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Corporate Governance and Firm Performance: Evidence from Textile Sector of Pakistan

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Abstract

This study is intended to examine the relationship between three important mechanisms of corporate governance (ownership concentration, board size, CEO/Chair duality) and two firm performance proxies (Return on Asset, ROA, and Return on Equity, ROE) for a sample of 12 textile firms of Pakistan listed on the Karachi stock exchange. The data ranges from 2007 to 2011.The empirical evidence indicates that ownership concentration positively affect both performance variables ROA and ROE. This is justified on the grounds that, because majority shareholders have more voting power so they can exert pressure on the management take decisions that optimize firm performance. Similarly, the study found significant positive relationship between small board size and ROA. The implication is that the board size should be limited to a sizeable number in order to avoid delays in important corporate decisions that can arise because of a larger board size. However, no significant relationship was found between board size and ROE. The empirical findings also suggest a positive significant impact of CEO/Chair duality on ROA and ROE. This indicates that because dual role enable the CEO to enjoy more autonomy and control as a result he/she can govern the firm in a way that increase the firm performance.

1. INTRODUCTION

Corporate governance is concerned with the mechanism or structure employed to preserve the rights of stakeholders. Khatab *et al.* (2011) defines corporate governance as the set of procedures laws, policies and institutions influencing the way a corporation is administered or managed. The need for corporate governance stems from the dilemma of agency issue. Jensen and Meckling (1976) argued that in corporate setting managers have more power and information than dispersed shareholders. While a shareholder is interested to get a return on his investment in the form of dividend or capital gain but the aim of the managers may be quite different like securing his job, getting a promotion or like. Corporate governance is a topic which is now of global significance for the

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researchers, practitioners, and corporate governing bodies. The cases of Enron and World com led the attention of the corporate world towards the need to introduce a governance mechanism. Sarbanes-Oxley act was a step in this regard to ensure transparency and appropriate disclosure of financial matters of the firm. Codes of corporate governance were first introduced by the Organization for Economic Cooperation & Developments (OECD) in the year 1999. Till then these codes captured the attention of a vast variety of stakeholders like policy makers, shareholders and companies. These codes or principles provide common standards of corporate governance and good practices that are applicable in diverse corporate setups.

Majority of European countries have employed the corporate governance structure since its inception and now they are well ahead in implementation of corporate governance than developing countries and emerging economies. Pakistan was quite late in the adoption of corporate governance strategies and principles. Securities and Exchange Commission of Pakistan is the body that finalized the codes of corporate governance in the year 2002. However, to further improve the corporate governance practices in Pakistan SECP introduced the institute of corporate governance in the year 2004. However corporate governance is still at an initial stage and lacks in proper implementation because of various hazards.

Several studies have been conducted to explore the impact of corporate governance mechanism on firm operating and financial performance both in the context of developing and developed countries. The results of these studies strongly suggested that an effective corporate governance structure can direct the management to work in a way that improves performance of the firm by preserving the rights of shareholders. Past empirical work revealed that variables like ownership concentration, board composition, board size, CEO/Chair Duality, are key measures of corporate governance mechanism. Firm performance was usually measured by using return on asset (ROA), return on equity (ROE), and Tobin’s Q.

The objective of this study is to analyze the impact of corporate governance on performance of 12 listed textile firms of Pakistan. Ownership concentration, board size, and CEO/Chair duality are used as measures of corporate governance whereas firm performance is measured by ROA and ROE. The rest of the study is organized as follows. Section 2 provides a detailed insight of past empirical work from Pakistan and abroad. Section 3 briefly describes the methodology and variables used in this study. Section 4 portrays the discussion of empirical results and section 5 concludes the study.

2. LITERATURE REVIEW

The utility of introducing a corporate governance structure arises from the fact that an effective governance mechanism can help to solve the agency issue. Providers of funds want to ensure that their money is being wisely invested and utilized in profitable venues. Below is a description of the empirical studies on the relationship between corporate governance and firm level performance variables both in developed and developing countries.

