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CORPORATE GOVERNANCE AND FIRM PERFORMANCE: AUTOMOBILE ASSEMBLERS LISTED IN PAKISTAN STOCK EXCHANGE (PSX)

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ABSTRACT

The purpose of this study is to analyze the relationship between (PM and ROE) and the corporate governance mechanisms (BS, AC, CEOD, AGM) on automobile listed firms in Pakistan Stock Exchange. Data has been examined from 2010 to 2016. Multiple Regression analysis and t-test have been applied to examine the impact of corporate governance on firm performance. The results show that Board size, Audit Committee Size and number of meetings are much adequate to show positive impact on firm performance; whereas near to 70%, CEOs hold dual positions in automobile organizations; which gives a negative sign on firm performance. Regression analysis show a positive relationship with the dependent variables (PM, ROE) and also on independent variables (BS, AC, CEOD, AGM). Results also conclude a negative relationship between performance measures (PM and ROE) with corporate Governance Mechanisms (BS, AC, CEOD, AGM). The proposition of the results states that CEO dual status should not be used; single position should be held by an individual especially for the top-level positions like CEO.

Keywords: *Corporate Governance, Performance Management (PM), CEO Duality, Annual General Meeting (AGM), Return on Equity (ROE)*

INTRODUCTION

Effective Corporate Governance practices make an organization constructive to contribute positively towards sustainable economic development, by addressing the internal organizational issues and delivering outside capital access. In emerging markets like Pakistan, corporate governance plays a vital role as a part of the public policy. Due to China Pakistan Economic Corridor, a huge revival has been witnessed in the automobile assemblers in Pakistan; which makes this sector worthy to study. Companies like Ghandhara Industries and Hino Motors have observed drastic growth results since CPEC announcements. Some companies turned out in profits which were in losses for many years. Pakistan at present is in the list of emerging markets, which makes corporate governance an essential aspect for organizations in this conutry to reap maximum benefits out of the emerging opportunities. As Firm's performance is also dependent on corporate governance practices. This paper thus attempts to analyze the automobile sector performance in Pakistan, which is measured by the profit margin (PM) and return on equity (ROE). Further, the impact of the practical execution of corporate governance practices is tested on firm performance.

LITERATURE REVIEW

Governance

Governance can be defined as the framework and procedures that are strategized to safeguard "accountability, transparency, responsiveness, the rule of law, equity and inclusiveness, empowerment, and broad-based participation." Further Governance also signifies "norms, values, and rules of the game" through which a State or an organization can manage its affairs in a better transparent manner.

"Dynamic interaction between people, structures, processes and traditions that support the exercise of legitimate authority in provision of sound leadership, direction, oversight, and control of an entity in order to ensure that its purpose is achieved, and that there is proper accounting for the (ethical) conduct of its affairs, the (efficient) use of its resources, and the results of its activities" is defined as Governance (Gill, Vijay, & Jha, 2009). International Organizations such as World Bank, UNDP term Governance as an authority to fare a state`s fiscal, radical and organizational affairs.

Corporate Governance

International Finance Corporation has defined Corporate Governance as, "the structures and processes for the direction and control of companies. Corporate Governance concerns the relationship among the management, board of directors, controlling stakeholders, minority shareholders and other stakeholders" Good CG practices make an organization more profitable, reduces risk, smoothens operations efficiently and can help to secure from external shocks as well. Also, having best corporate practices can make an organization more accountable and can help to present a clear picture of the companys` performance to their shareholders (IFC, 2013).

Corporate Governance is further defined as the power of an organization to take care of all of the organizational resources with the intention to maximize shareholders` value. Elaborating it further, that proper legal, institutional and economic environment is to be maintained to nurture human resource development and forebenefiting shareholders` long-term values and the society as a whole (Lubale, 2012). Lubale further contributed to corporate governance by justifying it with following five pillars:

1. Accountability: *Leaders should come up to have accountability on them.*
2. Efficiency and Effectiveness: *Leaders to contribute to the effective and efficient process to achieve organizational targets.*
3. Integrity and Fairness: *Leaders should be honest, truthful, obedient and should follow and act on the rule of law.*
4. Responsibility: *Leaders should be capable to take full responsibility on their shoulders*.
5. Transparent and Open Leadership: *Leaders should ensure timely disclosure of correct, accurate information without any favor* (Lubale, 2012).

