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Impact of Quality Corporate Governance on Firm Performance: A Ten Year Perspective

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Abstract

Corporate governance remained most discussed issue in the 2000s during accounting standard adoption, and Asian financial crisis. This study intends to contribute toward the impact of corporate governance features on the firm performance in presence of certain firm specific attributes and uncontrollable (macro) events: firm size, capital structure, adoption of accounting standards, and Asian financial crisis.

In this study, corporate governance scores are calculated by adopting an index from earlier studies. This index consists of two sections: structure (ownership concentration and managerial ownership) and independence (board independence and audit committee independence). High scores for the index denote quality corporate governance and vice versa.

By using the fixed effects estimation method of panel data of 50 largest (by market capitalization) companies (listed at Karachi Stock Exchange), we found quality corporate governance significantly determining firm performance. Leverage (measured by debt ratio) moderates the relationship between quality corporate governance and firm performance by implying stronger relation for high levered firms and negative relationship of governance scores with performance for the case of low levered firms, firm size (measures by log natural of total assets) also changes the intensity of relation for variables of study (stronger relation for larger firms but no relation for small size firms). However, adoption of accounting standards doesn't have any significant for the association between the governance scores and firm performance.

This study targets to gauge the impact of governance features on the performance through composite governance scores.

Keywords: corporate governance; firm performance; Pakistan; Karachi Stock Exchange.

1. Introduction

Debate on the corporate governance is among contemporary issues in business. Investors always seek information that may help them in order to earn abnormal returns. After the eminent studies on market efficiency by Fama, (1965 & 1970) and consequent discussion has turned the research toward fundamental analysis perspective: methods that use financial information to forecast profits, supply and demand, industry strength, management ability, and other intrinsic matters affecting a stock's market value and growth potential (Thomsett, 1998). Researchers use many company specific as well as macro-economic fundamentals. These are earnings, equity, economic value added, dividends, leverage, interest rate, gross domestic product, oil prices, and consumer price index. Ohlson (1995) is popular for its contribution toward this stream of research, who proposed share price as the function of earnings and equity. However this area got expanded by researchers who included macroeconomic factors too, for example Menike (2006); Humpe and Macmillan (2007); Rashid (2008); Muhammad, Hussain and Ali, (2009); Khan (2012); and Osamwonyi and Evbayiro-Osagie, (2012). Last but not least valuation research also targeted corporate governance variables. Latest researches on corporate governance include Sami, Wang, and Zhou, (2011); Ammann, Oesch, and Schmid (2011); Stefanescu, (2011); Garcia-Meca and Sanchez-Ballesta, (2011); Lam and Lee, (2012); Sheikh and Wang, (2012); Ujunwa, (2012); Rashid and Islam, (2013); and Kumar and Singh, (2013).

In Pakistan's capital market accounting profession is controlled by the ICAP (Institute of Chartered Accountants Pakistan) and the corporate sector is monitored by the SECP (Securities and Exchange Commission of Pakistan). Other provisions for the financial reporting are adopted with compliance to the pronouncements of IFRS (International Financial Reporting Standards) foundation. After the accounting frauds of "Enron" and "WorldCom" and issuance of Sarbanes-Oxley act in 2002, in Pakistan SECP also issued the code of corporate governance in same year and referred its adoption mandatory. Later on this code was reviewed and revised in 2012.

For our study we used the index to calculate the corporate governance scores and tested its relationship with the firm performance (measured by market to book ratio and earnings per share). Other variables included are leverage (debt ratio) firm size (log natural of total assets), occurrence of Asian financial crisis and adoption of accounting standards. Corporate governance scores are calculated by adopting an index from earlier studies. This index consists of two sections: structure (ownership concentration and managerial ownership) and independence (board independence and audit committee independence). High scores for the index denote quality corporate governance and vice versa. By using the fixed effects estimation method of panel data of 50 largest (by market capitalization) companies (listed at Karachi Stock Exchange) we found quality corporate governance significantly determining firm performance. Leverage (measured by debt ratio) moderates the relationship between quality corporate governance and firm performance by implying stronger relation for high levered firms and negative relationship of governance scores with performance for the case of low levered firms,

firm size (measures by log natural of total assets) also changes the intensity of relation for variables of study (stronger relation for larger firms but no relation for small size firms). Asian financial crisis tends to interrupt the relation. However, adoption of accounting standards doesn't have any significant for the association between the governance scores and firm performance.

