

# Corporate Governance and Firm Characteristics

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## ABSTRACT

The study tries to understand the dynamic relationship between different firm characteristics and corporate governance variables in Indian context by taking the sample of BSE-Sensex companies for a period of 12 years. The paper tries to estimate the impact of selected corporate governance attributes such as board size, outside directors, ownership concentration etc., on capital structure of sample firms. It applies correlation analysis and panel data framework by taking into account both short term and long term debt equity ratio as dependent variable and different variables representing ownership structure, corporate governance and other control variables to study the relationship. Overall results indicate a positive relationship between short term and long term debt equity ratio which was considered as a proxy for capital structure of a firm and the corporate governance variables providing evidence that capital structure of the firm is influenced by governance variables. The positive relationship suggests that companies with higher debt are better governed which indicates that debt may be acting as a self-enforcing governance mechanism.

**Keywords:** Corporate governance, ROCE, RONW, EPS, PBDM, CPM

## 1. INTRODUCTION

Corporate governance (CG) issues have come out stronger in recent years because of corporate scandals and unethical behaviour of executives. Firms, board members and executives have been subject to criminal and civil actions over hidden debt, inflated earnings, insider trading, tax evasion, misuse of funds, and breaches of fiduciary duties (Picard, 2005). The Indian scenario on corporate governance has been evolving rapidly especially after markets have been hit by various scams like UTI-US 64, Ketan Parikh, Harshad Mehta Scam and Satyam Scam. These scams set the stage for good governance reforms and led to the formulation of various committees like the Naresh Chandra Committee, Dr. J. J. Irani Committee, the Kumar Mangalam Birla Committee (2000) and N. R. Narayana Murthy Committee constituted by SEBI in 2003. These committees have given many important recommendations relating to the number of independent members, number of outside directors, frequency of meetings, role of outside directors etc.

Last ten years after the recommendation of various committees and changes in the companies act, the Indian scenario has witnessed a sea change especially in terms of corporate governance practices. Further, the issue of corporate governance has also attracted the attention of researchers in developed and

developing economies. In post liberalization era some firms have exhibited exemplary governance practices and on the other hand some also have given big shocks in terms of bad governance. The question here arises whether certain firm level characteristics influence its governance mechanism or in other words whether some firm characteristics negatively or positively influence the level of corporate governance practices.

In the same line our study tries to explore the relationship between corporate governance variables and firm characteristics including dividend decisions and firm performance. For studying dividends we take into account aggregate cash dividends paid by the company annually as a percentage of book value. For measuring financial performance we take into account both accounting as well as market measures of firm performance. In case of corporate governance measures we create an index of corporate governance indicators including the number of independent directors, total board members, number of board meetings held, percentage shares held by promoters and various other indicators.

## 2. LITERATURE REVIEW

The corporate governance has been a growing area of management research. Empirical research linking corporate governance and firm performance using an index to measure the quality of corporate governance have been conducted in various countries such as - the United States, Australia, Russia, Canada, Germany, Hong Kong, Korea, Greece, India, Ukraine, Thailand, and Switzerland. These studies find a positive relationship between corporate governance and firm performance.

A comprehensive review of literature reveals that empirical work is mostly focused on the impact of corporate governance on firm's performance or examines the influence of ownership structure on firm value (Claessens, 2002; Singh and Gaur, 2009; Chiang and Lin, 2007; Pant and Pattanayak, 2007; Douma, George and Kabir, 2006; Patibandala, 2006; Selarka, 2005; Miguel, Pindado and Torre, 2003; Mohanty, 2002; Sarkar and Sarkar, 2000; Khanna and Palepul, 2000; Sundaramurthy, 1996; Zattoni and Cuomo, 2010; Jackling and Johl, 2009; Sarkar and Sarkar, 2009; Adjaond, Zeghal and Andleeb, 2007; Nicholson and Kiel, 2007; Choi, Park and Yoo, 2007; Zang, 2007; Garca and Anson, 2007; Barako, Hancock and Izan, 2006; Arora, 2010; Arora and Sharma 2015)

A great deal of empirical research to analyze the influence of corporate governance and firm characteristics has been carried out in developed countries; whereas, little is known about the developing countries that have different institutional structures (see e.g. Abor, 2007; Bokpin and Arko, 2009; Kyereboah-Coleman and Biekpe, 2006; Wen et al., 2002). In particular, empirical research to estimate the impact of some corporate governance attributes such as board size, outside directors,

ownership concentration, in India is very much limited. Thus, a diminutive research in this area has evoked the need for this study. Furthermore, this study attempts to fill a gap in the literature by illuminating the significant links between corporate governance and firm characteristics in India.

