

# Corporate governance and firm performance



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## **Introduction**

Corporate governance is concerned with the process and structures through which members interested in the overall well being of the firm take measures to protect the interests of the stakeholders. (Ehikioya, 2009).

Corporate governance generally refers to the external rules and regulations and internal system that are designed to minimize agency problem and is “the system by which companies are directed and controlled” (Cadbury 1992, Cited in Lam and Lee, 2008)

Good Corporate governance is centered on the principles of accountability, transparency, fairness and responsibility in the management of the firm. (Ehikioya, 2009). Accountability comes from both within and outside the company. Responsible management works entirely in the interests of the owners. Board composition plays an important role in keeping the company transparent in its affairs. Board structure is important to keep the interests of management and owners aligned (Byrnes et 2003, cited in Ehikioya, 2009).

The institution of corporate governance in a firm is an attempt to ensure the separation of ownership and control, and this often results in Principal-Agent problems (Byrnes et 2003, cited in Ehikioya, 2009). Managers always have incentives to misuse a firm’s assets by undertaking projects that benefit themselves more personally but its impact on shareholder wealth works adversely (Jensen and Meckling, 1976; Fama and Jensen, 1983; cited in Brown and Caylor, 2004) and same goes with (Shleifer and Vishny, 1997)

Researchers have mixed opinion in Principal-Agent problem. According to (Jensen and Mecklings 1976 cited in Lia, Wang and Deng, 2009) managerial

agency costs always increase with the separation of ownership and management. Managers, as the agents of shareholders, are inclined to waste the corporate resources to satisfy their exploitative purposes. In contrast, stewardship theorists counter-argue that managers are inherently trustworthy and are good stewards of company resource (Donaldson, 1990 cited in Lam and Lee, 2008).

Central to the board's effectiveness is the question of board structure (size and independence). In addition to board size, board independence should also have an impact on firm value and performance. Inside directors provide firm and project specific knowledge that assists the board in understanding the detailed aspects of the firm's business. In contrast, outside (or independent) directors contribute expertise and objectivity that ostensibly mitigates managerial entrenchment and expropriation of firm resources (Bhagat and Black, 2002).

The governance literature generally suggests that as boards become increasingly independent of managers, their monitoring effectiveness increases thereby decreasing managerial opportunism and enhancing firm performance. (Harforda, Mansib, and Maxwellc, 2006).

Gov-Score is used in different researches to assess the governance and firm performance has been used with 51 factors (Brown and Caylor, 2004) or less i. e. 37 (Nishat and Shaheen, 2005). This paper will use the GOV-SCORE with 38 factors and including new factor i. e. more than one family member on board

The paper proceeds as follows: Section II is the Literature review, Section III will discuss rationale of study, Section IV will include theoretical framework, Section V hypotheses development and theoretical background, Section VI data and methodology, Section VII sample, instrument and structure of instrument, Section VIII Work cited and then Appendix.

### **Literature Review:**

Corporate governance is the process and structure through which a firm's business and affairs are managed by enhancing business prosperity and corporate accountability with the ultimate objective of enhancing shareholder's wealth (Mir and Nishat, 2004).

A well defined and functioning corporate system helps a firm to attract investment, raise funds, and strengthen the foundation for firm performance and good corporate governance shields a firm from vulnerability to future financial distress (Ehikioya, 2009). Effective corporate governance minimizes "control rights" of stockholders and their creditors to give on managers and increasing the probability that managers should invest in positive net present value projects for the firm gain (Shleifer and Vishny, 1997).

Prior studies have predominantly focused on US companies, while those are related to Asian countries are rather few (Kiel and Nicholson, 2003 Cited in Lam and Lee, 2008). The notion that corporate governance affects positively corporate performance is based on the fact that management in shareholder-friendly firms, in making corporate decisions, do what shareholders themselves would have done, had they been in charge of corporate decisions ( Kanellos and George, 2007).

It was found (Ehikioya, 2009) that where the CEO also acted as chairperson and more than one family member had a place on the board of directors this had an adverse effect on firm performance.

Corporations can be said like a republic. The major and highest level of authority is stockholder (Owners). These voters have the right to vote and elect their representatives which serve as directors, who delegate their most of their power to bureaucrats (managers). As in any form of government (republic), the real power-sharing depends upon the set of rules called governance. On one extreme, which is inclined toward a democracy, have little power for management and enable stockholders to immediately and easily replace directors of the company. On the other hand, it is vice versa to the democracy (Gomper, Ishii, Metrick, 2003).

CEO duality is another concern in corporate governance. In USA 70-80% of them combined the roles of CEO and Chairperson. (Rechner and Dalton, 1991; Rhoades et al, 2001, Cited in Lam and Lee, 2008). However the prevalent corporate governance practice in Europe separates the CEO and chairperson (Coles et al 2001; Higgs, 2003; Zardkhoohi, 2005, Cited in Lam and Lee, 2008). This Duality position places CEO in powerful position of managing the operations of the firm and also overseeing the direction the firm will take into the future (Petra and Dorata, 2008).

