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Impact of Corporate Governance on Firm Performance

Muid Hussain Chaudhry and Qaisar Ali Malik
Department of Business and Economics, FURC, PAKISTAN

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Abstract

This study aims to investigate the impact of corporate governance on firm's performance. To measure the corporate governance, four factors were used that are; Board Size, Ownership structure, Committees and CEO Duality. Data was collected from 30 listed companies of Karachi stock exchange for firm performance, whereas to measure the corporate governance index primary data was collected from top management and response rate was 86 percent. Regression and correlation were used to analyze the data. The results concluded that committees, board size and CEO duality have negative relationship, whereas ownership structure has positive impact on firm performance. For future research implication, other corporate governance measures can be used to investigate the impact on firm performance.

Keywords: CAPAM, stock price, liquidity, Ask-Bid, spread.

Introduction

The concept of corporate governance is not new to the world as it got famous and got momentum after the sighting of famous scandals like WorldCom and Enron. To avoid the agency problem the management needs to define their personal and corporate intentions which will arise the need for strong corporate governance. Companies always look for good corporate governance, same as a child cries to get the mother's attention and care. Corporate governance technique got famous and developed by qualified bodies when the small investors faced losses in corporate scandals. Corporate governance was introduced to improve the efficiency of people's savings which they had invested for high return[1].

The gate way towards financial uprising was Sabanes-Oxley Act, 2002 which proved to be helpful in enhancing corporate governance. This fulfilled the opportunity of reinforcing governance system, correctness and consistency of financial information was also assured. The safety of the interest of all stakeholders is considered as the important purpose of the corporate governance. This further involves the timely decision making at the higher management level, timely and accurate flow of information to the concerned and most importantly increasing the confidence of the investors in the company. As a result, the chances of the agency cost are minimized.

The development of a corporation is highly dependent on the corporate governance practices. This has been proved after evaluating corporate governance practices with different measures. This is aspect is true for both developed (America) and developing (Pakistan) markets. Companies which adopt strong corporate governance have certain cash flows while companies who have poor corporate governance faces higher risk.

The main and prime objective of research is to see influence of corporate governance on firm's performance. Here, we will take four facets of corporate governance such as Size of board, Ownership structure, Committees and CEO Duality. In Pakistan, majority of the businesses are family owned. So, this study will help to find out how corporate governance impacts those family owned businesses. Different researches have been conducted in different countries. All of them have different school of thoughts regarding corporate governance and also many researches had done on performance of company Empirical data shows mixed results of corporate governance and company's performance. In Pakistan, some companies consider corporate governance as an important part of companies' operations but some of them try a lot to make their corporate governance effective but unable to do so. This study helps the academia and practitioners; in academia this research will help to further incorporate different aspects of corporate governance for future studies whereas companies will take benefit from this research to make decisions as per research results in order to get better performance of their firms.

Literature review: Some important relationships have been shown with the help of practical researches between a variety of features of corporate governance and that of corporate performance during the last decade. However, numerous latest researches highlight particular characteristics of corporate governance due to which it is complex to create a general association among corporate governance and corporate performance. It might not be possible to detain the factual association simply by linking corporate performance to a specific feature of corporate governance until and unless that particular feature is managed for additional features of governance[2-4].

Numerous researchers were encouraged by this argument to create an index of sole governance, a scale which calculates the corporate governance of a firm over various aspects. For instance, indexes of governance had created for the Russia[5], U.S.A[6], U.K and Europe[7], Germany[8] and Korea[9]. Gull et al.[10]studies shows that independent board is a determinant of corporate governance and he scrutinized that banks which having the independent board are performing well than the dependent boards.

A link between inclusive corporate governance score of company and company's performance can be found out through indexes. This research determines significant and optimistic relationships in the majority cases. Corporate governance is essential factor for the performance of firm and also for the increasing economy of the country on the whole. There are number of facets that are used to measure the corporate governance index, some of them are explained below:

Board Size: In larger firms board of directors face difficulty in communicating with one another which damages the firm's performance. Whereas, Singh and Davidson[11] and Yermack[12] analyzed that firm performance have negative relationship with board size.

Ownership structure: Different authors have different arguments regarding ownership structure. Kao, Chiou and Chen[13] and Shima et al.[14] found that firms whose larger numbers of shares are pledged by directors can face agency problems.