2. Literature Review

It is generally accepted that ownership structure is an important component of corporate governance (Shleifer & Vishny, 1986). The relationship between ownership structure and economic performance has been a topic of great interest in strategic management literature (Oswald & Jahera, 1991; Li & Simerly, 1998; Bethel & Liebeskind, 1993; and Demsetz & Villalonga, 2001).

Since Berle and Means (1932) it has been largely argued that ownership structure is positively related to firm profitability. Continuing this debate, other scholars have examined and generally given supporting evidences to the agency theory expectations (Jensen & Meckling, 1976) that separation between ownership and control provides managerial incentives to diversification because of the personal benefits that managers would acquire from risk reduction. Indeed, large number of shareholders cannot exercise enough power to oversee managerial performance. Consequently, managers exercise more freedom in the use of firm resources as they would in case of a single shareholder or if the ownership would have been more concentrated (Shleifer & Vishny, 1997).

Jensen and Meckling, (1976) and Fama and Jensen, (1983) argue that insider ownership can cause two types of fully differentiated behavior: convergence of interests with shareholders and the entrenchment effect. Former study asserts that as insider ownership grows, the tendency of owners to consume company resources decreases, and therefore their interests and those of shareholders are aligned. In this way, conflicts between owners and managers tend to disappear, and the hypothesis of convergence of interests prevails. However, they also argue that the natural tendency of managers is to use company resources in their own interests, which may conflict with those of external shareholders. These authors note that with increasing insider ownership, conflicts of interest between shareholders and managers disappear because their interests tend to converge. However, Demsetz (1983) and Fama and Jensen (1983) argue that significant percentages of insider ownership generate compensation costs. They argue that even when the levels of insider ownership are low, market discipline may induce managers to seek to maximize value, despite scant personal incentives to do so. Conversely, when insiders hold a percentage of the capital of the company that is large enough to give them voting power or influence, they can achieve their own objectives other than the maximization of value without compromising either their jobs or their salaries.

These arguments show an entrenchment effect on the part of insiders, which means that too high a percentage of insider ownership has a negative impact on business performance. The entrenchment effect is based on the idea that concentrated ownership creates incentives for the controlling shareholder to expropriate wealth from minority shareholders (Fama and Jensen, 1983; Morck, Shleifer and Vishny, 1988; and Shleifer and Vishny, 1997). If family members occupy important positions both in management and on the board of directors, worse

governance mechanisms may result, since the supervisory body may not operate efficiently.

The existence of these two widely different effects suggests a nonlinear relationship between insider ownership and the value of the company, which has been already shown up in several studies (McConnell and Servaes, 1990). Various studies have also shown a nonlinear relationship between firm value and insider ownership (Morck et al, 1988; Wruck, 1989; Hermalin and Weisbach, 1991; Cho, 1998). Several authors have also addressed the entrenchment hypothesis, although their findings have not been conclusive (Morck et al., 1988; McConnell and Servaes, 1990; Leech and Leahy, 1994; Mudambi and Nicosia, 1998; Lasfar and Faccio, 1999; Lehmann and Weigand, 2000; Miguel et al., 2004).

Corporate board structure and its impact on firm behavior is one of the most debated issues in literature today. In recent years, the discussion has focused on the structure of the board of directors, the most outstanding governance mechanism of the internal control systems (Jensen, 1993). Researchers studying corporate governance have used a diverse set of theoretical perspectives to understand the characteristics, roles and effects of board of directors (Corbetta and Salvato, 2004). Although agency theoretic arguments represent one explanation in describing the relation between founding families and boards of directors, stewardship theory provides an alternative explanation (Anderson and Reeb, 2004). It is not necessary to choose one theoretical perspective over another. Indeed, one can obtain a better understanding of family business board by trying to integrate different theoretical perspectives (Corbetta and Salvato, 2004; Minichilli et al., 2009).

