

# Impact of Corporate Governance on Performance of a Firm: A Comparison between Commercial Banks and Financial Services Companies of Pakistan

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## Abstract

There is vital role of corporate governance in the establishment of a competitive market; this is also suggested by the empirical studies that nations having good corporate governance practices tend to have strong growth in their corporate sectors. This study examines the impact of corporate governance on the performance of firm. The impact of Board attributes, Audit committee attributes and Ownership attributes was checked on Return on Equity and Return on Assets of the Firms. The data related to the study was for Six years from 2009 to 2011 from 9 commercial banks and 9 financial service companies, listed in Karachi Stock Exchange based on convenience sampling. There were total 108 panel observations. Multiple regression (Panel least square) was used to analyze the data. The results show that Board Independence has significant impact on Return on Equity of the firm while Board size and Audit Committee Independence have significant impact on Return on Assets.

**Keywords:** Board size, Audit Committee Independence, Board independence, Ownership Structure, Ownership concentration, Corporate governance

## 1. INTRODUCTION

Corporate governance is a relatively new term in the debates, but the issues it addresses are as old as the business is. In recent years topics like effective corporate governance and accountability are of very much importance and subjects of heated debate especially after the global corporate scandals (Talimo, 2011). Corporate Governance describes the general principles to direct and control the business and management of the companies. There is vital role of corporate governance in the establishment of a competitive market; this is also suggested by the empirical studies that nations having good corporate governance practices tend to have strong growth in their corporate sectors. Some people think corporate governance as the most important issue that affect the performance of a corporate while others think that it is one of the most important issues that affects the corporate, implying that people mean different when they use the term corporate governance. The meaning of corporate governance varies from one phase to another phase of corporate life cycle.

The improvement of corporate governance is one of the basic factors of strengthening the foundation for the performance of corporation in long term. However corporate governance is the issue and has been the subject of much debate. One should have a closer look at the essence of this debate to understand the reason of these arguments (Ibrahim et al, 2010).

In Pakistan the framework of corporate governance was initially provided by institute of chartered Pakistan in 1998. The draft code of corporate governance was firstly issued by SECP on March 28, 2002 to all three stock exchanges of Pakistan to include the provisions of the code in the listing regulations of stock exchanges. Since corporate governance is a vast field and has importance in every organization. Being a student of management sciences, I feel the need of studying the impact of corporate governance on firm's performance. Hence, I would like to investigate that does corporate governance play any role in the financial performance of a firm and whether is there any difference between the performances of the firm because of corporate governance.

### 1.1 PROBLEM STATEMENT

At present the idea of having adept corporate governance practices are neglected in the corporate sector of Pakistan. Hence it is important to study its impact on the firm's performance. There may be serious consequences if it impacts on the performance of the firm. This study aims to investigate the impact of corporate governance on the performance of a firm. The study involves finding out the impact of Board Size, Board Independence, Audit Committee Independence, Ownership Concentration, Ownership Structure and Board Activity Intensity on Firm performance.

### 1.2 RESEARCH LIMITATIONS

1. This study is limited by the fact that the impact of corporate governance was checked by the attributes

- of board of director, Ownership and Audit Committee.
2. Sample is not large enough to generalize the observations to all Pakistani organizations.
  3. The time given for research is limited. It is not enough to conduct an in depth study because of which research quality may differ.
  4. The study focuses only on the financial services firms and commercial banks of Pakistan listed in KSE.

## 2. LITERATURE REVIEW

The shock of the corporate failures has brought economic crises across the globe. Inept corporate governance standards were one of the reasons of these crises and have drawn the attention of investors towards the corporate governance standards (Shah, 2009). Ehikioya(2009) explained that the corporate governance structure comprises of ownership structure, board composition, board size and CEO duality. The corporate governance structure greatly influences on the performance of the firm.

Concentration group of stockholders of the company has a role in controlling and directing the management to take biased decisions in the interest of a specific group. Furthermore the corporate governance allows the shareholders to direct the management to take keen interest for the betterment of the investment of shareholders (Rehman and Mangla, 2010).

The CEO Duality has also been addressed in many studies. There has not been consistent relationship between CEO Duality and Firm's performance Boyd (1994). Many studies provided the weak evidences that CEO Duality affects the long-term performance. There is a chance of agency cost when CEO performs dual role (Baliga et al, 1995). The shareholder value can be enhanced by separating the two positions (Fama et al, 1983).

Bhagat and Boulton(2008) reported that there is a relation between board size and performance of the firm. Ehikioya(2009) cited Yermack(1996) suggesting small board of directors results in better performance and argued that there is slow decision making when the boards are larger.

