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EFFECT OF CORPORATE GOVERNANCE ON FIRM FINANCIAL PERFORMANCE: EMPIRICAL EVIDENCE FROM TEXTILE SECTOR OF PAKISTAN

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Abstract

The aim of this study is to check the effect among four key indicator of corporate governance (Board size, CEO duality, Board meeting and non executive directors) with three financial performance indicator proxies (ROA, ROE and Tobin's Q) for the sample of 60 textile industries which are listed in Karachi Stock exchange of Pakistan and the Range of data between 2007 to 2016. The Board size, CEO duality, Board meeting and non executive directors has positively effect of performance indicator's variable ROA, ROE and Tobin's Q shows by empirical evidence. If the change accrues any independent variable the performance will also be changed accordingly. This study suggest looming instruction to the strategy and decision makers of any kind of corporation to make good decision to place appropriate Corporation hierarchy structure.

Keywords: corporate governance, financial performance, board size, ROA, ROE, Tobin's Q

1. Introduction

Governance word derived from Greek phrase kybernan which means "Govern". Governance is basically relationship between Governors and governed same as link among the government and people of the country. The share holder rights are protected by implementation of corporate governance (CG). Basically CG are set of rules, course of action and laws which are used to corporation administered (Borg, Brownfield et al. 2011). To preserved the shareholder rights or agency issue by corporate governance. The managers have more information and power as compare with shareholders says by (Jensen and Meckling 1976). Aspiration of the shareholder is to get maximum return in shape of dividend on their investment but managers have different like getting promotion, securing jobs and maintaining the status. Corporate governance is very hot topic for researchers, practitioners and it governing bodies. The companies of World com

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and Enron are the biggest example for corporate world intention toward implementation of corporate governance rules, and Sarbanes-oxley act was introduced in this regards. The organization for economic corporation and development (OECD) introduced first time code (Rule) of CG in 1999.

CG put a gigantic impact on firm financial performance. Firm’s financial performance is based on CG. In the developing countries the basic concern of the companies is to promote and apply corporate governance i.e. UK, USA, Netherland. Corporate governance play main factor for all business corporations’ success on long term basis (Gompers, Ishii et al. 2003). There are two key motivations, due to corporate governance increase the no. of investor in the business. Firstly, the investor thinks that the firm which is following the good corporate governance should be less risky. Secondly, the owners are spreading from firm which is more valuable for them. The good corporate governance’s firms are capable to run business in future with high cash flow Jensen and Meckling 1976). In the UK and Europe all the companies are rank according to their CG. The operation of corporate governance in Pakistan was to a certain extent behind schedule. Security and exchange commission of Pakistan bring in corporate governance in 2002.

Many studies reflect that corporate governance contributes a huge impact during crises, e.g. high-quality corporate governance companies prolong through universal financial crises (Joh 2003) taken 5829 companies of Korean before crises phase 1993-1997, he select these companies to check it. He says that the cause of crises of these companies is deprived corporate governance. Joh (2001a) says more than 60% companies do external audit which belongs to same business group. The question arise that why the other companies do better performance, they protect their shareholder rights by introduced good corporate governance.

Financial crises during 2007-08 were the biggest universal crises from the time when the huge depression of 1930s. The starting point of the current crises is preliminary quality to corporate governance failures among financial sector. The fall down of real estate business of America and succeeding collapse to relieve of subprime threat eventually cause of financial crises (Gregoriou, Gotts et al. 2009).

A lot of studies conducted to check the impact of CG on companies’ financial and operating performance in the perspective of developed and underdeveloped counties. And all studies’ result shows that good corporate governance add in firms profitability as well as take care of shareholder rights. Previous studies show that board size(BS), CEO Duality, Board composition(NED) and size of the company are the key variable to evaluate corporate governance system. Corporation performance is measured by return on assets (ROA), return on equity (ROE) and Tobin’s Q.

The aim of this study is to evaluate the influence of CG on textile firm’s profitability and operations. Investors don’t have proper knowledge about governance of textile sector this study will help out to the investors.

2 Literature Review

The bringing in corporate governance in Pakistan’s textile sector will help to remove agency problems. The investor wants that their money should be utilised in profitable and save venue. The explanations of variables and previous work on corporate governance impact on firm profitability with reference empirical studies as follows.