Board structure has relied heavily on agency theory concepts, focusing on the control function of the board. Agency theory treats the company as a nexus of contracts through which various participants transact with each other (Jensen and Meckling 1976). Since assets are the property of the shareholders, a principal-agent problem may arise because managers have to make decisions concerning the productive use of these assets. Installing a board of directors can be an effective instrument for monitoring top managers and coping with this problem and to reduce agency costs (Fama and Jensen 1983). Thus, agency theory is used to examine the role that the board of directors may play in contributing to the performance of the organizations they govern (Jackling and Johl, 2009). However, the agency problem seems less important in the context of family firms with high ownership concentration, given that the controlling shareholders have sufficient incentives, power and information to control top managers (Jensen and Meckling, 1976). High ownership concentration can trigger other problems with corporate governance and other types of cost. The asymmetric altruism, free rider problem and the family member's entrenchment could cancel or even exceed the benefits derived from the agency agreement between owners and managers (Schulze et al., 2001, 2003). If there are controlling shareholders, they are more likely to be able to use their power to undertake activities intended to obtain private profit to the detriment of minority shareholders' wealth (La Porta et al., 1999; Villalonga and Amit, 2006). The main contribution of independent directors according to agency theory is consequently their ability to be independent when oversee operating matters, protecting the assets of the firm, and holding managers accountable to the firm's various key stakeholders to ensure the future survival and success of the enterprise (Gabrielson and Huse, 2005).

The previous research on audit committee independence has primarily focused on whether committee independence is associated with enhanced effectiveness. In general, these studies have found greater audit committee independence to be associated with improved monitoring of the financial reporting process (Collier and Gregory 1999; Abbott and Parker 2000; Carcello and Neal 2000; Klein 2002; Abbott et al. 2003, 2004; Bédard et al. 2004; Lee et al. 2004). While these studies provide evidence that audit committee independence is associated with better corporate governance, all but two of these studies only use one measure of audit committee independence and thus do not provide insight as to what level of independence is optimal. We discuss these studies based on how audit committee independence is defined. The first group of studies defines independence using a binary measure capturing whether the audit committee is completely independent of management (i.e., 100 percent independence). The results suggest that completely independent audit committees are positively associated with audit fees (Abbott et al. 2003), and negatively associated with auditor resignations (Lee et al. 2004) and the occurrence of restatements (Abbott et al. 2004).

Another group of studies defines audit committee independence using the proportion of independent audit committee members. These studies find that a higher proportion of affiliated audit committee members is positively associated with the issuance of a clean audit opinion to financially stressed companies (Carcello and Neal, 2000) and auditor dismissals following the issuance of a new going-concern opinion (Carcello and Neal, 2003).

Klein (2002), one of the studies that use multiple measures of independence, examines the relation between abnormal accruals and audit committee independence. She finds that firms with a majority of independent audit committee members have significantly smaller abnormal accruals, but her results do not hold for completely independent audit committees. Bédard et al. (2004) also use multiple levels of independence, but, contrary to Klein, document a negative association between completely independent audit committees and earnings management that does not hold for firms with greater than 50 but less than 100 percent independent audit committees. Thus, given the inconsistent results of these two studies, the question regarding the optimal level of audit committee independence remains unanswered.

Studies on the corporate governance in Pakistan are also available however the problems like no consensus and differences on the methodological issues urge the need of further work on the subject. Recent studies on these issues are the Chaudar, Goergen and Syed, (2006); Javaid and Iqbal, (2007); Hasan and Butt (2009); Javaid and Iqbal, (2010); Rehman et al. (2011); Khatab et al. (2011); Yasser, (2011a); Yasser, (2011b); Dar et al. (2011); Latif et al. (2013); Sajid et al. (2012); Ahmed et al. (2012); and Gul et al. (2012). But none of these studies addressed all these issue by forming composite governance scores or an index.

3. Research Design

3.1. Measurement of variables

Quality is measured by calculating the corporate governance scores adopted from Shah et al. (2011). This score is calculated as below:

$$\text{Score} = [(\text{Ownership concentration scores} + \text{Managerial ownership scores}) * (0.45) + (\text{Board Independence Scores} + \text{Audit Committee Independence}) * (0.55)]$$

Performance is measured on two dimensions: financial and stock market, measured by Earnings per Share and Market to Book Ratio respectively, except these variables, firm size (calculated by taking natural logarithm of total assets) and leverage (calculated by debt ratio) are used as independent variables. We extend our analysis by adding dummies of two macro events: adoption of accounting standards, and Asian financial crisis. These dummy variables are also used as independent variables.

3.2. Sample and data collection

500 firm-year observations of 50 non financial companies (for the period of 2001 to 2010) listed at Karachi Stock Exchange (KSE) are used for analysis. Companies are selected on the basis of market capitalization. Data for the corporate governance is collected through the annual reports of respective companies. Other financial data is collected the "Balance Sheet Analysis of Joint Stock Companies Listed at Karachi Stock Exchange" published by State Bank of Pakistan. Data for share price were collected through from website of KSE.

