interests of stockholders, employees, customers, suppliers, regulatory agencies, and the community (OECD, 2004). The fundamental role of corporate governance is to maximize shareholder wealth while also considering social responsibility, socio-cultural-environmental aspects of business practices, and adherence to legal and ethical standards, with a focus on customers and other stakeholders (Cadbury Committee, 1992). The increasing significance of corporate governance has garnered attention from policymakers, entrepreneurs, business professionals, stakeholders, and related organizations, leading to a growing body of empirical literature documenting key aspects of corporate governance. In addition Chalise, Adhikari, and Lekhak, (2024). Highlights significant relationships between key corporate governance determinants, including ownership structure, board leadership, board diversity, political influence, globalization, and technology. The findings indicate that while board leadership, diversity, and external factors such as globalization and technology positively contribute to corporate governance effectiveness, ownership structure exhibits a negative impact in Nepalse Telecommunication sector. This suggests that concentrated or dominant ownership patterns may hinder governance transparency, accountability, and decision-making processes.

Gupta et al. (2003) analyzed the corporate governance reporting practices of 30 selected Indian companies listed on the Bombay Stock Exchange (BSE) for the years 2001-02 and 2002-03. Using content analysis and regression techniques, the study identified variations in reporting practices and instances of non-compliance with mandatory requirements as per Clause 49 of the listing agreement. Collett and Hrasky (2005) analyzed the relationship between voluntary disclosures of corporate governance information and companies' intention to raise capital in the financial market using a sample of 299 Australian companies. They found limited voluntary disclosure and significant variation among companies. Subramanian (2006) identified differences in disclosure patterns of financial information and governance attributes using a sample of Indian companies, finding no significant differences between public and private sector companies in terms of financial transparency and information disclosure. Fagernas (2007) found a significant increase in the compensation of Indian CEOs between 1998 and 2004, with a greater proportion of pay based on performance, and noted a correlation with the introduction of corporate governance codes. Kali and Sarkar (2011) argued that diversified business groups in India could increase the opacity of fund flows, leading to a greater separation between control and cash flow rights, which can facilitate tunneling. Ahmed et al. (2012) highlighted concentrated ownership as a key weakness in Bangladesh's corporate governance mechanisms, suggesting that streamlining ownership and reforming government and institutional infrastructure are crucial for improvement. Bhagat, S. & Bolton, B. (2019) identified director stock ownership most consistently and positively related to future corporate performance. Using the MCGI as a measure, Bhatt and Bhatt (2017) found a positive and significant correlation between corporate governance and firm performance.

In Nepal, Shrestha (2005) found inadequate disclosure standards due to overlapping authority and non-compliance. The study highlighted that information disclosure norms specified in various acts, bylaws, directives, and guidelines related to securities transactions and price determination were not being satisfactorily followed due to overlapping authority and conflicting laws and regulations. A comprehensive assessment of corporate governance in Nepal by the ROSC Report (2005) identified several weaknesses and provided numerous recommendations. The report urged the continuation of reforms, prioritizing the strengthening of institutions responsible for enforcing new legislation. It specifically recommended a major overhaul of the Office of the Company Registrar (OCR), emphasizing its need for willingness and ability to enforce AGM requirements and the filing of required documents, along with the necessary resources and political independence. Financial measures are utilised more prominently than non-financial measures, and performance measures act as an essential managerial tool, adjusting to strategic shifts within the Nepalese telecommunication sector (Adhikari, & Chalise, 2021).). Gnawali (2023) found that various aspects of corporate governance, including discipline, transparency, accountability, responsibility, fairness, independence, and social awareness, significantly contribute to improved organizational performance. Poudel and Hovey (2012) examined its impact on the efficiency of Nepalese commercial banks. The qualifications of employees, the administrative efficiency of hotel management, and the training and experience provided to employees are recognised as key predictors of organisational performance; however, the geographical factor was not found to impact organisational performance in the Nepalese hotel sector (Chalise, 2021). While existing studies focus on developed countries, this paper addresses the research gap by examining corporate governance and firm performance in Nepalese companies, investigating distinct characteristics in this underdeveloped economy. Corporate governance is a critical concern, and this study aims to contribute to understanding its specific dynamics in Nepal.