Heenetigala and Armstrong (2007) conducted a study to explore the relationship between corporate governance and operating performance of the firm in an unstable political and economic enviroment of Siri Lanka. The data set includes 37 listed companies from 2003 to 2007. Spearman’s correlation and analysis of variance was used to discover this relationship. Measures of corporate governance included in the study were separate leadership, board committee and board composition while firm performance was measured by Tobin’s Q and return on equity. Results revealed that after the implementation of corporate governance codes firms profitabilty and market performance increased significantly. Ehikioya (2009) found that ownership concentration positively effects the performance of the Nigerian firms. However the analysis found no evidence in support of

the relationship between board composition and firms performance. CEO duality observed a significant negative impact on the performance level of the firm. More than one family members being part of the board was negatively associated with corporate performance. Drobetz (2003) constructed a corporate governance index constituting the board characteristics and ownership concentration pattern. He found that as corporate governance index increases it positively effects the firm performance showing an increased value of the Tobins Q. Yasser *et al.* (2011) found that firm performance variables have a significant positive relationship with all the corporate governance components except CEO/ chair duality. The finding also recommends that board should have an optimal mix of executive directors and non-executive directors. Javed and Iqbal (2007) used corporate governance index and three other sub indicies Board, shareholding pattern, and disclosure and transprancy for a sample of 50 companies listed on Karachi stock exchange. Composition of board members and ownership concentration was associated with increased firm performance. However, disclosure and transparancy shown no significant relationship with firm performance. Findings signify that poor management performance and decreasing productivity can not be covered with transparent disclosure.

Khatab *et al.* (2011) found that firms with good corporate governance practices performs better than the firms whose corporate governance is weak. Role of corporate governance in influencing firm performance was also evaluated by Ibrahim *et al.* (2010). The data values consisted of companies from Chemical sector and Pharmaceutical sector of Pakistan for the period of 2005-2009. The investigation found that corporate governance significantly effects return on equity however its impact on return on assets was insignificant. In addition the impact of corporate governance on two sectors was quite different.

However corporate governance structure of financial institutions is significantly different from other firms because of different nature of business and varrying gonernance mechanisim. Love and Rachinsky (2006) used data sample of fifty banks of Russia and Ukrine. They discovered that corporate governance practices have a positive impact on the operating performance of the banks. Furthermore, banks with concentrated ownership structure was found to have weak corporate governance score. A study from the Malaysian perspective was conducted by Kim and Rasiah (2010) to check the relationship between corporate governance and bank performance during the pre and post asian financial crisis. Capital ratio and fixed assets and inventory to capital ratio were used as a proxy of corporate governance while the banks performance was measured by return on equity. Results of the quantitative analysis concluded that corporate governance significantly effects perofrmance of the banks in Malaysia.

From the developed countries standpoint Balsmeier and Czarnitzki (2010) studied the relationship of ownership concentration with firm performance in 28 Central and Eastern European transition economies. The data was taken over a period ranging from 2002 to 2009. They found a U-shaped relationship between ownership concentration and firm performance. The firm performance increases up to 50% ownership concentration but after passing a peak value of 55% increased ownership concentration negatively impact the firm performance. This is because of the fact that the block holders tend to enjoy these benefits rather than sharing them with the minority shareholders. From the emerging markets viewpoint, Grosfeld (2006) indicated that firms that belongs to the sectors where high technology is used have diluted ownership structure, while the firms belonging to more mature sctors have higher ownership concentration. The results also disclosed that firms with concentrated ownership pattern performs better than firms with dispersed ownership pattern.

The literature about the impact of board size on firm performance provides mixed results. Guest (2009) examined the impact of board size on the performance of firms using a large sample of 2746 listed companies from

the year 1981 to 2002. Board size was measured by the number of directors on the board.The analysis found that board size has a strong negative impact on these firm performance variables. These evidence support the argument that communication and decision making problem weaken the effectiveness of larger board size. Additionally findings suggest that negative relation in board size and firm performance is strongests in large firms. Unlike the previous researches. Topak (2011) established that there is no relationship between the board size and Turkish firm performance.

Weterings and Swagerman (2011) explored the impact of board size on firm value using a sample of 155 property firms and real estate investment trust listed in the exchanges of Singapur, Hong Kong, and Malaysia. A positive relationship was observed between board size and firm value form the property firms. However the results for real estate investment trust was insignificant. Garg (2009) found an inverse relationship between board size and firm performance.

The impact of CEO/Chair duality on firm performances was investigated by Chen *et al.* (2008) after controlling the important variables such as ownership structure, firm characteristics. CEO compensation and agency cost. The results do not show any significant relationship between dual CEO structure and firm performance. However, Harjoto and Jo (2009) found that CEO/Chair duality positively effects firm performance at early stage of the firm. While it adversely influences firm operating performance and value in later stages. Sridharan and Marsinko (1997) explored this phenomenon in the paper and forest products industry of USA. The results indicated that firms with dual role of CEO performs better as they make better utilization of assets and generates greater profit margins as reflected by higher market value of these firms. In addition, the dual role of CEO will enable the executive to enjoy more autonomy and power in managing the firm activities and in strategic decision making as a result the firm performance will increase.