Empirical evidences suggest that there is an inverse relation between the majority of executive directors and performance of the firm (You et al. 1986). Denis and Sarin(1997) found that companies that significantly increase the number of NEDs (non-executive directors) have better returns. Conversely, several studies provided the evidence that organizations with large number of NEDs do not perform better than those with relatively small number of NEDs (Leng, 2004). A study conducted by Bhagat and Black(1997) also suggests that the more the NEDs in the board the lower the returns. The efficiency of a board is dependent on the combination of executive and non-executive directors (Coleman, 2007).

If the CEO also performs as the chairperson of the Board of directors in a firm it is called the dual role of CEO. Rechner and Dalton (1989) investigated the impact of CEO Duality on returns of the firm, on stock Exchange data. They reported that CEO Duality does not affect significantly on firms' performance i.e. returns. The results indicated that firm having dual role of CEOs have lower returns. Some other researcher like Donaldson and Davis (1991) also investigated the impact of dual role of Chief Executive on firm's return and they found the contradictory results to those found by the earlier. Some Empirical evidences suggest that the dual role of Chief Executive can positively impact on companies returns in case of different industries.

However, Beluga, Moyer, and Rao (1996) reported that there is unresponsiveness to variations in a companies' leadership structure; they did not report any evidence of performance changes due change in the role of Chief Executive.

Empirical results regarding the association of ownership concentration and the profitability of the firm were inconclusive in the USA. No significant relationship found between ownership concentration and rate of returns in the study done by Demsetz and Lehn (1985). In most of under developed economies even Pakistan; the closely held organizations control the economy. The dominant stockholder makes the decisions without bearing its full cost. There can be negative impact on firm performance if large family shareholders hold decision-making power in the company.

A number of studies in accountancy have concentrated on structure of audit committees, finding the reasons that affect the decision of creating an audit committee being responsible for auditing the financial results of the firm (Pincus, Rubarsky, and Wong 1989). A number of studies have incorporated the evidences that the existence of an independent audit committee has the association with smaller number of problems of financial disclosure. Carcello and Neal (1999) concluded that a firm performing inefficiently is likely to have fewer chances to survive when the percentage of executive members in the audit committee is greater. Coleman (2007) measured the independence of the audit committee by taking the ratio of independent directors in audit committee over total number of directors in audit committee.

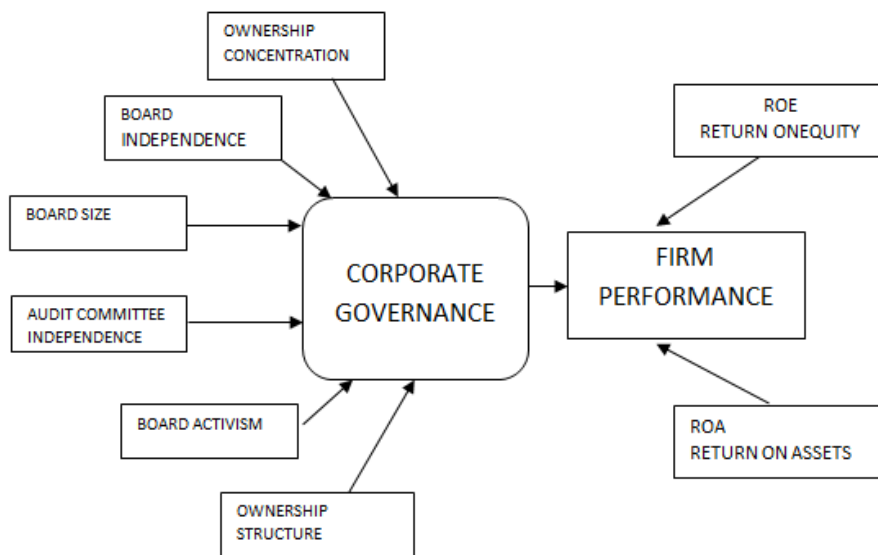
Jensen (1993) has reported that one of the characteristic of the board of directors, which is relevant to the value of the firm, is the size of board. Organizational theory assumes that if there is a large number of people in group it takes relatively more time in making the decisions. The question about determining the size of the board is difficult to answer because it seems to be subjective.

Lipton and Lorsch(1992) suggested an ideal board consists of 7 to 9 members. Sanda et al (2005)

reported the relationship of small board with better firm performance. Coleman (2007) argument that large boards have less effectiveness and the cost of processing problems is also higher in large boards, which is one of the reason to make the decision making process difficult and relatively more time consuming. Firms having smaller boards tend to have enhanced firm performance.