The primary objective of this study is to elucidate the corporate governance system within Nepal. Additionally, it examines the correlation between governance scores and return on assets, and investigates the similarities and differences in corporate governance features between Nepal and other countries.

## 2. Methodology

By the end of the fiscal year 2021/2022, the study sample consisted of 37 publicly listed companies in Nepal, selected based on the availability of data from the total population of listed firms. This sample included both financial and non-financial enterprises. Data for the analysis were sourced from various channels, including company circulars, publications, annual reports, reports from the Corporation Coordination Council of the Ministry of Finance, reports from the Securities Board of Nepal (SEBON), and information obtained from stakeholders. A Composite Governance Score was developed using data extracted from the firms' annual reports, as well as through direct observation and interviews conducted by the researcher, in accordance with the OECD Principles of Corporate Governance (OECD, 2004).To investigate the impact of the independent variable (Corporate Governance) on the dependent variable (Performance, measured using Return on Assets), the following multiple regression model was employed:

$ROA = \alpha + \beta_1 GS + \beta_3 Size + \varepsilon$

Where: ROA = Return on Assets $\alpha$ = Constant $\beta_1$ = Beta coefficient GS = Composite Governance Score Size = Log of Total Assets $\varepsilon$ = Error Term

The Composite Governance Score was calculated by classifying corporate governance topics discussed in the World Bank’s ROSC Report into six levels based on the extent of compliance with the OECD Principles of Corporate Governance (OECD, 2004). Points were assigned to each category as follows: Highly Observed = 4 points, largely Observed = 3 points, partially Observed = 2 points, Materially Not Observed = 1 point and Not Observed = 0 points.

### 3. Results and Discussion

**Table 1 Descriptive Statistics (Financial Companies)**

| | Governance Score | | Return on Assets | | Market/Book Ratio | | Size | |
|---|---|---|---|---|---|---|---|---|
| | 2022 | 2020 | 2022 | 2020 | 2022 | 2020 | 2022 | 2020 |
| Mean | 72% | 69% | 0.0278 | 0.0184 | 5.9871 | 5.3422 | 3.7921 | 3.6753 |
| Std. Dev. | 11.2341 | 3.4356 | 0.0356 | 0.0123 | 4.4327 | 1.3975 | 0.6511 | 0.1612 |

Table 1 presents selected statistics for financial companies, revealing an increase in the mean governance score from 69% in 2020 to 72% in 2022, accompanied by an increase in standard deviation. This trend suggests that Nepalese financial firms are increasingly focusing on corporate governance over time, potentially driven by the poor performance of some financial institutions leading to heightened scrutiny and compliance requirements from the central bank. The table also indicates an increase in the mean of return on assets, market-to-book ratio, and size for financial companies in 2022 compared to 2020, possibly due to new regulatory directives and increased attention from stakeholders.

**Table 2 Descriptive Statistics of Non-Financial Companies**

| | Governance Score | Return on Assets | Market to Book Ratio | Size |
|---|---|---|---|---|
| Mean | 62% | 0.1210 | 3.73 | 3.01 |
| Std. Dev. | 16.72 | 0.1569 | 4.95 | 0.69 |

Table 2 presents descriptive statistics for non-financial companies, revealing lower mean governance scores, market-to-book ratios, and size compared to financial companies. However, a notable finding is the higher mean return on assets for non-financial companies.

**Table 3 Descriptive Statistics of total companies**

| | Governance Score | | Return on Assets | | Market to Book Ratio | | Size | |
|---|---|---|---|---|---|---|---|---|
| | 2022 | 2020 | 2022 | 2020 | 2022 | 2020 | 2022 | 2020 |
| Mean | 65% | 62% | 0.0695 | 0.079 | 5.43 | 4.8973 | 3.56 | 3.67 |
| Std. Dev. | 14.67 | 13.53 | 0.1268 | 0.259 | 4..26 | 5.0156 | 0.87 | 0.67 |

Table 3 presents descriptive statistics for the total sample. The mean governance score increased from 62% to 65% between 2020 and 2022 with a slight increase in standard deviation. While the highest governance score increased, the lowest score decreased, suggesting that some companies within the sample have experienced a decline in governance standards despite regulatory developments. Although governance scores improved, the return on assets for the total sample decreased, suggesting that the positive effects of enhanced governance may take time to materialize. Conversely, both the market-to-book ratio and size show positive associations with governance scores, increasing with improved governance.