3. METHODOLOGY

The data set used in this study were extracted from the annual reports of 12 listed textile companies from 2007 to 2011. Simple random sampling was used to select companies from the textile sector. The panel approach was used for data analysis. Two types of variables are used in this study. Independent variables are used to measure the corporate governance whereas dependent variables are used as a proxy to firm perfromance. The table below provides the description of variables used in this study.

Table 1: Description of variables

Independent	**Definition**
BSIZE=Board Size	Total number of board members.
CONCEN=Ownership Concentration	Proportion of shares owned by the five largest shareholders to total outstanding shares.
Duality= Dual role of CEO	Value 1 if CEO is also Chairman of the Board and zero otherwise.
Dependent	Definition
ROA= Return on Assets	Measured in terms of percentage of net Income to total assets.
ROE=Return on Equity	Measured in terms of percentage of net Income to common equity.

The econometric model used in the study is as follows.

$$y_t = \beta_0 + \beta F_{it} + e_{it} \quad \text{.................................} \ (1)$$

In the above model Y represents dependent variable that is firm performance. The subscript t is used to denote the time series nature of the data. β_0 is constant term in the proposed regression model. β Denote the coefficient of explanatory variable that is

corporate governance mechanism in this case. F_{it} represents explanatory variables and e_{it} correspond to error term. Two important financial ratios ROA and ROE are used in this study as a measure the firm performance. By substituting the variables employed in this study into the econometric model, the following equation emerges.

$$PERF = \beta_0 + \beta_1 BSIZE + \beta_2 CONCEN + \beta_3 Duality + e_{it} \quad \text{......................................} \quad (2)$$

4. RESULTS AND DISCUSSION

Table 2 demonstrates the desriptive statistics of the variables used in this study. The mean value of ROA for the sampled firms is about 5.8% and that of ROE is 7.4%. The average of board size in the sampled firms is about 8 members. The mean ownership concentration is 55.7% which give a feel of concentrated ownership pattern in the textile sector of Pakistan. The statistics also indicates that 45% of the firms under observation have CEO that is also the chairman of the board. While 55% firms have seprate persons as CEO and board chair. The standard deviation of ROA is 10.05% and for that of ROE is 11.46%. These values indicates that there is a significant variation in return from the central value and sample involves some firms generating positive returns while some others are suffering losses.

Table 2: Descriptive statistics

	BSIZE	CONCEN	DUALITY	ROA	ROE
Mean	7.68	55.73	0.45	5.79	7.37
Std. Dev.	0.96	17.90	0.50	10.05	11.46
Maximum	10	87.20	1.00	41.35	48.46
Minimum	7	0.50	0.00	-5.09	-19.50
Observations	60	60	60	60	60

The Tables 3a and 3b presents the correlation among the variables. Table 3a demonstrates that ROA has a positive relationship with board size. Similarly, corrlation coefficient indicates a positive relationship between ownership concentration and ROA, suggesting that concentrated owners will exert pressure on firm,s management to take decisions that enhance coporate performance. A positve relationship is observed between ROA and CEO/Chair duality which shows that firms with dual role of CEO positively contributes towards firm performance in textile sector of Pakistan. Table 3b shows no significant relationship between ROE and board size. However, ROE is positively correlated with ownership concentration and CEO/Chair duality. In addition, statistics revealed that ownership concentration is negatively correlated with CEO/Chair duality. Reflecting that majority shareholders will prefer to have separate person as CEO and board chairs.

Table 3a: Correlations, ROA as a proxy of firm performance

	ROA	BSIZE	CONCEN	DUALITY
ROA	1	0.63	0.07	0.07
BSIZE	0.63	1	-0.05	-0.08
CONCEN	0.07	-0.05	1	-0.4
DUALITY	0.07	-0.08	-0.38	1

Table 3b: Correlations, ROE as a proxy of firm performance

	ROE	BSIZE	CONCEN	DUALITY
ROE	1	-0.08	0.19	0.13
BSIZE	-0.08	1	-0.05	-0.08
CONCEN	0.19	-0.05	1	-0.38
DUALITY	0.13	-0.08	-0.38	1