### 3. RESEARCH METHODOLOGY

The methodology for creation of corporate governance index is discussed in the next section followed by empirical model specification and results. In order to measure the quality of corporate governance for the firms, we have constructed an index – Corporate Governance Index. The index is based on both internal and external mechanisms of corporate governance. The internal governance mechanisms considered are: (a) Board Structure, and (b) Ownership Structure, while the external governance mechanisms included are: (a) Market for Corporate control, The variables representing board structure are: Proportion of Outside directors, Board Size, Number of board meetings, Ownership structure variables are Promoters’ equity, corporate holding and Institutional holding . Market for external control is represented by shareholding by non-promoters. Further, the following firm characteristics variable were also considered for the purpose of analysis like ROCE, RONW (%), PBDTM (%), EPS , Dividend rate (%), Cash EPS, PBDTM (%), Change in Price (CPM) (%),Sales, FIXED ASSETS, LONG TERM DEBT-EQUITY RATIO, DEBT-EQUITY RATIO and Closing price on BSE.

For creation of index Principal component analysis was used where in the variables which were highly correlated were removed. Then we estimate the correlation among our variables to determine the degree of correlation among variables. In the next stage, we proceed with the establishing the relationship among corporate governance variables and financial performance measures using least square method in panel framework. We take corporate governance score as dependent variable and the other variables as independent variables. The same relationship has been shown in equation 1 below.

$$C.G\ Score_{it} = \alpha_0 + \beta_0\text{MKT PERFORMANCE} + \beta_1\text{Size} + \beta_2\text{DIVIDENDS PAYOUT} + \beta_3\text{CAPITAL STRUCTURE} + \beta_4\text{OWNERSHIP STRUCTURE} + \epsilon_{it}$$

Equation 1

### 4. RESULTS

The results of PCA have been presented in Table 1. The value of Kaiser-Meyer-Olkin Measure of Sampling Adequacy was found to be 0.810 and value of Bartlett’s Test of Sphericity was 3077.141 and the results were statistically significant indicating data to be fit for pattern detection.

Further, the results of principal component analysis indicate four main factors having eigen values more than 1 as shown in Table 2 .The four components in total explained around 81 percent of the total variability. Further, component 1 explains around 45% of the variability followed by component 2, 3 and 4 explaining 16, 12 and 8 % of the variations.

Further, the results of the pattern matrix in Table 3 indicates the composition of individual factors in each factor. The factor components having less than 0.5 scores were suppressed to get a clear picture of the important components.

The sub components of four identified factors have been shown diagrammatically using path diagram (Figure 1) with the help of SPSS Amos. The analysis was also done in AMOS to check the robustness of the results.

Finally, on the basis of factor weights obtained from the PCA the composite variable of corporate governance was estimated in SPSS using ordinary least square method. The result generated four new variables and an average of the four variables was considered for evaluating the corporate governance and firm performance linkages.

Table 4 provides information about the standardized estimates of individual variables of the four factors. The Table 4 provides information about the relative weight of each variable in construction of index. In case of first factor the main variables are Non promoters share (NP), Indian promoters (indp), institution as non- promoters (instnp), shares held by banks as non- promoters (BankNP), Foreign Institutional Investors as non-promoters (FIINP) and Individuals as Non promoters(Indnp). The second factor comprises of three components namely Mutual funds as Non Promoters (MFNP), Non institutions as Non Promoters (Noninstnp) and corporate bodies as Non promoters (CBNP). The third factor has board size (BS) and Independent members on board (IM) as main variables and the fourth factor comprising of number of board meetings in each year (BM) and Promoters shares held (prom).