2.1 Board Size

The shareholder of the corporation elects the board of directors who can run the firm in proper way to achieve the revelation and shareholder interest by using their voting power. The board of the firm have power to involvement in salaries, gratuities, and bonus selection and change of the managers. The responsibilities of the board are transforming with respect to time and firms. (Caselli, Di Giuli et al. 2007) says that the individual who is the member of the directors team are actors, must keep in mind that their rule will be changed according to the situation.

Board size indicate member of the board as director. The selections of board member are according to the rule which is stated in the ordinance, and standard practice is seven directors (Andreou, Louca et al. 2014).(Yermack 1996) and (Eisenberg, Sundgren et al. 1998) says that if a firm have less no. of director it will be success full as compare to a company who have army of directors.

2.2 Non-Executive Boards

Non executive directors are measured in percentage form among the board. The directors make the decision on information provided by managers to remove the conflict among shareholder and top management says by (Harris and Raviv 2008). These non executive managers have all important information of the firm which is required to control the firm that's why we can't hold back their significance. Some studies says that these manages have not full picture of the firm as directors have because they get it from all the managers who have expertise in their fields. (Agrawal and Knoeber 1996) said that if they are part of the board they can make decision without CEO reliant. Most of the researchers agree on it that non executive managers to do better decision because they have attachment in the business (Berger, Hunter et al. 1993).

2.3 Board Meetings

It means that how many times in a year the board of directors came for meeting to make strategies for the company. The code of corporate governance of Pakistan 2002 says that the board's meeting should be arranged four times during the year by sending a formal letter which contains all the issue which is discussed during the meeting. The board meeting plan of the whole year should be publicized at begin of the year so that all board of directors should be well-known with upcoming meetings and their importance of attendance.

2.4 CEO Duality

The top position is CEO in the hierarchy of the management of a firm. CEO duality stands that the highest position in the firm is CEO but some firms have add power as chairman post is also CEO (Latif, Shahid et al. 2013). The conflict of interest will be increased if these both position held by one person said by (Javid and Iqbal 2010). If there are two different person in both position the firm will be improved its performance. The cost of the company does not affected if there are two people in both positions infect it will reduced the conflict of interest (Core, Holthausen et al. 1999). (Brown and Caylor 2004) says that if there is division in top position it will reduced politics and conflict.

2.5 Return on Assets

Return on assets means that when total income of the firm earned during the fiscal year is divided by total assets of the company (Latif, Shahid et al. 2013). The manager of the company are self-sufficient to make decision to utilised companies assets which shows company performance by using this equation we can be judge manages capability that how much they are getting benefit by utilisation of company assets. By the passage of time this ratio is used to check the position of the company (Aras 2015). To check the performance of the management ROA is used in Brazil (da Silva and Leal 2005). Corporate governance put positive and significant impact on ROA.

2.6 Return on Equity

When the total income of the firm is divided by total shareholders' equity during the fiscal year is called return on equity. ROE also measure the profitability of the firm by the money which is invested by shareholder. (Adekunle, Alalade et al. 2015) says that return on equity give better idea about firms financial performance.

2.7 Tobin's Q Ratio

Basically Tobin's Q is market worth of the assets of the company and replacement of the company assets. This ratio is derived by James Tobin who is student of yale university. Tobin's Q ratio also applies for measuring stock market assessment. If the Tobin's Q ratio value is less than 1 it will show that the firm is undervalue and the corporate attackers would be attracted. They want to buy that firm because Tobin's Q ratio tells them the worth of firm that they have to invest on it.