Corporate Governance Failures

To observe the Corporate governance practices and its impact on organizational performance different studies have been carried out in different industries. A recent research study has been conducted to review the impact of corporate governance failure on financial reporting on Malaysian organizations. Organizational cases like Perwaja Steel, Technology Resource Industries, Megan, Malaysian Airlines System, WorldCom and other few organizations have been studied in this aspect. The results of the analysis of organizations, which failed to implement the corporate governance structure, revealed that poor monitoring and low enforcement mechanisms are treated as the primary hurdles in implementation of good corporate governance practices. The study suggested implementation of some transparency measures in financial reporting to instigate best CG practices.

In 2002, a study was conducted by Shaikh and Wang, to investigate the relationship of corporate governance characteristics and financial characteristics of financially distressed firms. 2690 firms who faced financial distress from 1988 to 1996 were selected as sample and the survival analysis techniques to judge financial distress relationship was applied. Result concluded that firms that changed their CEOs with outsiders had increased, twice the chances to experience bankruptcy. The study also suggested that insider ownership and block holders have a significantly positive relationship with organization`s survival.

Holmstrom and Kaplan (2003), conducted a research on United States of America`s corporate governance failures, and the changes made in organizational CG practices, as a lesson of these failures. Corporate Governance failures of Enron, Tyco, WorldCom, Global Crossing and others were focused on the research study. Top Executives` remuneration has been criticized in the US by academicians, press and even by Federal Reserve officials. These failures brought legislative changes regarding Sarbanes Oxley Act 2002. Research studies have been conducted to answer whether the US corporate governance system has really performed poorly? Moreover, will the changes made in terms of the act and SOPs for NASDAQ and NYSE, will be sufficient? Researchers concluded that these current changes regarding Sarbanes Oxley Act and SOPs for NASDAQ and NYSE are likely to have a positive impact on future corporate governance practices and organizational performances. Due to these regulations, United States has faced troubles in corporate governance regarding over-regulation in recent years.

The USA 2001 financial crisis created a market bubble burst while leading to a more severe crisis in Europe. Concerning strict measures to curb frauds in the USA, a similar study was conducted in the context of different corporate governance system scandals. The research concluded that dispersed ownership systems of corporate governance cause earning management, that lead to corporate governance failure in the US.

Before 1990, the banking sector was entirely controlled by the state in Pakistan. In 1990, Government of Pakistan decided to privatize five major banks, and top three bids were placed before the Governor State Bank of Pakistan, but the contract was signed with the third bidder (National Group). The deceptive bidding is a prevalent practice in organizations leading to dishonesty and distrust. Studies have been conducted on the failure of corporate governance in terms of bidding fairness process (Siddiqui & Anjam, 2013; Lipton, & Rosenblum, 1991; Mitchell, 1990).

Khanani and Kalia International (KKI) also suffered from the corporate governance failure which led to violations of policies of State Bank and

Security Exchange Commission of Pakistan. KKI has used an illegal money transfer method known as Hundi or Hawala, which was banned internationally after 9/11 incident. Because of weak and expensive banking transfer payment system, traders used Hawala to transfer money in fast and cheaper way. By illegal means, KKI violated corporate governance principles of transparency; disclosure; accountability and responsibility. Thus, Khanani and Kalia group violated CG practices and was involved in illegal money transfer practices.

Since privatization boom in 1990, and uptil now, the Government of Pakistan has sold about 166 state enterprises with an overall amount of Rs. 476.5 billion. Privatization of PTCL has raised many questions regarding corporate governance practices. First, whether it can give a chance to other countries to have access to phone calls data. On the other hand PTCL has still not paid in total the ownership amount but has received 100% possession. PTCL privatization has led to corporate governance failure during business transfer to Etisalat.

Mehran Bank scandal is treated the most prominent single cash recovery amounting Rs.1.6 billion. NAB and senior army officials have recovered the amount and transferred state amount to intelligence fund as per official rules. Later Mehran bank went to bankruptcy, and the general public amount could not be recovered. After few years, it has been noticed that 39 individuals have been bribed to push down the case (Salman & Siddiqui, 2013).