After computing the score of corporate governance index we proceed to our main objective which aims to determine the relationship among our dependent and independent variables.

Firstly we estimate the correlation among our variables to determine the degree of correlation among variables. Table 5 and Table 6 present the correlation values. The results indicate significant correlation among corporate governance index variable (CGAGG) and Closing Price of share(CP), Closing Price in percentage(CPM), Earning Per share(EPS), Long run earning per share(EPS1), Long term debt Equity ratio(LDE), Return on capital employed(ROCE) and return on Net Worth(RONW). The relationship were positive for all the variables which were significant excluding Long term debt equity ratio (LDE) indicating higher governance leads to lower amount of debt in a company and vice versa. Further, in case of both accounting as well as market performance measures we found positive relationship with the CG score.

In the next section we proceed with the establishing the relationship among corporate governance variables and financial performance measures using least square method in panel framework. The empirical model tested by us has been presented in equation 1. We first estimate the relationship with the composite variable i.e. average of the four factors of corporate governance and four factors individually. The results are presented in Table 7, Table 8, Table 9 and Table 10.

In case of our first model where corporate governance score was taken as dependent variable and financial performance variables were taken as independent variables along with control variables like size, capital structure, sales of the firm. The results have been presented in Table 8. As shown in Table 9 we find significant relationship between corporate governance score and four firm performance variables i.e. ROCE, RONW, EPS01 and EPS. Further, the relationships were positive for all variables except for EPS01. Furthermore, the relationship was not significant for other independent variables like PBDTM, CPM etc.

The F-statistic of our model indicates the model to significant though the value of r square is low. The low value of r square can be attributed to the complexity of the relationship between corporate governance and firm performance.

Next we analyse the results of individual components of corporate governance index. Here individual component is taken as dependent variable followed by the same independent and control variables as discussed in the previous section.

The results indicate significant relationship among three variables i.e. ROCE, RONW and EPS. Further, the relationship is inverse in case of RONW. In case of other variables the relationship is not statistically significant.

In case of other three models we find significant relationship for RONW, DE for second model. FA, PBDTM, CPM for third and EPS01, DIV for the fourth model.

## 5. CONCLUSION

Overall our study could not establish link between governance and dividend policy of the firm, however in case of firm performance significant relationship was established by our results.

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Table 1: KMO and Bartlett's Test

Kaiser-Meyer-Olkin Measure of Sampling Adequacy 0.810		
<b>Bartlett's Test of Sphericity</b>	<b>Approx. Chi-Square</b>	3077.141
	<b>Df</b>	78
	<b>Sig.</b>	.000

Table 2: Total Variance Explained

Component	Initial Eigenvalues			Extraction Sums of Squared Loadings			Rotation Sums of Squared Loadings <sup>a</sup>
	Total	% of Variance	Cumulative %	Total	% of Variance	Cumulative %	Total
1	5.830	44.844	44.844	5.830	44.844	44.844	5.660
2	2.080	16.003	60.847	2.080	16.003	60.847	2.660
3	1.542	11.865	72.712	1.542	11.865	72.712	1.992
4	1.059	8.144	80.856	1.059	8.144	80.856	1.195
5	.973	7.482	88.339				
6	.698	5.369	93.708				
7	.477	3.667	97.375				
8	.169	1.301	98.676				
9	.096	.742	99.418				
10	.041	.315	99.734				
11	.035	.266	100.000				
12	1.496E-5	.000	100.000				
13	5.159E-8	3.968E-7	100.000				

Extraction Method: Principal Component Analysis.