According to Kao and Chiou[15] investigated that directors and supervisors made strategies which have a positive influence on shares prices or escalate their authority,which can be done through purchasing of more shares and collateralized shares, this will directly affect the firm performance.

Committees: The role of committee in the area of corporate governance is vital. Different committees have be formed for different decisions like audit committee, remuneration committee etc. UK firms are unwilling to institute committees that causes of failure of corporate governance[16]. Whereas, nomination of committees are weakly correlated with the financial reporting of the firm. Another studied concluded that presence of audit committee enhance the value of firm[17].

CEO Duality: CEO duality is also an integral part of corporate governance. If company's chairman serves two positions in company at the same time then it will lose the independence and monitoring power. So in result the performance of the company will become weaker and cause agency problem. According to Dahya et al.[18] and Daliy and Dalton[19] suggested that CEO duality cause deterioration of firm performance.

Hypothesis: H1: Committee exerts a negative effect on company's performance. H2: Board Size is negatively related to firm performance. H3: Ownership structure is negatively related to firm performance. H4: CEO Duality has a negative effect on firm performance.

Methodology

Data is taken from 30 listed companies of KSE (Karachi Stock Exchange). Data on corporate governance is available so, it is taken as purposive sampling.CGI is taken from Shah[20]. The data was collected from 2002-2012 from annual reports, business recorder and KSE website. The sample consists of time series in which panel data was used to remove the auto correlation of variables and this study also consist of cross sectional data in which heteroskedasticity is used. Two types of regression models are used in panel data such as random and fixed effect model. According to the above proposed hypothesis, we constructed regression model. This model scrutinized the relationship of mechanism of corporate governance and company's performance. Regression equation is mentioned below:

Firm performance$_{it}$= a_0 + a_1Board Size$_{it}$ + a_2Ownership structure$_{it}$ + a_3Committees$_{it}$ + a_4CEO Duality$_{it}$+ a_5Firm Size$_{it}$ + a_6Capital expenditure$_{it}$ + a_7Leverage$_{it}$ + $\mathcal{E}_{it,}$ Firm performance$_{it}$ = return on asset and return of stock of companyi in year t. Board size$_{it}$ = board size of companyi in year t. Ownership structure$_{it}$ = No. of shares hold by directors of companyi in year t. Committee$_{it}$ = committee of companyi in year t. CEO duality$_{it}$ = used as dummy variable of company I in year t, Firm size$_{it}$ = size of companyi in year t. Capital expenditure$_{it}$ = capital expenditure of company i in year t. Leverage$_{it}$ = leverage of companyi in year t. $\mathcal{E}_{it}$ = error term of company in year t.

In our research we take different measures like stock return, return on asset and Tobin's Q as proxies of market performance, firm's profitability and recital of accounting correspondingly. Furthermore, primary data of corporate governance index was collected from the top management of the companies. We received 43 responses and descriptive analysis is used to explain the results.

Results and Discussion

Data analysis: The corporate governance is measured through questionnaire constructed by Shah, total 50 questionnaires were floated but response rate was 68%. After getting the response weights were assigned to each variable as mentioned in table-1.

Table-1
Weights Given to Variables

Variables	Weight assigned
Board size	5%
Ownership Structure	10%
Committees	10%
CEO Duality	5%

These weights were assigned on the basis of strongly agree and agree. The respondents who had a view of strongly agree were assigned a weight of 10% whereas agree respondents were assigned 10% weight. By using the selected data provided in yearly reports, mean of every variable was measured from 2002 to 2012. The range given to the data was from 1 to 5 with the average of 3. After that we applied normal distribution curve to classify the companies on both sides of average score. Then weight assigned of the responses provided by the respondents to every company was multiplied with each variable. Finally, we concluded with the Corporate Governance score by adding up all the variables scores.

Table-2 demonstrated the mean of annual stock returns that is 8.171, the mean of return on asset was 5.96, and the mean of Tobin's Q was 1.038.

The table 3 explains the relationship of corporate governance and company's performance.