The Table 4 exhibit the results of coefficient estimates of the dependent variables with their respective t- statistics and p-values. The ownership concentration has a coefficient of 0.0994 which infer that 9.94% of positive variation in dependent variable (ROA) is explanied by ownership concentration and the results are significant at 11%. The board size has a significant positive relationship with ROA and results are robust at 1% significance level. Moreover, the study found a positive impact of dual role of CEO on ROA. By interperating the results of board size obtained from pooled regression alongwith the descriptive statistics, there is a positive relationship between smaller board size and ROA. As indicated by the table 2 of descriptive Statistics the average board size is approximately 8 which is considered small in the context of Pakistan. These results are inline with the previous emperical studies like Ujunwa (2012) and Yermack (1996), that suggest a small board leads to greater firm performance.

In relation to ROE, The ownership concentration has a positive relationship with ROE. The p-value indicates that results are significant at about 5% level. The board size seems to have no significant relationship with ROE as indicated by p-value of 0.7213. However, The CEO/Chair duality has positive impact on ROE at 10% significance level. Considering the panel nature of the data, R square of ROA model is quite good. However, it is very low in the case of ROE regression model. Additionaly, F-statistic supports the overall fitness of the models.

Table 4: Coefficient estimates of the dependent variables

Independent variables	ROA	ROE
CONCEN	0.0994 (1.6342) {0.1078}	0.1762(1.9866){0.0519}
BSIZE	6.8322(6.5176) {0.0000}	-0.5476(-0.3585){0.7213}
DUALITY	3.9079(1.7940) {0.0782}	5.3902(1.6984){0.0950}
R^2	0.4408	0.08724
Adjusted R^2	0.4108	0.0383
F-statistic	14.715	1.7842

t-Statistics are shown in ( ), while p-values are shown in { }

Table 5a and 5b presents the results of ANOVA considering the ROA and ROE as dependent variables respectively. Results highlight that significant differences exist in ROA and ROE among the sampled textile firms. These results indicates that the predicting variables like board size, ownership concentration, and duality effected the performance of different firms differently. A substantial value of F statistic and corresponding significance level justify this argument. This is quite obvious, because corporate governance structure is just one factor that effects firm performance besides there are many other factors that effects performance of the companies.

Table 5a: ANOVA, ROA as a dependent variable

Model	Df	Sum of square	Mean square	F statistic	Sig.
Between group	5	5596.369	1119.274		
Within group	54	365.0069	6.759387	165.5881	0.00
Total	59	5961.376	101.0403		

Predictors: Concen, bsize, duality

Table 5b: ANOVA, ROE as a dependent variable

Model	Df	Sum of square	Mean square	F statistic	Sig.
Between group	3	5860.786	1953.595		
Within group	56	1891.663	33.7796	57.8334	0.00
Total	59	7752.449	131.3974		

Predictors: Concen, bsize, duality

5. CONCLUSION

In a corporate setting, corporate governance is an important factor that can influence firm,s performance because the owner and managers are different entities. The area of coporate governance got significant attention in recent years because of the increased number of management frauds like Enron, World Com. Several studies has been conducted in the developed world to test the perceived relationship between the components of corporate governance and firm performance. This study examines the similar phenomenon in the textile sector of Pakistan. Data values were based upon the 12 textile firms listed on the Karachi stock exchange from 2007 to 2011. The corporate governance is measured by the variables like ownership concentration, board size and CEO/Chair duality while ROA and ROE were used as proxies to firm performance. The results of the multiple regression revealed that ownership concentration has positive relationship with both the firm performance proxies. These results are inline with the previous emperical studies suggesting that concentrated owners will be able to exert better corporate governance upon the firm managers because of their voting power and influence. Moreover, board size has a positive and significant relationship with ROA but the impact of board size on ROE was insignificant. As the results of the descriptive statistics shows that the average board size is approximately eight members that is quite small considering the Pakistan's scenario. Considering the results of descriptive statistics alongwith multiple regression we can recommend that small boards positively contribute towards firm performance. Although, the literature presents mixed results about the impact of CEO/Chair duality and firm performace. Emperical findings of this study are in support of the dual role of CEO as it positively and significantly effected both ROA and ROE. The reason is, when the CEO is also the head of the board he/she will have greater autonomy in firms strategic decision making. These results signify that corporate governance has a positve and significant effect on firm performance in textile sector of Pakistan. Therefore, firms operating in the textile sector of Pakistan shall improve corporate governance practices to boost company's operating and financial performance.

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