Pakistan Railway, an East India Company gift to Pakistan was a trusted travel partner of the general public and reliable mode of goods transport and logistics. It mostly routes to the majority of cities. However, due to corrupt practices by the top managers, which led to poor management with the incapable human resource. These reasons led Pakistan Railways in corporate governance failure with heavy losses.

Corporate Governance in Pakistan

Study was conducted to find the relationship of corporate a governance with corporate valuation; ownership structure and need for external financing for KSE listed firms in the period of 2003-08. Governance factors such as board composition, ownership and its composition, disclosure, auditing and transparency have been used as variables the study. Researchers selected 80 listed non-financial firms. The research concluded that organizations with best investment opportunities and with large size lead to the adoption of better corporate governance practices. Research also confirmed agency theory assumption that the family owners and foreign owners carry better governance practices in organizations, study also concluded that connection between ownership concentration and external financing has an inverse relationship with each other.

In another study the relationship between firm performance measure as ROE and PM, considering the corporate governance factors as the size of the board, board composition, CEO status, and Audit committee was conducted. A sample of 30 listed firms in Karachi Stock Exchange was selected during 2008-09. The research concluded a statistically significant relationship between selected corporate governance mechanisms and firm performance measures. However, CEO status relationship with performance measures such as ROE and PM have an insignificant negative relationship.

The relationship between corporate governance and capital structure of KSE listed 58 non-financial companies have also been gauged from 2002-05. Regression Analysis has been applied; CG factors as board size, board composition, and CEO status has been assessed in research. It concluded that board size and managerial shareholding is negatively correlated with debt to equity ratio. Research suggested that corporate governance selected variables play a vital role in regulating financial mix of organizations.

Similarly, a study on business groups and its impact on corporate governance in Pakistan have been studied. Karachi Stock Exchange listed firms from the period of 1998 to 2002 have been selected. Result concluded that group firms have more ability to pay short-term debts and lower financial leverage than non-group firms. Research further suggested that business groups are efficient financial arrangements that take place in effect outside the markets.

A research was conducted to measure the impact of corporate governance factors on capital structure choices of Pakistan based firms (Dar, Naseem, Rahman & Niazi, 2011). Corporate governance factors as outside directors, board size, ownership concentration, directors` remuneration, CEO’s status and managerial ownership have been incorporated in the study. The sample for non-financial firms listed on Karachi Stock Exchange has been selected from the period of 2004-08.

Result concluded that ownership concentration, board size and outside directors have a positive relationship with total debt ratio and long-term debt ratio; but directors` remuneration is negatively correlated. Research suggested that corporate governance attributes in Pakistan, impact the financial behavior of Pakistani firms.

Corporate Governance Mechanisms

To assess corporate governance, researchers in the current study have used Board Size, Annual General Meeting (AGM), Audit Committee and CEO Duality. However, to measure the firm performance, the Profit Margin (PM) and Return on Equity (ROE) have been used.

Board Size

Previous studies demonstrate that the corporate governance system in the United States of America is not up to the mark. Problem is not with the Judiciary, regulations, and laws; but the problem is with an excess number of board of directors, which lead to failure of corporate governance mechanism. It has been noticed that most of the time; directors are out of time and mostly meet less than eight times a year. Other than that, directors spend less time on committee meetings, official gatherings, and pre and post board meetings. Lipton and Lorsch (1992), believed that standard maximum number of board size must be ten, having at least two independent directors. They further suggested that board of directors should meet at least twice a month including committee sessions and other meetings. Also, directors should spend at least 100 hours annually on each board of which they are part of.

Research has been carried out to measure the relationship between board size and its composition on banking efficiency of European banks operating during 2002-06. It has been found that board size is statistically insignificant with banks` efficiency in terms of cost and profit of selected banks. Average board of directors' size in Pakistan is 9, in Malaysia 7 and in Saudi Arabia is 11.