Table-2
Descriptive Results

Variable	No. of Observations	Mean	Standard Deviation	Minimum	Median	Maximum
Stock returns (%)	30	8.171	51.44	-75.423	0.336	657.142
ROA (%)	30	5.96	8.701	-72.968	5.688	44.152
Tobin's Q	30	1.038	0.612	0.224	0.866	9.559
Board Size	30	0.499	0.134	0.152	0.484	1.771
Ownership Structure	30	4.211	7.389	0.000	0.992	59.744
Committees	30	0.091	0.124	0.000	0.000	0.6
CEO Duality	30	0.25	0.371	0.000	0.000	0.8
Firm Size	30	12.14	1.048	9.242	12.018	16.232
Capital Expenditure	30	0.053	0.317	0.000	0.0136	17.621
Leverage (%)	30	31.56	13.718	1.168	31.28	89.208

Table-3
Pearson Correlation Coefficient Analysis

Variable	Board Size	Ownership Structure	CEO Duality	Committees	Firm Size	Capital Exp	Leverage (%)	ROA_{t-1}	ROA_{t-2}
Board Size	1	.0368**	-.1**	.0936**	-.0912*	.0008	-.072**	.0184*	.0312**
Ownership Structure	.0368**	1	.0384**	.02*	.165**	.0112	.065**	.019**	.233**
CEO Duality	-.1**	.0384**	1	.122**	.116**	.010	-.0072	-.036**	-.036**
Committee	.0936**	.02*	.122**	1	.106**	-.0016	-.027**	.0336**	.0288**
Firm Size	-.0192*	.165**	.116**	.106**	1	-.171**	.014	.079**	.084**
Capital Expenditure	.0008	.0112	.010	-.0016	-.171**	1	-.011	-.008	-.007
Leverage (%)	-.072**	.065**	-.0072	-.027**	.014	-.011	1	-.253**	-.232**
ROA_{t-1}	.0184*	.019**	-.036**	.0336**	.079**	-.008	-.253**	1	.589**
ROA_{t-2}	.0312**	.233**	-.036**	.0288**	.084**	-.007	-.232**	0.589**	1

**significancelevel ** strongly significant*

Table-4
Relationship between corporate governance and performance of firm

Dependent Variable		Return on Assets	Stock Return	Tobin's Q
Independent Variable	Predicted Sign	(a)	(b)	(c)
Board Size	-	-2.074	-9.674	-.101
Ownership Structure	+	.0926	-.272	.003
CEO Duality	-	-.571	.248	-.006
Committees	-	-.065	.098	-.0002
Firm Size	+	1.896	.507	.061
Capital Expenditure	+	-.312	1.307	.007
Leverage	-	-.177	-.186	-.005
Fixed Effect		Industry	Industry	Industry
Fixed Effect		Year	Year	Year
Sample Size		30	30	30
$AdjR^2$		.198	.163	.174

The results of table 4 exhibit the correlation of corporate governance and company's performance. ROA was the dependent variable which was used to measure the financial performance whereas stock return was used to measure the market performance, last but not the least Tobin's Q was used to calculate the firm value as shown in the above table. Adjusted R^2 values of dependent variables are 0.198, 0.163 and 0.174 respectively. After getting the results, we investigated that there was significantly negative correlation between board size with stock return, ROA and Tobin's Q. whereas there was positive and significant relationship of ownership structure with Tobin's Q and ROA.CEO duality had negative significant relationship with return on asset. To sum up all the results, we came up with the conclusion that hypothesis 1, 2 and 4 were accepted whereas hypothesis 3 was rejected. These results were also supported by Wu, Lin andLia[21].

Conclusion

The above results show that board size, committees and CEO duality had negative link with the performance of firm. It is justified from the previous literature that large board size will affect negatively on the performance of firm because number of insider opinions effects the decision making process of the company. On contrary, CEO duality has a significant and negative relationship with company's performance because if CEO's serves in number of companies will affect negatively to the firm's performance. If CEO serves in more than one company then his keen objectives would be distracted, that are beneficial for the company. Moreover, there is a positive correlation of ownership structure and company's performance because if the ownership is held by insiders then they take care of the interests of outside shareholders as well as insiders which consequently benefit the company.

From the above conclusion, we investigated that board size, ownership structure, CEO duality and Committees have significant relationship with firm performance. There are number of others facets of corporate governance that may affect the performance of the firm but due to time limitation, I only investigated on these four facets of corporate governance. For future research, different variables can also be used to elucidate the firm performance and to measure the corporate governance. Due to scarcity of time, this research was limited to few companies but in future this research may be extended by incorporating number of companies.

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