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Ali, Amjad and Alim, Wajid and Ahmed, Jawad and Nisar,
Sabahat

European School of Administration and Management, France.
Lahore School of Accountancy and Finance, University of Lahore,
Pakistan., Lahore School of Accountancy and Finance, University of
Lahore, Pakistan., Lahore School of Accountancy and Finance,
University of Lahore, Pakistan., Lahore School of Accountancy and
Finance, University of Lahore, Pakistan.

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Impact of Corporate Governance on Performance: A Study of Listed Firms in Pakistan

Amjad Ali

European School of Administration and Management, France.
Lahore School of Accountancy and Finance, University of Lahore, Pakistan.

Wajid Alim

Lahore School of Accountancy and Finance, University of Lahore, Pakistan.

Jawad Ahmed

Lahore School of Accountancy and Finance, University of Lahore, Pakistan.

Sabahat Nisar

Lahore School of Accountancy and Finance, University of Lahore, Pakistan.

ABSTRACT

The objective of this exploration is to show the relationships among corporate governance tools (Board size, board independence, CEO status, Board Education, and Established Years of the firm) and firm performance which is determined by Return on Asset (ROA). Quantitative data is used to discover the association between the variables. The top seventy-five companies registered on the Pakistan Stock Exchange involving the period from 2010 to 2019 are taken as a sample. The research found that there is a connection between the performance of the firm with the overall extent of directors, board independence, and average education of board representatives. Insignificant results came for CEO duality and established years of the firm. The result predicted that an increase in total board members and average education of board members will increase firm performance (ROA) whereas a reduction in board independence will reduce firm performance (ROA) which explains the importance of corporate governance for the success of firm performance. Unlike previous studies, this study tried to find a long-term influence of corporate governance on firm performance by analyzing five different variables for the listed firms of Pakistan. The study provides the importance of corporate governance tools and their effectiveness for the success of organizations, especially in Pakistan.

Keywords: Corporate Governance; Firm Performance; Pakistan; ROA; CEO Duality; Board Size; Board Independence; Board Education

JEL Codes: G3, G30

I. INTRODUCTION

Corporate governance is the procedure and relation managed by numerous groups to manage and run a business (Cadbury Committee, 1992). Corporate governance has to turn out to be a prevalent debate in the growing economies. The general view is that corporate governance implementation improves the performance of the firm and safeguards the interest of shareholders (Switzer, 2015). Corporate governance is necessary to ease differences of opinion among the stakeholders especially shareholders and executives so that organization's performance can be improved. However, the implementation of corporate governance is different in every country because of its economic, political, and other local structures (Chan, 2012). Most businesses are inherited businesses and are the building blocks for the economy (Zellweger, 2017). According to Daily, &

and Dalton (1997a), stock exchange listed businesses are the backbone of the economy and overall stock exchange results show the growth or decline of the economy. Miller, & Breton-Miller (2006) found that firms run better when they have the aim to lead business for the next generations and to achieve this vision, they must follow certain frameworks. For example, in developed countries, firms work under well-managed regulatory frameworks but in developing countries like Pakistan, political instability and economic crises affect the implementation of such frameworks badly. Listed corporations of Pakistan are an important pillar of the economy and are operated under Pakistan corporate governance act which was established in 2002. Many businesses started implementing corporate governance acts in their firms (Hussain, 2018) but these corporations are either ignorant of the principle of corporate governance or do not want to focus on the corporate governance of the firm (Jan et al.,2021). Although corporate governance has been discussed worldwide in many ways, there is an inadequate study on the firms of Pakistan. Therefore, the goal of this research work is to fulfill this disparity and improve the firm performance of listed companies in Pakistan.

II. LITERATURE REVIEW

It is known that the world's leading organizations are listed firms (Casillas & Pastor, 2015). Corporate governance features are inclined by law which opens the opportunity for new investors (Houcine et al., 2021). In the non-presence of a defined structure, investors find it difficult to know about their investments. Also, it makes it easy for internal management to find flaws for misusing the assets which affect the shareholder's wealth and firm performance. A strong link is found between corporate governance and the performance of the firm (Sami et al., 2011). According to Shaheen & Nishat (2005), corporations that do not follow corporate governance procedures usually bear the loss or a lack in their desired profits. They also state that firms with no or fewer corporate governance practices achieve fewer financial advantages. Firms with competent corporate governance procedures pay high value to the investors (Nandelstadh & Rosenberg, 2003).

