Relationship between Corporate Governance Indicators and Firm Performance in case of Karachi Stock Exchange

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Corporate governance

- A corporate governance system is comprised of a wide range of practices and institutions, from accounting standards and laws concerning financial disclosure, to executive compensation, to size and composition of corporate boards.
- In its broadest sense, corporate governance refers to a complementary set of legal, economic, and social institutions that protect the interests of a corporation's owners.
- According to La Porta et al.(2000) ‘corporate governance is to a certain extent a set of mechanisms through which outside investors protect themselves against expropriation by the insiders’. They define the insiders as both managers and controlling shareholders.

Corporate Governance in Pakistan

- The code of corporate governance introduced by SECP in early 2002 is the major step in corporate governance reforms in Pakistan. The code includes many recommendations in line with international good practice. The major areas of enforcement include reforms of board of directors in order to make it accountable to all shareholders and better disclosure including improved internal and external audits for listed companies. However, the code’s limited provisions on director’s independence remain voluntary and provide no guidance on internal controls, risk management and board compensation policies.

Objective

- In this study, we examine whether variation in firm-specific governance is associated with differences in firm value in case of Pakistani stock market. To examine the relationship between corporate governance and firm performance, a corporate governance index (CGI) is developed as a proxy for firm-level governance quality with a variety of different governance practices adopted by listed firms. Tobin’s Q is used as valuation measure.

Data and Sample

- The sample of 50 firms is selected: which are representative of all non-financial sectors and active in their sector, comprises more than 80% of market capitalization and listed on KSE. The data is obtained from the annual reports of these firms for the year 2003, 2004 and 2005. The Tobin Q, CGI and other control variables are constructed and average is taken out for these three years.

Construction of CGI

- In order to construct corporate governance index for the firms listed on KSE, a broad, multifactor corporate governance rating is done which is based on the data obtained from the annual reports of the firms submitted to SECP.
- The index construction is as follows: for every firm, there are 22 governance proxies or indicators are selected, these indicators are categorized into three main themes.
- The three categories or sub-indices consist of indicators: eight factors for the Board, seven for ownership and shareholdings and seven for transparency, disclosure and audit.

Weighting Criteria

- The weighting is based on subjective judgments. The assigned priorities amongst and within each category is guided by empirical literature and financial experts in this area.
- The maximum score is 100, then, a score of 100 is assigned if factor is observed, 80 if largely observed, 50 for partially observed and 0 if it is not observed
- The average is taken out and we arrive at the rating of one sub-index. By taking the average of three sub-indices we obtain CGI for a particular firm.

Sub-Index 1: The board of directors

- Board Size (number of directors)
- Board Composition (Clear cut job description of all board members, composition of board of directors).
- Chairman CEO separation (if not any lead director).
- Outside directors available to board (independent directors, nominee directors)
- Board attendance (board meetings).
- Meetings of outside director attendance.
- Existence of the position of CFO.
- Directors representing minority shareholders.

Sub-Index:2 Ownership and Shareholdings

- Presence of outside block holder (more than 10 % shareholdings).
- Do the CEO owns shares.
- Directors ownership (block ownership) other than CEO and Chairman.
- Chairman or CEO are Block Holder (10%).
- Concentration of ownership (Top five).
- Dividend Policy
- Staff benefits other than wages and salaries

Sub-Index 3: Transparency, Disclosures and auditing

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- Does the company have full disclosure of corporate governance practices
- Does the company disclose how much it paid to its auditor for consulting and other work
- Does the company disclose full biographies of its board members
- Disclosure of internal audit committee
- Disclosure of board directors and executive staff members' remuneration
- Disclosure in the company's annual report) of share ownership according to the requirement of Code.
- Information of the executive management staff members ownership (employees ownership)

Methodology

- The empirical specification of the model is

$$Q_i = a + bCGI_i + cX_i + \varepsilon_i$$

- where Q_i is the firm performance measure, the CGI_i is a vector of governance index and X_i is a vector of firm characteristics for these three years.