Table 3: Pattern Matrix<sup>a</sup>

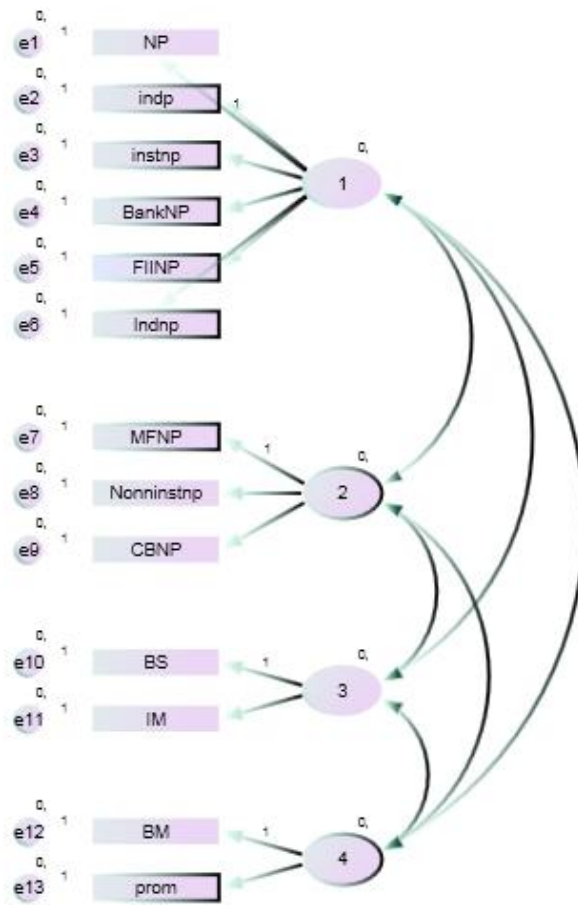
	Component			
	1	2	3	4
<b>BS</b>			.955	
<b>IM</b>			.969	
<b>BM</b>				.757
<b>Prom</b>	-.924			
<b>NP</b>	.928			
<b>Indp</b>	-.801			
<b>Instnp</b>	1.023			
<b>MFNP</b>		.430		.401
<b>BankNP</b>	.824	-.443		.389
<b>FIINP</b>	.754			-.482
<b>Noninstnp</b>	.405	.727		
<b>CBNP</b>		.870		
<b>Indnp</b>	.568	.401		

Extraction Method: Principal Component Analysis.

Rotation Method: Promax with Kaiser Normalization.

a. Rotation converged in 7 iterations.

Figure 1: Four identified factors, Method CFA AMOS



**Table 4: Standardized Regression Weights: (Group number 1 - Default model)**

VARIABLE			Estimate
<b>NP</b>	<---Factor	1	1.073
<b>indp</b>	<--- Factor	1	-.039
<b>instnp</b>	<--- Factor	1	.882
<b>BankNP</b>	<--- Factor	1	.238
<b>FIINP</b>	<--- Factor	1	.404
<b>Indnp</b>	<--- Factor	1	.022
<b>MFNP</b>	<--- Factor	2	.830
<b>Nonninstnp</b>	<--- Factor	2	.992
<b>CBNP</b>	<---Factor	2	.459
<b>BS</b>	<--- Factor	3	.963
<b>IM</b>	<--- Factor	3	.788
<b>BM</b>	<--- Factor	4	.688
<b>Prom</b>	<--- Factor	4	.299

Table 5: Results of Correlation Analysis

Probability	CGAGG	CP	CPM	DE	DIV	EPS	EPS01
<b>CP</b>	0.257117	1					
	0.0062	-----					
<b>CPM</b>	0.40833	-0.12981	1				
	0	0.1725	-----				
<b>DE</b>	0.089939	-0.02472	-0.06566	1			
	0.3456	0.7959	0.4915	-----			
<b>DIV</b>	0.094684	0.461352	-0.04482	0.025724	1		
	0.3207	0	0.6389	0.7878	-----		
<b>EPS</b>	0.293285	0.891314	-0.11045	-0.09561	0.460995	1	
	0.0017	0	0.2463	0.316	0	-----	
<b>EPS01</b>	0.227758	0.87333	-0.13452	-0.13257	0.475123	0.965146	1
	0.0157	0	0.1573	0.1635	0	0	-----

Table 6: Correlation among different variables

Correlation							
Probability	FA	CGAGG	LDE	PBDTM	ROCE	RONW	SALES
<b>FA</b>	1						
<b>CGAGG</b>	0.153326	1					
	0.1065	-----					
<b>LDE</b>	-0.36265	0.10421	1				
	0.0001	0.2742	-----				
<b>PBDTM</b>	-0.14966	-0.40619	-0.06873	1			
	0.1153	0	0.4715	-----			