Corporate governance procedures address every sector within the organization and set a rule to improve the functional capability of the organization. The goal of every organization is to increase the shareholder's wealth (Gompers et al.,2003), and to do so corporate governance processes need to be followed.

Internationally, there has been plenty of research, but the empirical evidence varies from country to country. Almost, researchers have found results from their work but these results have never been consistent. The result has been going around in both ways.

According to one school of thought, CEO duality, firm size, board sovereignty, and ownership structure has a constructive effect on the performance of the firm, whereas other schools of thought, states opposite to it by claiming that these variables harm firm performance.

The result of adverse relation of board size and performance of the firm was found by Mashayekhi & Bazaz (2008) and Yermack (1996). Whereas constructive result was found in the study by Abor & Biekpe (2007); Kiel & Nicholson (2003) when comparing board size and corporate performance. Some researchers also found no correlation between firm size and the performance of the firm in their studies (Mohd Ghazali, 2010; Ali, 2015; Ali and Audi, 2015; Ali, 2018).

In the studies related to independent directors and business performing Jackling & Johl (2009); Mashayekhi & Bazaz (2008); Rosentein & Wyatt (1990; Alim et al., (2021); Alim et al., (2021); Audi et al., (2021)) found the independent board members are certainly related to firm performance whereas Agrawal & Knoeber (1996) stated that independent directors harm the firm performance. Also, some researchers found no relation of outside directors on the firm (Coles et al.,2001)

CEO duality is considered to harm the profitability of firm performance in the corporate governance procedure but in different studies, opposite results were found, according to Abor & Biekpe (2007), CEO duality has a positive relationship whereas according to Ehikioya (2009), CEO duality harms the performance of the firm. Jackling & Johl (2009) stated no relationship between the CEO duality and firm performance.

The Sri Lankan researcher, Guo & Kumara (2012) tried to find the procedures of corporate governance in the Columbian stock market and found an inverse connection between performance and board size. He also noticed that independent directors have a destructive relationship with firm performance.

For the Chinese market, Sami et al. (2011) found positive relations amongst the board size and education of directors with firm performance. According to Lam & Lee (2008), different theories give different results and he suggested that mixture of both agency and stewardship theory can only improve duality and performance relationship. The result of Lam and Lee (2008) found a favorable impact of CEO duality on non-family firms but an adverse effect on family firms. According to Hermalin & Weisbach (1998), board success relies upon the structure of the board whereas Ehikioya (2009) states that there is no relationship between the structure of the board and business performance. Ujunwa (2012) recommended that an inverse link exists between the board size and the performance of the organization. Li et al., (2008) recommended a beneficial link between outside directors and organizational performance. According to Eloumi & Gueyie (2001), firms that have financial crises are mostly found with few or no independent directors. Krivogorsky (2006) endorsed many studies and states a positive relation of board independence with profitability ratios in European companies. Yermack (1996) insisted on the shaky relationship between the board size and performance whereas Vafeas (1999) and Golden & Zajac (2001) forecasted that no link exists between performance and the board size. No link was found by Abdullah (2004) and Daily & Dalton (1992) of the creation of the board and firm performance. Donaldson & Davis (1991); Brickley et al. (1997); Coles et al. (2001) stated that board structure should have consisted of independent and dependant directors. According to Ujunwa (2012), Nigerian firms have negative relation of firm performance with CEO duality but if board size is small, then CEO duality provides a better impact on firm performance. Kang & Zardkoohi (2005) explain in their research that CEO duality result compared with firm performance is still not sure and requires more research. Fama & Jensen (1983) stated the result that CEO duality is the cause of agency cost as it gives equal chance to the CEO to keep control upon board decisions and an eye on management. Laing & Weir (1999) found in their research that the CEO dual role is unfavourable for investors' money as more self-interest decisions are made in the dual role rather than maximize the shareholder's wealth

There has been plenty of work done on the investigation of different corporate governance procedures and measurement of firm performance but still, outcomes are confusing. No one-line statement can be provided. As corporate governance style differs from country to country (Gulzar & Wang, 2010) so no solution has been found to date. The only point that is common amongst all research is that the future of any organization is conditional to the successful implementation of corporate governance and that is why Porfirio & Carrilho (2020) emphasis applying corporate governance in every firm.

Hence, this issue is still unresolved especially for the firms of Pakistan. To resolve this dispute, we took a sample of Pakistani listed firms and linked the corporate governance and performance, expecting to obtain valuable findings which will improve the firm performance of listed companies of Pakistan.