Estimation Technique

- In exploring that good corporate governance causes higher firm valuation, an important issue is endogenity. The firms with higher market value would be more likely to choose better governance structure because of two reasons. First, firm’s insiders believe that better governance structure will further raise firm value. Second, firms adopt good governance to signal that insider behave well.

Set of Control Variables

- Along with three governance indices, board, shareholdings and disclosure, a set of control variables which include size (ln assets), leverage (debt/total asset ratio) and growth (average sale growth) are used in estimation. Firm size and growth control for potential advantages of scale and scope, market power and market opportunities. The leverage controls for different risk characteristics of firm

Set of Instruments

- This endogeinety problem in estimation is resolved by applying Generalized Method of Moments as estimation technique.
- The instruments: Age is natural logarithm of number of years of listing at KSE, Profit is logarithm of net income/total assets , DFOR is dummy variable which is one if the firm has foreign investment and zero otherwise, DN is a dummy variable if the firms has block holder zero otherwise, DKSE, is a dummy variable if the firm is included in KSE 100 index and zero otherwise.

Table 2 Evidence on Performance and Corporate Governance

CGI	0.08 (2.17)	0.02 (1.59)	0.02 (1.32)	0.06 (1.55)
Size		0.05 (3.61)	0.03 (2.02)	0.02 (2.66)
Growth			0.65 (0.64)	0.10 (0.20)
Leverage				0.86 (1.47)
Intercept	-3.30 (-1.71)	-1.60 (-1.83)	-1.32 (-1.36)	2.79 (-1.02)
R^2	0.10	0.14	0.15	0.29

Empirical Evidence

- There is positive and significant relationship between CGI and Tobin’s Q supporting our hypothesis that corporate governance affects firm value. The CGI remains positive but significance level reduces with adding more explanatory variables. This shows that the inclusion of omitted variables have improved the specification of the model. Therefore we find some evidence that corporate governance effects firm’s performance. This result suggests that a certain level of governance regulations in emerging market like Pakistan has not make the overall level of governance up to a point that governance remain important for investor. The inter-firm differences are matters to investor in valuing firm.

Table 3 Evidence on Performance and Corporate Governance Sub-Indices

	1	2	3	4	5
CGI	0.06 (1.55)				
Board		0.02 (2.06)			0.01 (1.13)
Share			0.01 (1.41)		0.01 (1.67)
Disc				0.01 (0.44)	0.02 (0.51)
Size	0.02 (2.66)	0.04 (1.38)	0.02(1.40)	0.02 (0.91)	0.001 (0.05)
Lev	0.86 (1.47)	4.56 (2.02)	3.03(1.83)	2.21 (1.84)	0.92 (2.72)
C	-2.79 (-1.02)	-2.13 (-1.50)	-0.77(-0.81)	-0.80 (-0.38)	1.65 (0.94)
R^2	0.29	0.15	0.18	0.29	0.35

Empirical Findings

- The results based on sub-indices reveal importance of Board composition, ownership and shareholdings with firm performance. However investors are not willing to pay a premium for companies that are engaged in open and full disclosure.

Empirical Evidence

- The results of firm performance including control variables are also consistent with prior research. The coefficient of size is positive and significant in most of the cases. This shows that the listed firms that are likely to grow faster usually have more intangible assets and they adopt better corporate governance practices. The coefficient of growth is significant and positive because higher growth opportunities are associated with higher firm valuation. The coefficient of leverage is positive and significant, is consistent with the prediction of standard theory of capital structure which says that higher leverage increase firm’s value due to the interest tax-shield

Conclusion

- Our results show that Corporate Governance Code potentially improves the governance and decision making process of firms listed at KSE. Large shareholders still have a tight grip of companies. However we point out that adequate firm-level governance standards can not replace the solidity of the firm. The low production and bad management practices can not be covered with transparent disclosures and transparency standards.