<b>ROCE</b>	0.561907	0.064436	-0.24819	0.278729	1		
	0	0.4997	0.0083	0.0029	-----		
<b>RONW</b>	0.475232	-0.01832	-0.10075	0.386292	0.952073	1	
	0	0.8479	0.2905	0	0	-----	
<b>SALES</b>	-0.0988	0.069931	-0.08669	-0.12408	-0.16595	-0.17452	1
	0.3	0.4638	0.3634	0.1924	0.0803	0.0657	-----

Table 7: Panel OLS Aggregate Score as Dependent Variable

Variable	Coefficient	Std. Error	t-Statistic	Prob.
FA	-0.12	0.14	-0.85	0.40
LDE	0.56	0.81	0.69	0.49
PBDTM	0.02	0.02	0.72	0.47
ROCE	0.08	0.04	1.96	0.05
RONW	-0.09	0.05	-1.82	0.07
SALES	0.00	0.00	0.59	0.55
EPS01	-0.04	0.02	-2.24	0.03
EPS	0.07	0.03	2.73	0.01
CPM	-0.02	0.02	-0.79	0.43
CP	0.00	0.00	0.03	0.98
DE	-0.15	0.55	-0.27	0.79
DIV	0.00	0.00	0.21	0.84
C	-0.54	0.49	-1.12	0.27
<b>R-squared</b>	0.337824	<b>Mean dependent var</b>		-8.93E-08
<b>Adjusted R-squared</b>	0.25756	<b>S.D. dependent var</b>		2.195266
<b>S.E. of regression</b>	1.89155	<b>Akaike info criterion</b>		4.221434
<b>Sum squared resid</b>	354.2181	<b>Schwarz criterion</b>		4.536974
<b>Log likelihood</b>	-223.4	<b>Hannan-Quinn criter.</b>		4.349458
<b>F-statistic</b>	4.208919	<b>Durbin-Watson stat</b>		0.874711
<b>Prob(F-statistic)</b>	0.000025			

**Table 8: Panel OLS, First Component as Dependent Variable CG1**

<b>Variable</b>	<b>Coefficient</b>	<b>Std. Error</b>	<b>t-Statistic</b>	<b>Prob.</b>
<b>FA</b>	0.059	0.070	0.837	0.405
<b>LDE</b>	0.359	0.397	0.904	0.368
<b>PBDTM</b>	-0.005	0.011	-0.489	0.626
<b>ROCE</b>	0.059	0.021	2.809	0.006
<b>RONW</b>	-0.074	0.023	-3.217	0.002
<b>SALES</b>	0.000	0.000	0.037	0.970
<b>EPS01</b>	-0.013	0.009	-1.428	0.157
<b>EPS</b>	0.028	0.013	2.160	0.033
<b>CPM</b>	0.005	0.011	0.480	0.632
<b>CP</b>	0.000	0.000	-0.747	0.457
<b>DE</b>	-0.058	0.268	-0.216	0.830
<b>DIV</b>	0.000	0.000	0.034	0.973
<b>C</b>	-0.193	0.237	-0.813	0.418
<b>R-squared</b>	0.24	Mean dependent var		
<b>Adjusted R-squared</b>	0.15	S.D. dependent var		0.00
<b>S.E. of</b>	0.92	Akaike info		1.00

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<b>regression</b>		crit	
<b>n</b>			
<b>Sum squared resid</b>	84.39	Schwarz criterion	2.79
<b>Log likelihood</b>	-143.07	Hannan-Quinn criter.	3.10
<b>F-statistic</b>	2.60	Durbin-Watson stat	2.92
<b>Prob(F-statistic)</b>	0.00		0.43
<b>Dependent Variable: CG2</b>			
		<b>Coefficient</b>	<b>Std. Error</b>
	<b>Variable</b>	<b>t</b>	
	<b>FA</b>	0.03	0.05953 4
	<b>LDE</b>	-0.01	0.33602 8
	<b>PBDTM</b>	-0.01	0.00933 7
	<b>ROCE</b>	0.02	0.01774 2
	<b>RONW</b>	-0.03	0.01950 2

