

Corporate Governance and Firm Performance of Non-Financial Firms in Pakistan

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Abstract: *This research study examines the effect of corporate governance (board advisory group) on financial performance (ROA) of non-financial firm listed in Pakistan Stock Exchange. Out of 399 firms listed in PSX, a sample of 196 firms were selected randomly by using formula of Krejcie & Morgan (1970) covering period of 2002- 2018 from the annual reports published firms or from published by State Bank of Pakistan. Pooled regression model were selected from the diagnostic tests. Results of the research shows that corporate Governance has a significant effect on the on financial performance of non-financial firms. The findings recommends that The institutional shareholdings have significant effect on ROA, the firm should increase their institutions as this will increase their profit and value and the firm should adopt debt financing who have less shareholders as this will give them tax yield and will increase their profit but the firm who are interested in equity financing will try to lower the debt level as this will negative effects on the firm value. Furthermore he managers should be involved as shareholders as this will increase their hold and they will increase the firm profit.*

Keywords: Non-financial Firms, Corporate Governance, Board Advisory Group. Pooled OLS, Pakistan Stock Exchange

INTRODUCTION

Corporate governance is the name of relationship between management, board of directors, stakeholders and shareholders of the company. Corporate governance is a system through which the firm is directed and controlled. It represents the set of rules and producers to be followed by the firm to achieve its objective efficiently (Durney and Kims, 2005). According to La Pota et al. (2000) "Corporate Governance is a set of procedures or means by which minority shareholders/ outside investors protect themselves from expropriation and fraudulent activities of management/ Insiders". Shleifer and Vishy (1997) explains the Corporate Governance as the ways by which the investors who provides equity to the firm get the return on their investment in a lawful manner.

The basic features of good corporate governance includes clear corporate structures, the producers and responsibility of managers and board of directors towards the best interest of the firm. The board of directors is very vital for corporate governance mechanism. This board is responsible to ensure that firm has a good mechanism of shareholder rights, solid environment, a good disclosure, transparency and exert for the high interest of the firm. The board plays a key role in directing and controlling and is accountable for the business operation and firm. The recent financial crises has been found a lot of shortcoming in the corporate governance mechanism and the regulators.

Corporate governance has shown that weak monitoring causes risk and effect the financial performance badly (Chidambaram et al, 2008). Corporate governance represents the procedures and rules of firm which help in attaining the stake of stakeholders and the interest of corporation. (Clarke, 2004). Dittmar and Smith (2007) found that better corporate governance system helps the firm towards better approach in financing and lowering capital cost. This is the prime responsibility of BOD to manage entire firm in better way; the BOD also plays a vital role in making decision about financing mix. According to Classens et al, (2002) sound governance practices facilitate firm in finding best avenues and markets and minimizing the cost of capital for the firm shareholders.

Keeping in view the importance of corporate governance, this study is conducted with the main objective to investigate the main component of corporate governance practices and its impact on performance of non-financial firm in Pakistan. .

LITRATURE REVIEW

Previous literature testing the association between numerous components of corporate governance and firm performance is broad. Studies employ various features to assess corporate governance, for example, CEO duality, extent of non-official chiefs, board panels, proprietorship structure and focus, directors' remuneration and others. This research study will show just a portion of the exact examinations. The main corporate governance component that we will consider is the board advisory groups.

Defond and Hung (2004) establish that the closeness of compensation advisory group is associated with larger volumes of official pay that resolves a gainfulness diminish (negative relationship) for US organizations. Roe (2000) found that compensation board of trustees has a positive association with performance (measured by ROA, efficiency and market returns) for the US economy. Weir and Laing (2000) got similar results employing ROA as a degree of performance. For the review board the results are also merged. In 2002 Weir et al. (2002) argued that the presence of review board of trustees doesn't impact the firm performance (Tobin's Q).

Black and Kim (2012), using Tobin's Q as a degree of implementation found that review board of trustees is absolutely associated with firm performance (Tobin's Q) in considerable Korean organizations, while in the smaller firms they didn't found any relationship. This result wasn't admitted for Nigerian firms, in Kajola (2008) think about. The author employed ROE and net revenue as measures for performance and 7 years as study period (2000-2006), and the results showed no effect of the review board of trustees on firm performance. Other variable representing corporate governance utilized as a part of such examinations is measure board. Board estimate varies starting with one nation then onto the next as per Corporate Governance Codes.