III. THEORETICAL FRAMEWORK

Agency theory is one of the most popular academic frameworks which has led to the development of the Anglo-Saxon model of corporate governance. The model is widely used to help the board of directors curb excessive executive power in the hands of management (Pande, 2014).

The Agency Theory, Stakeholder Theory, Stewardship Theory, and Resource Dependency support our research which aims to improve the firm performance with the help of corporate governance instruments. Corporate governance has significant importance especially to examine the performance of the board of directors. As a result, the theories which best explain the structure and reporting practices are being used for better understanding and increasing performance.

Corporate governance has been focussed on the separate entity concept which results in a principal-agent problem. It is the view that the board of directors has a key responsibility to minimize any conflict between managers and owners of the business. The intention behind the theory is to minimize self-interest and boost the value of the firm by minimizing agency costs and implementing accounting procedures (Deegan, 2004). The agency problem is different in each country. In some countries, if investors are not satisfied with the performance of management, they leave the organization which results in a reduction in share price whereas vice versa in some countries majority shareholders are dominant on minority shareholders and management and they control them according to their needs (Spanos, 2005).

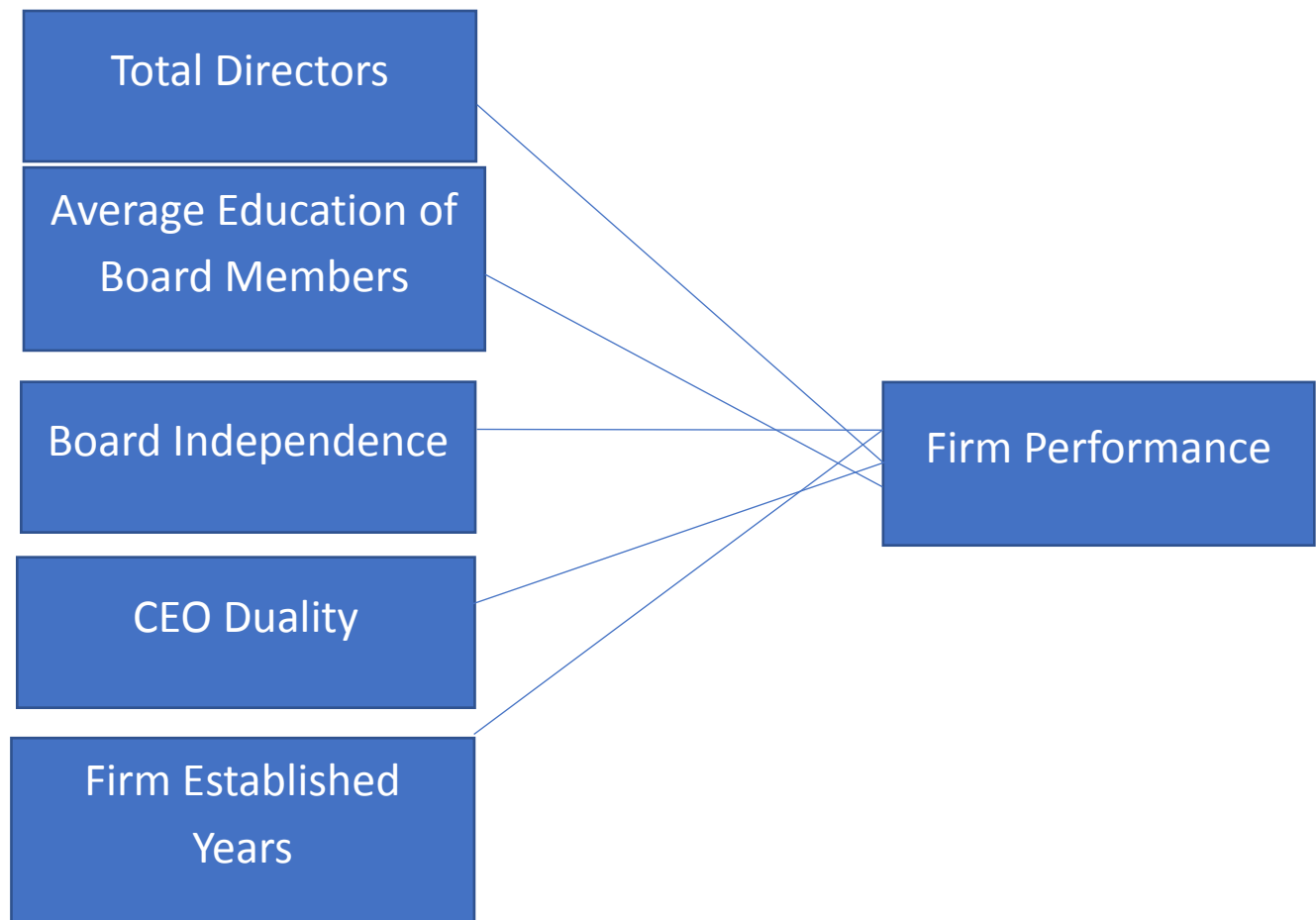
Stakeholder theory was introduced by Milton Friedman (Dmytriyev et al.,2021) which expresses the significance between business and the stakeholders such as investors, employees, and customers. The stakeholder's philosophy is the expansion of agency theory where the obligation of the board of directors is added from investors to other key participants attached to the business. According to the theory, not only increase in the shareholder's wealth be the priority of the firm management but also growth is essential. The theory also states that if policies are applied properly, they will cover all rights of shareholders and the business life cycle of the firm will be increased.