**Table 4 Result of regression analysis**

| | Total Sample | Financial Companies | Nonfinancial Companies |
|---|---|---|---|
| (Constant) | 0.067 | 0.043 | -0.291 |
| Sig. | 0.543 | 0.642 | 0.194 |
| GS | 0.011 | -0.010 | 0.006 |
| Sig. | 0.10 | 0.521 | 0.071 |
| MB | 0.031 | -0.001 | 0.013 |
| Sig. | 0.45 | 0.78 | 0.23 |
| Size | -0.054 | 0.016 | -0.023 |
| Sig. | 0.01 | 0.34 | 0.52 |
| R Square | 0.34 | 0.14 | 0.47 |

Table 4 presents the results return on assets as the dependent variable. The total sample analysis revealed a positive relationship between ROA and the governance score, significant at the 10% level. This finding aligns with prior research (Gupta et al., 2003; La Porta et al., 1999; Shleifer & Vishny, 1997), suggesting that higher governance scores are associated with higher market valuation due to lower cost of capital and higher returns for shareholders. A significant negative relationship was found between company size and governance score, which contradicts some arguments (Mc Conomy, 2002; Tsamenyi et al., 2007). The value of R Square indicated organizational performance highly explained in non-financial companies than financial companies.

**Table 5 Statistical result of overall regression analysis**

| | Total Sample | Financial Companies | Nonfinancial Companies |
|---|---|---|---|
| (Constant) | -11.213 | -17.034 | 4.102 |
| Sig. | 0.03 | 0.014 | 0.634 |
| GS | 0.178 | 0.167 | 6.01E-01 |
| Sig. | 0.018 | 0.053 | 0.543 |
| ROA | 3.278 | -2.566 | 8.895 |
| Sig. | 0.431 | 0.703 | 0.332 |
| Size | 0.712 | 3.356 | -1.71 |
| Sig. | 0.498 | 0.078 | 0.289 |
| R Square | 0.47 | 0.61 | 0.42 |

Table 5 presents the results of market-to-book ratio as the performance measure. For the total sample, a positive association was revealed between governance score and MBR, significant at the 1% level, consistent with the argument that good governance practices lead to better financial performance. This contradicts some previous findings (Core et al., 2006; Bauer et al., 2004). The organizational performance revealed highly explained in financial companies than non-financial companies.

**4. Conclusion and Implications**

The results of this study indicate that while there is an increasing focus on corporate governance in Nepal, disclosure practices remain a significant area for improvement. The low average disclosure score and the wide range of scores highlight inconsistencies in the application of disclosure requirements. The higher governance scores observed in financial companies may reflect the greater regulatory scrutiny and the specific disclosure requirements imposed on this sector by the central bank. Crucially, the study identifies a strong positive relationship between corporate governance standards and firm performance, underscoring the importance of robust governance mechanisms for enhancing firm value in the Nepalese context.

These findings have several important implications for policymakers, regulators, and firm management in Nepal. The low disclosure levels suggest a need for enhanced enforcement of existing regulations and potentially the introduction of more stringent disclosure requirements to improve transparency and investor confidence. The disparity in governance scores between financial and non-financial companies suggests that targeted interventions may be needed to elevate governance standards in the non-financial sector. The strong positive relationship between corporate governance and firm performance reinforces the idea that investing in good governance is not just a matter of compliance but a strategic imperative that can lead to improved financial outcomes. This study provides empirical evidence that can inform policy discussions aimed at strengthening corporate governance practices in Nepal and ultimately contributing to a more robust and transparent business environment.

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