3. Research Methodology

3.1 Population and Sample selection

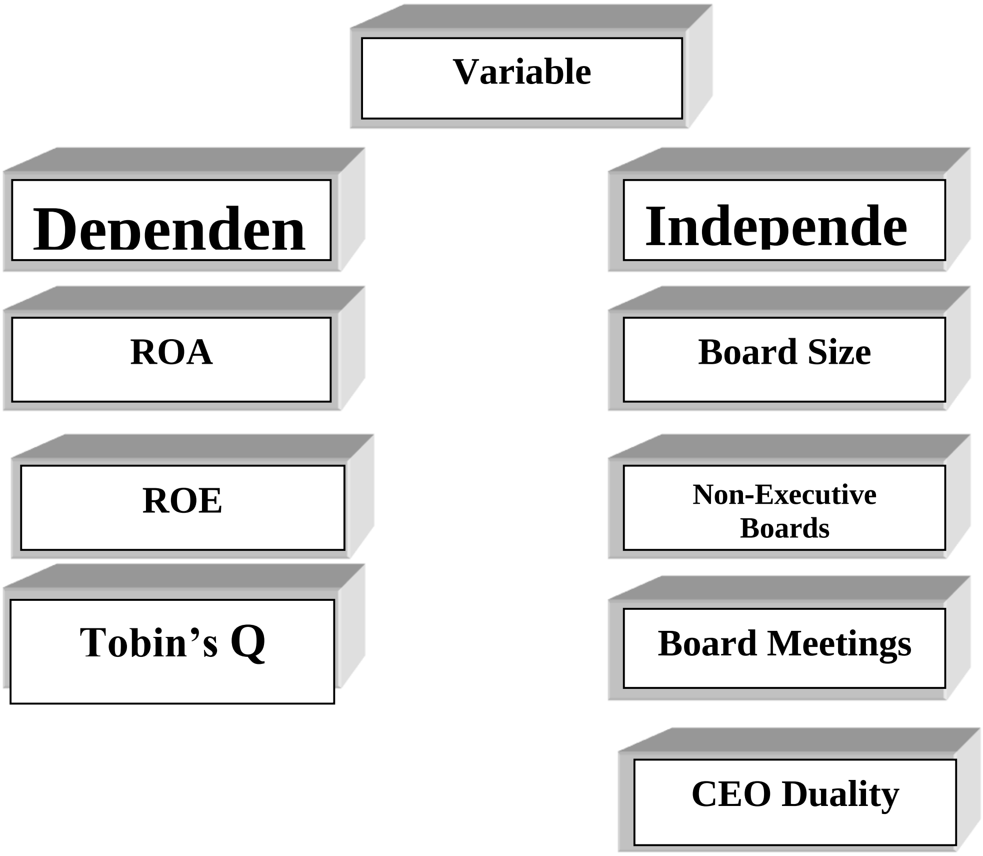
The population of this research article is textile sector of Pakistan and those firms which are registered in Karachi stock exchange of Pakistan. These firms are dealing in different segment of textile industry i.e. spinning or complete process of this industry, a lot of companies are independent in this field to do all operation by the way in Pakistan 156 companies are listed in stock exchange. Out of 156 only 60 textile companies are selected for research purpose, so the technique which is used to select 60 companies is random selection technique. During the selection of the companies following things are keep in mind i.e. the data is vital for analysis and all other information are available for research. The data which are selected are 10 year from 2007 to 2016; in 2002 the code of corporate governance applied in Pakistan but in 2012 the security and exchange commission of Pakistan revised that. During last decade this sector did not play very well in economically in Pakistan but now government put reforms in this sectors. The purpose to choose this sector is to check how the change in management can control and improve the economy.

3.2 Sources of data collection

The data which are used in this study are collected from annual reports of the companies and their booklets. And the other data like board size, CEO duality, Board meetings are collected from BSA is the data base of SBP which have all the information related dividend and other major decision of the corporation.

3.3 Theoretical Framework

The following figure shows the theoretical framework. In this research article we check the effect of CG on firm financial profitability or performance.



The equations of pooled ordinary least square are as follows

Yit=□o+□1X1it+□2X2it+□3X3it+□4X4it+□it

Yit represent ROA, ROE and Tobin's Q

i) X1 Represents Board size
ii) X2 Represents non executive Directors
iii) X3 Represents Board meeting
iv) X4 Represents COE duality
v) Uit Represents Error term.

4. Results and Findings

The corporate governance put a significant impact on corporate financial performance. This study shows that effect of CG on financial performance of the companies which are listed in Karachi stock exchange of Pakistan. Study used 60 firm's data which are collected from annual reports of random textile firms and apply Pooled OLS.

Table 1 Regression of ROA

Variables	Coefficient	Sta. Error	T.Ratio	P.Value
C	- 1.678O6	1.O7223	- 2.5436	O.O12O **
B.S	O.12143	O.O72485	2.5271	O.O348 **
N.E.B	O.16334	O.39372	2.4362	O.O342 **
CEO	O.O9578	O.13462	2.7259	O.O143 **
B.M	O.15836	O.26349	2.2762	O.O217 **

Mean of Dep. Var.	O.162452	**S.D of Dep. Var.**	1.24320
S.S. Resid.	52.6348	**S.E. of Regression**	1.62130
R-Suq.	O.O3267	**Adjusted R.Squ.**	-O.O6134
F-Statistic	5.32472	**P. Value**	O.O3982
Log. Likelihood	- 72.4376	**Akaike Crit.**	141.44328
Schwarz Crit.	145.6734	**Hanna-qui**	136.3428