Resource dependency theory explains that the inner structure of an organization needs to match with the external environment which can be fulfilled by the existence of the board, its size, and competent board members. The theory states that the directors bring knowledge, talent, and different policies from the outside world to the organization for the improvement of the performance of the organization.

Stewardship theory considers the managers as good steward who acts in the best interest of the organization. The concept is established on the behavior of executives. According to Smallman (2004), when investors' capital is boosted, management will get the reward as well. Stewardship theory considers the position of CEO and Chairman similar and as no need for non-executive directors as theory explains that all the individuals will be working in the favour of the organization.

Corporate governance covers the following practices:

- A1: Boards with CEO duality will have high performance
- A2: More the executive directors, better the performance of the company
- A3: Smaller boards have better performance
- A4: Young board member leads to better performance
- A5: Higher average education of board results in better performance
- A6: Similarity in the interest of board members and management results in better performance
- A7: Lower level of board independence leads to better results in performance.



The primary focus of corporate governance procedures is to understand how humans can be motivated to contribute to the achievement of organizational vision (Chrisman,2009). According to Fan et al., (2011), corporate governance has two main models:

- 1) Anglo American Model
- 2) German Model

Anglo American model focus is on the management by a single board of directors and the purpose of this is to supervise and manage the company (Floyd & Lane, 2000). This concept is mostly used in the US, UK, Canada, and other countries. The board is designed from the executive directors who work as the manager of the company whereas others are independent directors who work as a supervisor and bring external experience to the company whereas the German model is mostly used in Europe such as in Germany, the Netherland, Sweden, etc (Fan et al., 2011) and this model includes two-tier structures. It has a supervisory board as well as other boards. The supervisory board includes non-executive directors whereas the board consists of managers. Clearly. As the name suggests, the supervisory board supervises the activities of the company by directly managing the management which is included in the board.

As stated by Goergen et al., (2008), the other main difference between both models is that the Anglo-American Model does not cover the interest of stakeholders in the corporate governance and non-executive directors do not have sufficient supremacy to take part in controls whereas, in the German model, the interest of all stakeholders is taken care of especially the banks, workers, and suppliers. To adopt the best corporate governance practice, both models can be combined and policy for the company can be adopted.

The quantitative approach is used in the research by us. The approach helps us to find the link among the variables. Many studies have already used the regression test to check the procedures of corporate governance and we will also use the same. The study consists of the data of the top 75 companies registered in the Pakistani stock market.

Table 1: Summary of Research Design

Research Design		
1	The Type of Study	Explanatory Study
2	The Method of Data	Secondary Source
3	The Purpose of Study	Causal Research
4	The Time Dimension	Panel Data

Selecting the top seventy-five companies in the sample of the total registered company of stock exchange is because it performs a significant role in GDP and helps in generalizing the result as most of these companies have been in the top position since 2005. The information for corporate governance procedures is gathered from the approved internet site of the stock exchange and the reports are disclosed with the corporate governance practice of all the enterprises. The record for the financial report is taken from Pakistan Stock Exchange (PSX) official website and shows the annual reports of all listed companies registered in the Pakistani stock market.

The correlation test is used to measure the relationship between each assumption to see the firm performance. The result will help in finding the direct and significant relation whereas a regression run will help to predict the stewardship policy practice in the firm performance.