Annual General Meeting (AGM)

Annual General Meetings are treated as the most import part of corporate governance. Even though, it does not impact much on company's performance as compared to other corporate governance factors. Annual General Meetings are an important part of United Kingdom`s corporate governance practice. As it gives a platform where all stakeholders (shareholders, directors, auditors, employees, suppliers, and others) can come and share their views and suggestions in front of the board and media. Annual General Meeting is claimed to achieve CG practice as it is considered as the most critical part of the report (Tesco, 2006). Apostolides researched corporate governance in 2010. Forty AGMs were attended to evaluate the best and worst CG practices and to build up a picture of successful AGM. Result concluded that a successful Annual General Meeting should consist of a balanced and independent set of skills including justified remuneration with rewards for the board of directors; awareness of corporate social responsibilities to the directors and giving importance to the shareholders.

Audit Committee

Previously, research has been conducted on the role of audit committee, executive committee and board of directors in earning management. 280 firm observations have been collected to analyze the impact of the audit committee, which compost of 15% of the affiliated directors and rest others. The research concluded that audit committee and board member with financial background are more inclined to those small firms who have a smaller number of current accruals. It is further concluded that members of the audit committee and board` financial classiness may play a key role in limiting the capacity of managers in earning management (Xie, Davidson, & DaDalt, 2003).

Overall interest in audit committee has been increased dramatically with reference to members` knowledge, independence, and their experience. Another study, on the effects of experience and financial reporting and audit knowledge on the members of the audit committee was conducted. Researchers selected 69 audit committee members to test their hypotheses. Result concluded that the higher the experience and audit knowledge of an audit committee member, greater be the support to an auditor who advocates “substance over form” in disagreement with client management. Researchers further concluded that audit committee should be composed of the total independent basis to select their directors.

CEO Duality

According to Agency theory, CEO Duality badly affects firm`s performance as it adjusts for control and monitory of the CEO. Whereas, Stewardship theory suggests that CEO duality may positively affect firm`s performance as it gives one person a unity of command. Previously, research has been conducted on an archival database of organizational transitions. Researchers have included 403 listed firms and 1,202 company years in China. The research favored the stewardship theory and has called for a contingency perspective to review the factors which can influence CEO dualities such as resource scarcity, societal dynamics and others (Peng, Zhang, & Li, 2007).

A study on Egyptian listed firms was carried out to analyze whether corporate leadership structure affects organizational performance. The research concluded that on the econometric level, no impact of CEO duality had been found of organizational performance, but when researchers checked the industry wise impact, it has been found that CEO duality affects the organizational performance.

RESEARCH METHODOLOGY

Research Sample & Design

Automobile assemblers listed on Pakistan Stock Exchange (PSX) has been selected for the study, data of these 11 listed firms have been collected from their audited annual reports from the year 2010 to 2016. A total number of observations was 86, data of the companies were retrieved from their annual reports.

Model Specification

The model used in the research is:

$Y = a + bX + e$ **(Equation No. 1)**

In the above equation, Y is treated as the dependent variable, a is constant in the equation, b is the coefficient of the variables that are corporate governance mechanisms (board size, CEO duality, audit committee and board of directors) and e is the error term in the equation. By applying the equation No. 1, two new equations have been designed to fit the model for desired research demand that are:

$ROE = a + b_1 * AGM + b_3 * AC + b_4 * CEOD + e$ **(Equation No. 2)**

$PM = a + b_1 * AGM + b_2 * BS + b_3 * AC + B_4 CEOD + e$ **(Equation No. 3)**

Two types of variables have been used in all equations that are independent and dependent variables. Below is the description of the variables:

Table 1. Dependent Variables Justification

Dependent Variable	Formula
Return on Equity = (ROE)	$\frac{Net\ Profit}{TotalEquityShares}$*100
PM= Profit Margin	$\frac{EAT}{Turnover}$*100

Table 2. Independent Variables Justification

Independent Variable	Description
BS = Board Size	Number of Board of Directors
AGM = Annual General Meeting	Total Number of Meeting in a financial year
COED = CEO Duality	• Value Zero (0) has been assigned if the same person has more than one position at a time, i.e., CEO and GM. • Value One (1) has been assigned is CEO holds only one position at a time.
AC = Audit Committee	Number of Audit Committee Members