It is often alleged that boards of directors are more independent as the proportion of their outside director increases (Jhon and Senbet 1998, Cited in Brown and Caylor, 2004). Strong positive relationship between the portion of independent directors on the board and profitability ratios in continental

Europe countries (Krivogorsky 2006, Cited in Li, Wand and Deng, 2008). A higher proportion of the independent directors may lead to lower probability of financial distress (Li, Wang, Deng, 2008). However, there is no relation between the proportion of outsider directors and various performance measures (i. e., SG&A expenses, sales, number of employees, and return on equity) (Fosberg 1989, Cited in BRown and Caylor, 2004). and (Bhagat and Black, 2002) find no linkage between the proportion of outside director and Tobin's Q, ROE, asset turnover and stock returns. Thus the relationship between the proportion of outside directors, a proxy for board independence, and firm performance is mixed (Brown and Caylor, 2004). Researchers (Gomper, Ishii, Metrick, 2003) and (Bebchuk, Cohen, Ferrell, 2004) showed in their studies that with stronger stockholder rights have higher Tobin's Q, their proxy for firm value, suggesting that better-governed firms are more valuable our second measure of firm performance.

Most of the empirical work for exploring possible relationship between corporate governance and firm performance is done for single jurisdiction. For US Firms a broad measure of Corporate Governance Gov-Score is prepared by (Brown and Caylor, 2004)with 51 factors, 8 sub categories for 2327 firms based on dataset of Institutional Shareholder Service (ISS). Their findings indicate that better governed firms are relatively more profitable, more valuable and pay more cash to their shareholders. (Gomper, Ishii, Metrick, 2003)

Earlier (Mir and Nishat, 2004) empirically tested the relationship between the structure of corporate governance and firm performance in Pakistan, and (Nishat and Shaheen, 2005). Mir and Nishat's study included a different set

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of performance parameters which include ROE, net profit margin, sales growth, Tobin's Q and dividend yield. Moreover (Mir and Nishat, 2004) used secondary data from the annual statements. While (Nishat and Shaheen, 2005) study was based on secondary as well as on primary survey of different companies listed with Karachi Stock Exchange (KSE).

This study is different to (Nishat and Shaheen, 2005) as it extends the GOV-Score factor to 38 by adding the " More than family members on the board" to (Nishat and Shaheen, 2005)'s study which was 37 factors.

### **Rationale:**

As the global debate on corporate governance heats, the importance of this topic to any country-particularly any developing country-cannot be ignored. Being one of the important countries of South Asia, with immense trading potential and ideal geopolitical location, Pakistan has proactively pursued various policy reforms to stimulate its economic activity, in recent years (Mehwish Mumtaz, 2005).

Pakistan stock market is one of the leading emerging markets in the world. It has gone through series of reforms and structural changes since 1991 (Nishat and Shaheen, 2005). Financial reforms during 1990s have influenced the pattern of capital structure, dividend policy and compliances to corporate governance (Nishat, 1999 Cited in Nishat and Shaheen, 2005). Better Corporate Governance is supposed to lead to better corporate performance by preventing expropriation of controlling shareholder and ensuring better decision-making (Nishat and Shaheen, 2005), (Shleifer and Vishny, 1997).

Most of the research in the area of corporate governance is done for developed economies, as rich data is only available for these economies where active market for corporate control exists and the ownership concentration is low (Bohren and Odegaard 2001, Cited in Shaheen and Nishat, 2005).

This study will fill the gap by analyzing the relationship between corporate governance and firm performance for the firms as previous studies lack a factor in GOV-SCORE i. e. “ more than one family member on board” while measuring level of governance. As this variable was found very first time by Benjamin Ehikioya as in his study (Ehikioya, 2009).

### **Theoretical Framework:**

#### **Hypotheses and Theoretical Background:**

According to above mentioned literature following hypotheses are formed.

#### **H1: Better-governed firms have better operating performance**

Better and effective corporate governance minimizes the control rights of both stockholders and creditors confer on managers which increases the probability that managers will invest in positive NPV projects (Shleifer and Vishny, 1997) leading it to better operating performance, which is our first proxy to firm performance

#### **H2: Better-governed firms are more valuable**

(Gomper, Ishii, Metrick, 2003) and (Bebchuk, Cohen, Ferrell, 2004) show that firms with stronger stockholder rights have higher Tobin’s Q which is the proxy of firm value and suggest that better governed firms are more valuable which is second proxy for firm performance.



**H3: Better-governed firms pay more cash to stockholders**

Firms with smaller dividend payout have low earning growth, suggesting that better-governed firms payout more cash to stockholders, which our third proxy to firm performance (Arnott and Asness 2003, Cited in Nishat and Shaheen, 2005).

**Data and Methodology:**

Gov-Score will be used to measure the strength of a firm' governance on the patterns of (Brown and Caylor, 2004), (Nishat and Shaheen, 2005) and (Y Attiya and R Iqbal, 2007). Computation of Gov-Score for 20 firms using data obtained from annual reports. The primary data will be collected through questionnaire containing 38 factors as either 0 or 1 depending on whether the firm's governance standards. Then sum of each 38 binary variables to derive GOV-Score.

This paper consider four performance measures spread across three categories: operating performance, valuation and shareholder payout. This paper selects two operating measures i. e. ROE and profit margin. One valuation measure i.. e. Tobin's Q and single measure of stockholder payout i. e. dividend yield.

This paper adopts methodology used by (Nishat and Shaheen, 2005) which involves two types of cross-sectional analyses. Firstly, correlation between Gov- Score with each industry-adjusted fundamental variable using Pearson and Spearman correlations. Then order Gov-Scores from highest to lowest (i. e., from best to worst governance), and analyze if firm performance differs in the extreme governance deciles. Next to assess which categories and factors are associated with expected/unexpected (good/bad) performance, we  
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correlate the four performance measures with seven governance categories and 38 governance factors.

### **Sample and Instrument:**

The sample size will be 20 firms listed in Karachi Sock Exchange.

Convenience sampling technique will be used. A structured questionnaire will be used containing 38 factors of governance spread across seven categories

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