IV. THE MODEL

The model used for analysis is as follows:

$$FP_{it} = \alpha + \beta_1 TDIR_{it} + \beta_2 INDIR_{it} + \beta_3 ESTYEAR_{it} + \beta_4 CEOD_{it} + \beta_5 AVGED_{it} + u_{it}$$

Where:

FP_{it} = Firms performance is measured by ROA

$\beta_1 TDIR_{it}$ = Total Number of Directors

$\beta_2 INDIR_{it}$ = Board Independence

$\beta_3 ESTYEAR_{it}$ = Established Years of Firm

$\beta_4 CEOD_{it}$ = CEO Duality

$\beta_5 AvGED_{it}$ = Average education of Board of Directors

u_t = Error term

V. DATA AND SAMPLE

The data include the top seventy-five Pakistani organizations registered on Pakistan Stock Exchange over the period 2010-2019. We collected data for total members of the board, board independence, CEO Duality, Average Education of Board Members, and Years of the establishment of the firm from the yearly reports of the firms available at the Pakistan Stock Exchange database. The sample data includes total assets, net income, leverage, and other financial variables covering 2010-2019. Firms are divided into 5 different categories according to PSX. We manually collected board size, their independence, CEO dual role, education of board members, and year of establishment of each company. This data comes from: i) financial website for securities (PSX.com) ii) annual reports for 2010-2019 iii) Google and related search engines.

ROA which is the dependant variable is calculated in the same method as have been calculated in the previous studies (Parkinson, 1980) which are dividing the total assets by net income. Return on equity has been calculated by dividing net income with shareholder equity. The result shows how much shareholders are earning on the investment they have made.

VI. FINDING AND ANALYSIS

The summary of descriptive figures is shown in the below table number 2. Mean is the quantity of significant propensity. The evocative figures for the seventy-five firms (75 companies) were determined individually to relate the firm performance in this research paper.

The sample consists of 75 firms registered in PSX from 2010-2019 making 750 observations in total. The average return on assets (ROA) for the sample is 6.36 percent. The average education and established year of the firm in the test has an average percentage of 1.19 percent and 1.54 percent.

Table 2: Descriptive Analysis of the Variables

	ROA	TDIR	INDDIR	ESTYEAR	CEOD	AVGED
Mean	6.367441	0.900063	0.021368	1.548560	0.153333	1.197908
Median	4.960000	0.903090	0.020408	1.580000	0.000000	1.197000
Maximum	68.20000	1.146128	0.160000	1.851000	1.000000	1.334000
Minimum	-40.02000	0.698970	0.000000	0.301000	0.000000	1.079000
Std. Dev.	12.06999	0.069740	0.019933	0.230492	0.360549	0.030121
Skewness	0.596291	1.258765	1.974041	-2.312266	1.924277	0.422760
Kurtosis	5.682277	4.363297	9.536696	12.68558	4.702841	7.018919
Jarque-Bera	269.2770	256.1419	1822.367	3599.897	553.4698	527.0817
Probability	0.000000	0.000000	0.000000	0.000000	0.000000	0.000000
Sum	4775.581	675.0475	16.02576	1161.420	115.0000	898.4310
Sum Sq. Dev.	109117.7	3.642934	0.297596	39.79188	97.36667	0.679531
Observations	750	750	750	750	750	750

The result of Table 3 shows that variables are certainly connected. Therefore, multicollinearity can not be seen. The p-value of INDDIR, EST YEAR, and CEOD are less than or equal to 0.010 resulting in rejecting Ho and showing a bond between variables.

Table 3: Correlation Matrix Between the Variables

	ROA	TDIR	INDDIR	ESTYEAR	CEOD	AVGED
ROA	1.000000					
TDIR	0.120454	1.000000				
INDDIR	-0.021723	-0.041845	1.000000			
ESTYEAR	-0.081087	-0.053836	0.150597	1.000000		
CEOD	-0.061315	-0.139979	0.017068	0.063646	1.000000	
AVGED	0.153412	0.148553	0.155634	-0.050596	-0.011731	1.000000

Table 4 shows the result of regression analysis. The establishment and implementation of board independence show a negative impact on ROA whereas total directors and average education show a positive impact on ROA. In this model, a 10% increase in board independence will reduce the ROA by 36% whereas a 10% increase in total directors and average education of directors will increase ROA by 10% and 39 % respectively. As CEO duality and established years of the firm give insignificant value it means that EST YEAR and CEOD do not affect ROA. However, 32.7% ($R^2 = 0.32$) shows that the model explains all the adaptability of the information around its mean and the values are acceptable in panel data.