3.3. Research models and methodology

Following equations are to be tested:

$$FP_{it} = \beta_0 + \beta_1 CGQ_{it} + \varepsilon_{it} \quad Eq. 01$$

$$FP_{it} = \beta_0 + \beta_1 CGQ_{it} + \beta_2 DR_{it} + \beta_3 CGQ_{it} * DR_{it} + \varepsilon_{it} \quad Eq. 02$$

$$FP_{it} = \beta_0 + \beta_1 CGQ_{it} + \beta_2 FS_{it} + \beta_3 CGQ_{it} * FS_{it} + \varepsilon_{it} \quad Eq. 03$$

$$FP_{it} = \beta_0 + \beta_1 CGQ_{it} + \beta_2 AFC_t + \beta_3 AFC_t * CGQ_{it} + \varepsilon_{it} \quad Eq. 04$$

$$FP_{it} = \beta_0 + \beta_1 CGQ_{it} + \beta_2 ASA_t + \beta_3 ASA_t * CGQ_{it} + \varepsilon_{it} \quad Eq. 05$$

Where FP is firm performance either measured by MB or EPS. MB is Market to Book Ratio, EPS is Earnings per Share, CGQ is Corporate Governance Quality, DR is Debt Ratio, FS is Firm Size, AFC is a dummy for Asian Financial Crisis, and ASA is a dummy for Accounting Standards Adoption. β_0 is the intercept, β_1 to β_3 are regression slope coefficients.

As data used for study is of panel type, so we used panel data estimation methods. Fixed effects model is used to test the relationships.

4. Empirical Findings

To test our first and basic hypothesis we estimated aforementioned equations. Total ten models are estimated (Table 1 at the end of this paper). Model 1 uses MB as dependent variable and CGQ as only explanatory variable. Coefficient of CGQ (0.370) is significant at 5% and standard error is as low as 0.18. Coefficient of determination R-squared is 22.6%, however, adjusted R-squared value is low (13.9%). Overall standard error of regression is also quite low (0.5387). Overall goodness of fitness for the model is also sufficiently appropriate as shown by the F-statistics. This equation is estimated with the slight change again (used EPS as dependent variable) in model 6. CGQ significantly determine the EPS, and level of significance is less than 1%. Slope coefficient of CGQ for EPS is 3.477 which is much greater than the coefficient for MB although the standard error is also high. R-squared for EPS is also high (49.6%) and adjusted R-squared is 44%. So comparatively the CGQ better determine the EPS than the MB. For concluding remarks, CGQ is better associated with profitability rather than stock market performance.

Model 2 is designed with the intention to investigate the effect of leverage on this relationship. It consist the proxy of leverage (debt ratio) as the independent variable along with the CGQ and the interaction term is also added to estimate the moderation of the leverage. All the explanatory terms are significant at 5% level of probability. Slope coefficient of interaction term 1.655 shows the strong positive relation between CGQ and MB for the larger firms. However, CGQ's coefficient containing remaining variations shows negative sign, which means negative impact on the concerned relationship. R-squared is 23.7%. Overall model is valid. Same equation is estimated with replacement of dependent variable in model 7 (EPS is dependent variable). Here, profitability is determined significantly and positively by the CGQ for low levered firms as interaction term doesn't affect EPS significantly. R-squared is appropriate and high (50%) and adjusted R-squared is also shows acceptable figure of 44%. F-test implies that overall model is also valid. To investigate the role of firm size, estimated model 3, and model 8. CGQ has 0.577 times effect on MB ratio and 2.089 times effect on EPS (for both significance probabilities are less than 5%). R-squared is higher for EPS (50.6%) than MB (23.4%).

After discussing the firm specific variables we considered macroeconomic (uncontrollable) factors. Next section contains the estimation to investigate the effects of the financial crisis and adoption of accounting standards. For measuring impact of financial crisis a nominal variable (dummy) is included in the model. Results of model 4 show that financial crisis doesn't have significant direct affect to the MB ratio of sample companies. However occurrence of financial crisis affects the relationship of CGQ and MB. Determination power of the model is 23.3% and adjusted R-squared is 14.4%. While measuring the effect of financial crisis over the relationship of CGQ with EPS (profitability) again financial crisis doesn't have any affect directly on the profitability, so the affect on the relationship under discussion is significant positive during the crisis period and other sample years. Relationship is stronger in this case as shown by the slope coefficient, and also the overall predicative ability is high (R-squared is 50.5%). For both the cases overall models are valid. After discussing one aspect, last issue included in the scope of this paper is adoption of accounting standards. The adoption (mandatory) is notified by ICAP and SECP to the public limited companies of Pakistan in June 2005. Mathematical estimation resulted in no significant relationships between the ASA and MB ratio, and even no affect to the relationship between the CGQ and MB. However results of the ASA with EPS and CGQ are bit confusing. Adoption directly doesn't affect profitability directly, however CGQ affects strongly during before adoption period. Overall model's determination power is high as indicated by R-squared (51%). However these results are less clear and justifiable.