4.1 Regression of ROA

The result of table 1 shows that the impact of board size (BS) on ROA is significant (0.0348) 0.12143 which is positive and indicate if one unit change in B.S it will bring 0.12143 change on ROA (Mollah, Al Faoque and Kaim, 2012). The non executive board also have positive impact on ROA which is 0.16334 (0.0342). CEO duality have 0.09578 (0.0143) impact on return on assets, and Board meeting 0.15836 (0.0217). The value of R-square is 0.03 which indicate that ROA variable explain 3% of all independent variable. The F-statist value is 5.32472 which are greater than F tabular value, so we can declare that adopted model is fit for this research. This research used t value for analyze coefficients of the vaiables. The t-value in table 1 is 2.5271, 2.4262, 2.7259 and 2.2762 which is greater than its tabular value which means they have positive relation with ROA.

Table 2 Regression of ROE

Variables	Coefficient	Standard Error	T.Ratio	P.Value
C	-O.428322	O.2372	-2.3571	O.O212 **
B.S	O.O72371	O.O27436	2.6574	O.O163 **
N.E.B	O.30647	O.11432	2.1276	O.O321 **
CEO	O.31238	O.14823	2.3672	O.O267 **
B.M	O.20134	O.O9923	2.8364	O.O213 **
Mean of Dep. Var.	O.O9873	**S.D of Dep. Var.**	O.386631	
S.S. Resid.	1.4763	**S.E. of Regression**	O.261831	
R-Suq.	O.1486	**Adjusted R.Squ.**	O.O7894	
F-Statistic	5.7638	**P. Value**	O.O2174	
Log. Likelihood	12.2364	**Akaike Crit.**	-16.4287	
Schwarz Crit.	-11.26743	**Hanna-qui**	-13.3476	

4.2 Regression of ROE

The table 2 shows the impact of Board size on ROE which is positive and significant 0.072371 (0.0163), the Non executive Directors also have positive relationship with ROE which is 0.3647 (0.0321) significant, CEO duality also gives positive and significant impact 0.31238 (0.0267) and board meeting shows positive relationship with ROE which gives value as 0.20134 (0.0217). if unity change in B.S, N.E.D, CEO and B.M the ROE will change as 0.072371, 0.3647, 0.31238 and 0.20134.The R-square is 0.14 which shows that the ROE explain 14% if all independent variables. In the table 2 the value of t ratio is (2.6574, 2.1276, 2.3672 and 2.8364) which is also greater than it tabular value, it show independent variable have positive relationship with ROE.

Table 3 Regression of Tobin's Q

Variables	Coefficient	Standard Error	T.Ratio	P.Value
C	-1.6346	O.9342	-2.3164	O.O142 **
B.S	O.2134	O.07634	2.4657	O.O274 **
N.E.B	O.1921	O.3867	2.7568	O.O124 **
CEO	O.2319	O.O989	2.1272	O.O243 **
B.M	O.1673	O.23426	2.4129	O.O311 **

Mean of Dep. Var.	O.2134	**S.D of Dep. Var.**	1.2432
S.S. Resid.	32.4655	**S.E. of Regression**	1.0986
R-Suq.	O.O237	**Adjusted R.Squ.**	-O.1211
F-Statistic	5.2314	**P. Value**	O.O3897
Log. Likelihood	-60.4387	**Akaike Crit.**	127.967
Schwarz Crit.	134.432	**Hanna-qui**	127.8762

4.1 Regression of Tobin's Q

In the table 3 the effect of board size, Non executive directors, CEO duality and Board meeting on Tobin's Q have positive and significant as follows 0.2134 (0.0274), 0.1921 (0.0124), 0.2319 (0.239) and 0.1673 (0.0311) respectively. The value of R- square is 0.02 which mean the dependent variable Tobin's Q explain 2% of independent variables.

5 Conclusions

The CG is very significant factor which is control the firm financial performance as the ownership and management are separate entities. In the area of CG every one put their major attention in last decade because a lot of management frauds happen like Lemmon brothers, Enron and WorldCom. To analyze the relation between corporate governance and financial performance of textile sector of Pakistan is the aim of this study. The result of the study shows that corporate governance effect valuation and operating profitability. The variable which are used to measure CG effect on firm financial performance are BS, CEO, BM and NED while Tobin's Q, ROE and ROA were used as proxy variable of corporate performance. All the independent variables i.e. BS, CEO, BM and NED have positive effect on firm performance. So this study tells the textile sector firms can improve their performance by strongly implement corporate governance.

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