Kajola (2008) found a positive significant association among's board size and firm performance (measured by ROA). In 2009, a comparable positive relationship was originate between considerable firm sheets and firm performance measured by Tobin's Q and ROA by Jackling and Johl (2009). These results were midway accomplished by the examination of Adams and Mehran (2012). They used an example of 35 recorded puts money on the US capital market for a period from 1986 till 1999 and assumed that board estimate positively affects firm performance measured by Tobin's Q, however no relationship with ROA.

Experimental inquiries that exposed negative relationship between board size and firm performance are both for created economies (Cheng, 2008; Guest, 2009) and creating economies (Guo and Kga, 2012), applying as performance measures ROA, ROE, Tobin's Q and offer returns. As to representation of non-official officials on the board, the confirmation from the exact examinations led is merged, despite the fact that it is required to affect firm execution. They found a positive relationship between the level of non-official chiefs and firm execution (Weir et al., 2002), while some researchers found a negative association (Lawal, 2012) and others that didn't found any association among the two (Kajola, 2008). The measures of implementation used as a part of these investigations were Tobin's Q, ROA, ROE, advertise returns and market esteem. The structure of board decides board autonomy. A sensible extent amongst inside and outside chiefs gives the freedom of the board that guarantees the protection of partners' interests. One of the key examinations with respect to this relationship was made by Morck, Shleifer and Vishny (1988).

MATERIALS AND METHODS

The study was conducted in the non-financial sector of Pakistan. There are 434 non-financial firms enlisted in Pakistan Stock Exchange but the reports of State Bank of Pakistan published a financial data of 399 non-financial firms. The current study will take these 399 non-financial firms are the population of the study. A sample of 196 non-financial firms were taken randomly by using formula of Krejcie & Morgan (1970). The data covering period of 2002- 2018 were collected from the annual reports published by the sample non-financial firms or from the Balance Sheet Analysis (BSA) published by State Bank of Pakistan.

Econometric Model – Panel Data Regression

This research study employ the following multiple regression model

$$ROA = \beta_0 + \beta_1 ISH + \beta_2 MSH + \beta_3 BS + \beta_4 BC + \beta_5 LEV + \beta_6 SG + \varepsilon$$

$\beta_1, \beta_2, \dots, \beta_6$ are slopes/ regression coefficients of independent variables.

ε Random Variable

Variables Explanation

ROA =The current study used return on assets as proxy for the firm performance. The ROA will be taken as the dependent variable and measured as a ratio of net income to total assets.

Independent variables

Institutional Shareholdings (ISH) measured by proportion of total shares held by different institutions (Bansal, 2005).

Managerial Shareholdings (MSH) measured as the proportion of shares holding by the managers working the same firm (Bansal, 2005).

Board Size (BS) The variable Board size is measured as logarithm of number of board members. It is hypothesized that larger boards have positive relationship with performance (Wen et al, 2002). **Board Composition (BC)** represents the percentage of non-executive directors on board and is calculated as the number of non-executive directors divided by total number of directors (Abor and Biekpe, 2007).

Control Variables

Leverages (LEV)

The leverage of the firm is the total amount of debt with respect to the equity of the company (Daher, 2010).

Sales Growth is measured as log of the ratio of total sale divided by the previous sale of the firm. (Shah, 2011).

Model selection Tests

The study consist of of the panel data for determining the firm performance in non-financial sector of Pakistan. The most common methods used by the researchers for panel data are Fixed Effect Model (FEM), Random Effect Model (REM) and Pooled Ordinary Least Square method (POLS). Further, the tests employ by the researcher to select appropriate model for regression analysis arefor t are Chow test, Hausman test and Breusch Pagan test.