5. Conclusion

Corporate governance is the major pillar for corporate control in financial environment. In this study, comprehensive data have been used to investigate and analyze the relationship between corporate governance and performance. Good corporate governance is rightfully seen as the most important task of today's regulators, planners, industry leaders, and managers. Formally exploring the relationship between these important aspects of the economy has been opportune and timely. As mentioned earlier, one important aspect of corporate governance that has been highlighted by this study is the fact that boards and audit committees are not as independent in Pakistan as the

development of a good corporate governance culture would demand. One reason for this could be that the data are skewed toward the spinning sector, in which most companies are family-owned. Another reason for this state of affairs is the absence of a clear definition of INEDs in Pakistan. Companies are inclined to label all NEDs as independent at will. We believe there is an immediate need for the law to come up with a precise and enforceable definition of INEDs, and for regulators to ensure that it is properly followed. With the emergence of truly independent directors, who act not for a particular stakeholder but for the collective interest of all stakeholders, companies will become more transparent in their decision making. In turn, this should lead to better corporate governance and greater investor confidence in listed companies.

This study, as well as the literature reviewed for the purpose of the study, shows that there is an urgent need to introduce and effectively enforce laws for better corporate governance in Pakistan. Better corporate governance will bring down the cost of equity, leading to greater investment in new projects, bringing about greater overall development for the economy. The Code of Corporate Governance 2002 needed to be revised, and luckily SECP revised it in 2012 to encompass more stringent measures and be made mandatory for all listed companies. Another good decision was the establishment of the PICG (Pakistan Institute of the Corporate Governance).

Our study is limited in one particular respect: the aspects of good corporate governance included in the CGQ. These components were limited principally due to non-availability of data from published sources on all aspects of corporate governance. We believe that, by considering a greater volume of data and including more variables to calculate CGQ, more reliable results can be obtained. The study leaves room for further research on the issue that can be filled by addressing the effects of the revised Code of Corporate Governance (2012), and investigating the qualitative effects of the establishment of PICG on financial reporting quality and other governance aspects of public listed companies at KSE.

Table 1: Empirical Findings

	Model 1	Model 2	Model 3	Model 4	Model 5
C	0.458 (0.862)	3.987 (1.622)**	8.341 (3.598)*	0.216 (0.868)**	0.733 (0.878)
CGQ	0.370 (0.180)**	-0.527 (0.390)	-1.727 (0.947)***	0.451 (0.187)	0.252 (0.197)
DR		-6.444 (2.514)**			
FS			-2.252 (0.998)**		
AFC				2.560 (1.622)	
ASA					-1.409 (1.476)
CGQ*DR		1.655 (0.640)**			
CGQ*FS			0.577 (0.256)**		
AFC*CGQ				-0.587 (0.304)***	
ASA*CGQ					0.385 (0.280)
R-squared	0.226*	0.237*	0.234*	0.233*	0.230*
Adj R-square	0.139	0.148	0.145	0.144	0.141
Std Error	5.387	5.359	5.368	5.373	5.382

Table 1: Empirical Findings (Cont.)

	Model 6	Model 7	Model 8	Model 9	Model 10
C	1.773 (3.543)	2.623 (6.681)	30.254 (14.711)**	3.133 (3.548)	3.623 (3.548)
CGQ	3.477 (0.740)*	2.967 (1.608)***	-4.145 (3.871)	2.888 (0.764)*	2.131 (0.794)*
DR		-1.514 (10.355)			
FS			-8.123 (4.080)**		
AFC				-9.953 (6.628)	
ASA					0.652 (5.962)
CGQ*DR		0.899 (2.637)			
CGQ*FS			2.089 (1.046)**		
AFC*CGQ				2.841 (1.243)**	
ASA*CGQ					1.581 (1.132)
R-squared	0.496*	0.501*	0.506*	0.506	0.516
Adj R-square	0.440	0.443	0.449	0.448	0.460
Std Error	22.129	22.071	21.948	21.957	21.734*

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