One of the important value-relevant attribute of the board is the intensity of its activity (Vafeas, 1999). The empirical evidences suggest that the relationship between frequency of board meetings and the performance of company are inconclusive. Several empirical studies suggest that board meetings are beneficial to stockholders (Lipton and Lorsch, 1992). Conger et al (1998) suggest that board meeting frequency can be important source of improving efficiency of the board. It implies that frequent board meeting results in enhancing the performance of the firm; hence directors perform their duty in the interest of stockholders (Vafeas, 1999). Jensen (1993) believed that the routine work absorb more time of the meeting, limiting opportunity for Independent non-executive directors meaningful interaction in controlling management. Jensen (1993) also suggested that boards should be more active when there is the crisis. The argument related to the relationship of number of meetings with the performance of the organization is still an open debate. (Coleman, 2007)

**Conceptual Framework: Impact of Corporate Governance on Performance of a Firm.**



### 3. RESEARCH METHODOLOGY

#### 3.1 TYPE OF RESEARCH:

The study on “Impact of corporate governance on firm performance: a comparison between commercial banking and financial services sector” of Pakistan is a quantitative research.

Information will be collected through secondary source i.e. the annual reports of the companies and their websites.

#### 3.2 UNIVERSE & TARGET POPULATION:

Universe of population of study is all private companies in commercial banking sector and non-banking financial service sector in Pakistan.

The target population is all listed companies of Karachi Stock Exchange in commercial banks sector and financial service sector. Presently 23 banks and 41 none banking financial service companies listed.

#### 3.3 SAMPLE SIZE & SAMPLING DESIGN

The data related to the study has been for Six years from 2009 to 2011 from 9 commercial banks and 9 financial service companies, listed in Karachi Stock Exchange based on convenience sampling. For the study, non-probability sampling is chosen. In non-probability, the sampling has been done on convenience basis.

#### 3.4 QUESTION RAISING

- i. Whether the corporate governance of the company plays any role in performance of the company?
- ii. Is there any difference between the performances of commercial banks and financial service sector due to corporate governance practices?

### 3.5 HYPOTHESIS TESTING

- i.  $H_1$ : corporate governance of the company plays a significant role return of a company over its assets.
- ii.  $H_1$ : corporate governance of the company plays a significant role return of a company over its shareholders equity
- iii.  $H_1$ : corporate governance of the company plays a significant role return of a company over its assets regarding different sub-sectors
- iv.  $H_1$ : corporate governance of the company plays a significant role return of a company over its shareholder's equity regarding different sub-sectors

### 4. DATA ANALYSIS

Table 1 shows that Return on Equity is significantly affected by Board independence as it has the highest t-statistics of 2.32 where as other dependent variables like ownership concentration, Audit committee Independence, Ownership structure and Board Activity Intensity are not contributing significantly due to their low t-statistics.

Table 2 shows that Return on Assets has been significantly affected by Board Size due to its t-statistics of 3.23 (99% Significance Level) another element of corporate governance which is contributing to Return on Asset is Audit Committee Independence as its t-statistics is 1.95 (95% Significance Level). Other factors like Ownership Concentration, Ownership structure, Board activity intensity (SHA) and Board Independence are not much influential towards Return on Assets.

When Industry wise dummy variable are introduced in the model, we can conclude that it is not significantly affected by independent variables, due to lower t-statistics, and again it is only Board Size which has significant effect on Return on Assets with t-statistics of 2.98. When industry wise dummy are introduced in model to check the effect on Return on Equity, we may conclude that it is only Board Independence, which has some effect on Return on Equity, other variable are not much contributing.

Table 1

Dependent Variable: ROE  
 Method: Panel Least Squares  
 Date: 11/20/12 Time: 18:48  
 Sample: 2006 2011  
 Periods included: 6  
 Cross-sections included: 18  
 Total panel (balanced) observations: 108

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BS	4.145391	4.907465	0.844711	0.4002
OC	-2.496101	20.05918	-0.124437	0.9012
ACI	76.37378	52.11137	1.465588	0.1458
OS	-12.83856	70.22780	-0.182813	0.8553
SHA	-25.72891	43.06752	-0.597409	0.5516
BI	-99.94053	42.95776	-2.326484	0.0220
R-squared	0.061827	Mean dependent var		7.932118
Adjusted R-squared	0.015838	S.D. dependent var		82.22618
S.E. of regression	81.57243	Akaike info criterion		11.69481
Sum squared resid	678714.3	Schwarz criterion		11.84382
Log likelihood	-625.5199	Hannan-Quinn criter.		11.75523
Durbin-Watson stat	2.548710			

Table 2:  
 Dependent Variable: ROA  
 Method: Panel Least Squares  
 Date: 11/20/12 Time: 19:26  
 Sample: 2006 2011  
 Periods included: 6  
 Cross-sections included: 18  
 Total panel (balanced) observations: 108