RESULTS AND DISCUSSION

Table 3. Frequency Distribution

	BS	AC	CEOD	AGM	PM	ROE
Mean	8.290698	4.197	0.290	4.581	1.474	2.734
Median	8.0	4.000	0.00	4.00	1.6783	3.0396
Mode	9.0	3.000	0.00	4.00	-1.320	2.965
Std. Deviation	1.1868	1.146	0.456	0.803	1.086	1.113
Skewness	1.185	0.6092	0.938	1.467	-0.783	-1.140
Kurtosis	4.872969	-0.7046	-1.146	1.836	0.4907	0.916
Range	8.00	4.00	1	3.00	5.3187	5.188
Maximum Value	14.00	7.00	1.00	7.00	4.00	4.433
Minimum Value	6.00	3.00	0.00	4.00	-1.32	-0.755

As the Table C shows that average board size is 8 in size, which explains a positive sign for the company`s performance. Audit Committee of automobile sector shows an average of 4 audit members, which shows a strong sign for the firm's strong performance. CEO Duality shows that almost 70% of the CEOs occupy two or more positions in the Automobile sector in Pakistan, who can be CEO, GM or MD of the company. Also, Number of board meeting shows an average of 5 meetings per year, which also shows positivity towards firms` performance. Also, from the above table, we conclude that Profit Margin means for the automobile sector is 1.474 and Return on Equity are 2.734, which shows that for year`s turnover, profit earned by automobile sector is 1.474%.

Table 4. ANOVA-PM as a Dependent Variable

Model	Sum of Sq	Df	Mean Sq	F	Sig.
Regression	10.071	4	2.518	2.298	0.069
Residual	69.020	63	1.096		
Total	79.091	67			

Predictors: Board Size, Audit Committee, CEO Status, Board Meetings.
Dependent Variable: Profit Margin (PM)

Table 5. ANOVA-ROE as a Dependent Variable

Model	Sum of Sq	Df	Mean Sq	F	Sig.
Regression	15.445	4	3.861	3.548	.011
Residual	75.096	69	1.088		
Total	90.541	73			

Predictors: Board Size, Audit Committee, CEO Status, Board Meetings.
Dependent Variable: Return on Equity (ROE)

Table 4 and 5 show the variance analysis (ANOVA) with F-values of 2.298 (0.69 sig value) and 3.548 (0.11 sig value) for Profit Margin and Return on Equity as dependent variables. Results strongly support a positive relationship between dependent variables, i.e., profit margin and return on equity and independent variables as board size, audit committee, CEO duality and Board meetings at 1%, 5%, and 10% levels. A significance level for both PM and ROE are near to 5%, which makes them statistically significant.

CONCLUSION

There is no doubt that previously a large number of studies have been conducted on corporate governance practices and their impact on firm performance in Pakistan and the number continues to grow, but the results concluded from various studies are found mixed. This study is conducted to measure the relationship between firm performance indicators (PM and ROE) and Corporate Governance Mechanisms (Board Size, Audit Committee, CEO Duality and Board Meetings) in Automobile assemblers in Pakistan. To analyze the impact of corporate governance, authors selected 11 listed automobile companies in Pakistan Stock Exchange, taking data from 2010 to 2016. T-Test and Multiple Regression models have been applied. The Results concluded that:

- There is a positive association between firm performance measures that are PM and ROE, whereas board size, audit committee, CEO duality and board meetings also have a positive relationship with them, but only board size and audit committee are statistically significant.
- There is a negative relationship between Profit Margin and BS, AC, CEOD and AGM.
- There is also a negative relationship between ROE and BS, AC, CEOD and AGM.

FUTURE RECOMMENDATIONS

Asia is treated as the next business hub for the whole world, and the role of Pakistan is very much strategic. Present status of Pakistan is being highlighted in bold letters with the CPEC impact. Lots of multinational organizations are coming to invest and run their businesses in Pakistan; in future which will give a tougher competition to local Pakistani industry to survive the fittest. Corporate Governance practices clarify that an organization is much stable to apply the global standards on it; which in turn gives the capability to compete in the global market. As the present research is done only in one Pakistan Stock Exchange-listed sector (automobile); there are lots of other sectors on which further study can be carried out regarding corporate governance. Also, a mixed study can be carried out to compare the local and international profitability by applying best corporate governance mechanisms.

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