<b>SALES</b>	0.00	1.22E-07	t-Statistic	Prob.
<b>EPS01</b>	0.00	0.007832		
<b>EPS</b>	0.01	0.010769	0.539794	0.59
<b>CPM</b>	0.01	0.009663	-0.02375	0.98
<b>CP</b>	0.00	0.000288	-1.19051	0.24
<b>DE</b>	0.39	0.226993	0.922224	0.36
<b>DIV</b>	0.00	0.00014	-1.68101	0.10
<b>C</b>	-0.16	0.200606	-1.6143	0.11
			0.021072	0.98
<b>R-squared</b>	0.46	Mean depende nt var	0.825774	0.41
<b>Adjusted R-squared</b>	0.39	S.D. depende nt var	1.144009	0.26
<b>S.E. of regression</b>	0.78	Akaike info criterion	-0.17862	0.86
Sum squared resid	60.36	Schwarz criterion	1.714936	0.09
Log likelihood	-124.30	Hannan- Quinn criter.	0.968166	0.34

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F-statistic	6.92	Durbin-Watson stat	-0.77578	0.44
Prob(F-statistic)	0.00			

**Table 9: OLS Results, Third Component as Dependent Variable**

<b>Dependent Variable: CG3, Method: Least Squares</b>				
<b>Variable</b>	<b>Coefficient</b>	<b>Std. Error</b>	<b>t-Statistic</b>	<b>Prob.</b>
<b>FA</b>	-0.12	0.07	-1.72	0.09
<b>LDE</b>	0.46	0.40	1.13	0.26
<b>PBDTM</b>	0.02	0.01	1.81	0.07
<b>ROCE</b>	0.01	0.02	0.69	0.49
<b>RONW</b>	0.00	0.02	0.01	0.99
<b>SALES</b>	0.00	0.00	1.34	0.18
<b>EPS01</b>	-0.01	0.01	-1.39	0.17
<b>EPS</b>	0.02	0.01	1.31	0.19
<b>CPM</b>	-0.02	0.01	-1.86	0.07
<b>CP</b>	0.00	0.00	-0.36	0.72
<b>DE</b>	-0.17	0.27	-0.63	0.53
<b>DIV</b>	0.00	0.00	1.24	0.22
<b>C</b>	-0.22	0.24	-0.90	0.37

<b>R-squared</b>	0.22	Mean dependent var	0.00	
Adjusted R-squared	0.13	S.D. dependent var	1.00	
S.E. of regression	0.94	Akaike info criterion	2.81	
Sum squared resid	86.58	Schwarz criterion		3.13
Log likelihood	-144.51	Hannan-Quinn criter.		2.94
F-statistic	2.33	Durbin-Watson stat		1.58
Prob(F-statistic)	0.01			

Table 10: Panel OLS Results, Fourth Component as Dependent Variable

Dependent Variable: CG4				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
FA	-0.09	0.06	-1.48	0.14
LDE	-0.24	0.35	-0.70	0.49
PBDTM	0.01	0.01	1.30	0.20
ROCE	-0.01	0.02	-0.31	0.76
RONW	0.02	0.02	1.02	0.31
SALES	0.00	0.00	1.35	0.18
EPS01	-0.02	0.01	-2.03	0.05
EPS	0.02	0.01	1.61	0.11
CPM	-0.01	0.01	-1.36	0.18
CP	0.00	0.00	1.52	0.13
DE	-0.31	0.23	-1.33	0.19
DIV	0.00	0.00	-1.93	0.06
C	0.02	0.21	0.11	0.91
R-squared	0.42	Mean dependent var	0.00	
Adjusted R-squared	0.35	S.D. dependent var		1.00
S.E. of regression	0.81	Akaike info criterion		2.52
Sum squared resid	64.39	Schwarz criterion		2.83
Log likelihood	-127.92	Hannan-Quinn criter.		2.64
F-statistic	5.97	Durbin-Watson stat		0.81
Prob(F-statistic)	0.00			