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BS	0.089505	0.027701	3.231126	0.0017
OC	-0.070226	0.113227	-0.620224	0.5365
ACI	-0.575287	0.294149	-1.955766	0.0532
OS	0.088833	0.396409	0.224095	0.8231
SHA	-0.123696	0.243100	-0.508829	0.6120
BI	0.030195	0.242480	0.124525	0.9011
R-squared	0.096180	Mean dependent var		0.058975
Adjusted R-squared	0.051875	S.D. dependent var		0.472874
S.E. of regression	0.460446	Akaike info criterion		1.340709
Sum squared resid	21.62504	Schwarz criterion		1.489716
Log likelihood	-66.39827	Hannan-Quinn criter.		1.401126
Durbin-Watson stat	1.413367			

Table 3  
 Dependent Variable: ROA  
 Method: Panel Least Squares  
 Date: 11/20/12 Time: 19:27  
 Sample: 2006 2011  
 Periods included: 6  
 Cross-sections included: 18  
 Total panel (balanced) observations: 108

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BS	0.103009	0.034546	2.981809	0.0036
OC	-0.043034	0.118489	-0.363194	0.7172
ACI	-0.458847	0.317769	-1.443965	0.1519
OS	0.120924	0.409600	0.295224	0.7684
SHA	0.093078	0.323093	0.288086	0.7739
BI	0.063467	0.258263	0.245745	0.8064
BANK	-0.435301	0.480814	-0.905342	0.3675
FINST	-0.448258	0.453231	-0.989029	0.3250
R-squared	0.105602	Mean dependent var		0.058975
Adjusted R-squared	0.042995	S.D. dependent var		0.472874
S.E. of regression	0.462597	Akaike info criterion		1.367266
Sum squared resid	21.39959	Schwarz criterion		1.565942
Log likelihood	-65.83234	Hannan-Quinn criter.		1.447822
Durbin-Watson stat	1.435900			

Table 4

Dependent Variable: ROE  
 Method: Panel Least Squares  
 Date: 11/20/12 Time: 19:28  
 Sample: 2006 2011  
 Periods included: 6  
 Cross-sections included: 18  
 Total panel (balanced) observations: 108

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BS	5.444135	6.118207	0.889825	0.3757
OC	-1.763629	20.98475	-0.084043	0.9332
ACI	61.19150	56.27790	1.087310	0.2795
OS	-30.42327	72.54155	-0.419391	0.6758
SHA	-43.74221	57.22082	-0.764446	0.4464
BI	-90.14404	45.73924	-1.970825	0.0515
BANK	3.263309	85.15380	0.038323	0.9695
FINST	21.50166	80.26867	0.267871	0.7894
R-squared	0.072198	Mean dependent var		7.932118
Adjusted R-squared	0.007252	S.D. dependent var		82.22618
S.E. of regression	81.92748	Akaike info criterion		11.72073
Sum squared resid	671211.2	Schwarz criterion		11.91941
Log likelihood	-624.9196	Hannan-Quinn criter.		11.80129
Durbin-Watson stat	2.550979			

## 5. CONCLUSION

The findings of this research suggest that there is significant effect of board independence on Return on Equity. While other factors such as ownership concentration, Audit committee Independence, Ownership structure and Board Activity Intensity are not effecting significantly as their t-statistics are low. Return on Assets has been significantly affected by Board Size due to its t-statistics of 3.23 (99% Significance Level) another element of corporate governance which is contributing to Return on Asset is Audit Committee Independence as its t-statistics is 1.95 (95% Significance Level). Other factors like Ownership Concentration, Ownership structure, Board activity intensity (SHA) and Board Independence are not much influential towards Return on Assets. When Industry wise dummy variable are introduced in the model, we can conclude that it is not significantly affected by independent variables, due to lower t-statistics, and again it is only Board Size which has significant effect on Return on Assets with t-statistics of 2.98. When industry wise dummy are introduced in model to check the effect on Return on Equity, we may conclude that it is only Board Independence, which has some effect on Return on Equity, other variable are not contributing When industry wise dummy are introduced in model to check the effect on Return on Equity, we may conclude that it is only Board Independence, which has some effect on Return on Equity, other variable are not contributing When industry wise dummy are introduced in model to check the effect on Return on Equity, we may conclude that it is only Board Independence, which has some effect on Return on Equity, other variable are not much contributing.

## 6. FUTURE RESEARCH

As corporate governance is a big topic there are different aspect which can be investigate through a more comprehensive study employing the data from more companies and in different industries. Furthermore there may be more factors which may have significant impact on the firm performance. These factors can be investigated in the further research.

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