In the studies by Ehikioya (2009), she recommends the inverse relation between CEO duality and performance of the firm whereas Lam & Lee (2008) reveals in their research that years of establishment of the firm has a positive link with the performance but in our result for the period of 2010-2019 for top 75 companies of Pakistan, the result shows no relation and gives insignificant values.

Table 4: Result of Regression Analysis

Dependent Variable: ROA

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-48.88100	15.26688	-3.201768	0.0014
TDIR	10.26046	5.340334	1.921314	0.0551
INDDIR	-36.34014	18.75258	-1.937874	0.0530
ESTYEAR	-1.528253	1.605281	-0.952016	0.3414
CEOD	-1.192693	1.019310	-1.170098	0.2423
AVGED	39.77355	12.42869	3.200141	0.0014
R-squared	0.327046	Mean dependent var		6.367441
Adjusted R-squared	0.321611	S.D. dependent var		12.06999
S.E. of regression	9.941365	Akaike info criterion		7.440575
Sum squared resid	73431.24	Schwarz criterion		7.483696
Log likelihood	-2783.216	Hannan-Quinn criter.		7.457191
F-statistic	60.18115	Durbin-Watson stat		1.651846
Prob(F-statistic)	0.000000			

Table 5: Relationship of the Variables

S. No.	Variables	Nature	Exp. Relation	Symbol
1	Return On Assets	Dependent		ROA
2	Board Independence	Independent	-	INDDIR
3	Total Board Members	Independent	+	TDIR
4	CEO Duality	Independent	-	CEOD
5	Average Education of Board Members	Independent	+	AVGED
6	Established Years of Firm	Independent	-	ESTYEAR

The establishment and implementation of board independence, the total number of directors, and their education have effects on ROA. It can be seen from the table of Covariance Analysis that all the independent variables other than CEOD and ESTYEAR are affecting the dependant variable either inversely or positively.

The increase in board independence will affect the ROA negatively, hence meeting the standards for the corporate governance be followed in PAKISTAN. Moreover, the increase in total director and average education will affect ROA positively. CEO Duality and Established Year of firm will not affect ROA. Hence, total directors and their education do have a big effect on the firm performance. Moreover, 32.7. (R square = 0.32) shows that the pattern describes the changes in the numbers around its mean. Many studies have tried to measure the firm performance by a different measure, but we tried to measure it by ROA. The statistical significance is 1%, 5%, and 10%. And our result shows significance at 5%.

VII. CONCLUSION

The study intended to assess the present state of corporate governance in Pakistan and to see if the corporate governance practice affects firm performance. Several hypotheses were tested using secondary data to find the corporate governance difference of the instruction by international corporate governance standard and the one followed in Pakistan. The first crucial remark is that we validate that corporate governance procedures do play role in the firm performance. Sharma and Irving (2005) have already discussed that procedures are a great tool for the success of the organization. “High commitment management policy” is related to corporate governance philosophy and promotes free exchange of ideas, workers equality, and the formation of confidence. Secondly, we have preferred using the Anglo American Model which consists of one line of the board of directors having executive and non-executive directors as well as further having two committees: operational committee and control committee. Lastly, after applying corporate governance procedures, we have found the relation between firm performance and independent variables which are board independence, the total number of directors, and their education. CEO Duality and Years of the establishment of the firm have not shown significance in the case of Pakistan.

It is found during research that board independence has a key role in the firm performance and in most companies the board independence is very low (Vieira, 2018). The main reason figured is that either most of the firms are family-oriented in Pakistan and board independence is not taken seriously or the same board members are also part of the other committees which can be a conflict of interest. As result shows that the more board independence is lost the negative ROA will become. It can be proved from the result that a 10% change in board independence will move 36.3% positive ROA.

Earlier studies have revealed that average education performs a significant role in the success of the organization (Sheikh et al., 2018). The board leads the organization, and the more educated board member exists, the more modern way of communication will be transferred lower in the hierarchy. Our result shows that the average education of the board members affects firm performance and a 10% change in executive compensation will affect 39.6 % in ROA.

To wrap up the research, it can be concluded that board independence, the total board size, and the education of board members have a significant effect on the Pakistani firm’s performance which can be measured by ROA whereas CEO Duality and established years of the firm has an insignificant effect on firm performance. So, it is suggested for the cooperate sector to more focus on board characteristics rather than CEO duality and its life. The formation, functionality, and operationalization of the Board are key for corporate success.

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