Multicollinearity Diagnostic Test

For the purpose of identifying that whether there is Multi co linearity among our variables or not, along with our correlation analysis the Variance Inflation Factor (VIF) test is performed to support the validity of the regression analysis. If we get the result of VIF below 10, then it means there is no Multicollinearity (Gujrati, 2003)

White’s test for heteroskedasticity

The prevailing study has used **White's** test of heteroskedasticity for the sake of recommended model’s data nature. The test has been used to check the selection of model among data as of heteroskedasticity and homoscedasticity

RESULTS AND DISCUSSION

Table 1 Diagnostic Tests for model Selection (Return on Assets)

Test	Alternate	Null	Result
Chow Test	Fixed effect has been approved	Pooled OLS has been approved	0.3419
Bruesch Pagan Test	Random effect has been approved	Pooled OLS has been approved	0.2918
Hausman Test	Random effect has been approved	Fixed effect has been approved	0.2143

The results of tables show that the Chow Test and Bruesch Pagan recommend Pooled OLS for our dependent variable (ROA). On the other hand, the Hausman Test suggested the Pooled Ordinary Least Square. Therefore, according to the above given results it can be concluded that the Pooled OLS is the most suitable model for regression analysis in our study. Therefore the regression analysis is performed while using the Pooled OLS method.

Table 2 Collinearity Statistics for IV’s and ROA

Variable	VIF
INSH	1.010
MSH	1.140
BS	1.171
BC	1.011
LEV	1.106
SGR	1.106

The above is the model used in testing of multicollinearity used in present study. Test named as variance inflation factor (VIF) used and has a standard value of 10. The values of all variables are less than 10 which shows no issue of multicollinearity.

4.3 White's test for heteroskedasticity

Test statistic: $TR^2 = 30.226024$,

with p-value = $P(\text{Chi-square}(22) > 29.189811) = 0.7618$

The findings of **White's test for heteroskedasticity** suggest that the null hypothesis has been accepted and concluded that the model has no issue of heteroskedasticity.

Table 3 Regression (Pooled OLS-Firm Value)

	<i>Coefficient</i>	<i>Std. Error</i>	<i>t-ratio</i>	<i>p-value</i>
Const	0.3401	0.1290	2.6364	.0001
INSH	0.4961	0.1750	-2.1251	.0003
MSH	0.8710	1.1980	0.7270	.0000
BS	0.0179	0.1300	0.1376	.7610
BC	0.8120	0.0591	2.8071	.0000
LEV	-0.3719	0.3640	2.2307	.0002
SGR	0.0861	0.1961	0.4390	.5519
R ² =	0.491010	Adjusted R ² =	0.047180	
F(7, 278) =	6.910128	P-value(F) =	0.000000	

The value of R-square in the table of pooled OLS is 0.4910 which expressed that the explanatory variables have 49 percent effects on the firm profitability or performance. The F-value of the model is 6.910 which is more than the standard and concludes that the selected for the data analysis in the present study is statistically significant.

The coefficients of all explanatory variables in the above table shows a positive relationship except leverages with the explained variable (ROA), furthermore P- values of all explanatory variables except board size and sales growth indicates a significant impact on the dependent variable.

CONCLUSION AND RECOMMENDATION

Conclusion

Primarily corporate governance is constituent of economic context, where the firms operate according to OECD that includes competition in factor and product market and macroeconomic policies. The corporate governance also depends on some other factors i.e regulatory, legal and institutional environment. Additionally factors like corporate awareness, business ethics and societal interest of the communities in which company operate has also significant role. There is a variety of factors which affect the corporate governance but the corporate governance principles mainly focus on differentiation of management from ownership. The governance issues are different in different countries and regions, somewhere issue arise because of the powers of controlling shareholders over minority shareholders. Sometimes employees have important legal rights irrespective of their ownership rights and so on, but the broader approach is to minimize and eliminate the fraudulent practices. Notwithstanding formal governance component, a few specialists have discovered that casual governance systems, for example, media presentation (Dyck and Zingales, 2002), trust (Franks et al., 2009), social standards (Kreps, 1990; Coffee, 2001,) and to some degree notoriety (Allen, Qian, and Qian, 2005) assume a part in a company's governance hones and could supplement or if nothing else substitute for some formal governance characteristics (Aggarwal, et al 2009). There has been a huge measure of work on corporate governance. Generally considers have recommended a positive association among great governance and firm execution (Chidambaran et al., 2006). At first, nation level examinations tended to concentrate on large scale viewpoint and gave significant experiences into the impacts of administrative condition (La Porta et al. 2002).

Recommendations

- The findings recommends that the firm should adopt debt financing who have less shareholders as this will give them tax yield and will increase their profit but the firm who are interested in equity financing will try to lower the debt level as this will negative effects on the firm value.
- The institutional shareholdings have significant effect on ROA and firm value, the firm should increase their institutions as this will increase their profit and value.
- The managers should be involved as shareholders as this will increase their hold and they will increase the firm profit.

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