

Board Characteristics and Firms' Financial Performance in Eras of Corporate Governance Codes 2012 in Manufacturing Sector of Pakistan

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Abstract

This paper aims to examine the relationship between corporate governance practices and firm performance in Pakistan, as a result of the adoption of Corporate Governance Codes 2012. Fifty firms are selected randomly from manufacturing sector of Cement, Textile and Sugar industries. Data for CG Codes is taken from 2012 to 2016. The effectiveness of the board of directors is analyzed through the use of different variables: CEO duality, CEO compensation, CEO tenure, and board meetings. The financial performance is measured by return on assets (ROA). Literature in relation to corporate governance practices and firm performance reported mixed results. The conceptual framework underpinning this study described how the board structure and corporate reporting practices of firms in Pakistani manufacturing sector effect firm performance. In this framework Separate leadership refers to the separation of the position of chairman and CEO, CEO tenure means the time of CEO office holding, CEO compensation refers to the benefits and rewards of the CEO and board meetings refers to the frequency of board meetings in a year. Firm age and firm size are taken as control variables.

Keywords: Corporate Governance (CG); Return on Asset (ROA); Financial Performance

Introduction

The debates over corporate governance have been increased among public and other academicians across the world. The corporate boards have got importance and attention since the failure and demise of many reputed corporations, and their way of governing the organizations have been questioned. In this regards firms and regulators have started thinking on how to formulate the corporate governance mechanism to foster better results. A lot of significant changes have been made in boards' structure, regulations and management pattern to positively contribute and ensure best structure of corporate governance. It comprises of the board exercises of the undertaking and its associations

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with the investors, with the administrators and with other true partners. Corporate administration is well-thought-out to have notable inferences for the development projections of an economy. The recent financial downtown and crisis has found a lot of shortcomings in corporate governance mechanisms, and the frame work. Businesses across the world like to have well investment and thereby having more growth and development. Before investing in a particular business, investors prefer a secure investment and like to invest in a firm which is financial secure and sound in order to have a long term returns (Al-Manaseer & Sartawi, 2012). Therefore, it is assumed that if a company shows not a very sound position then attracting investors become difficult.

In a very dynamic business environment, the practices of boards have now become very important as it fosters the smooth functioning of firms. McNulty and Stiles (2005) also predicted that board helps to monitor the management to foster better results. Kemp (2006) also determined that board provides the framework of strategic directions to the firms. Bart and Bontis (2003) also confirmed that board can bring the organizational change and prosper the process compatible to the mission. Board helps to protect the interest of the shareholders in a kind of competitive business environment by fostering accountability and transparency for the reason to have improved performance (Ingley and Vander Walt, 2001). The similar findings about board were documented by many previous researchers.

Pakistani firms are in struggle to achieve better ranks in world markets by adopting the rules and regulations of CG. As these are the rules through which organizations are managed. In Pakistan many scholars have found link between CG and firm performance (Azeem, Hassan, and Kouser, 2013a); Achchuthan & Rajendran, 2013); (Al-Matar, Al-Swidi and Fadzil, 2014) (Jaradat, 2015) but still little evidence have found in context of board of Directors characteristics and firm financial performance (Javid & Iqbal, 2010). Furthermore, in a developing country like Pakistan a very few studies have investigated the relationship between board characteristics and firm performance. Very rarely this area has been touched by the researchers specially the CEO tenure and board meetings.

Research Questions of the Study

1. Does there exist any relationship between board characteristics and financial performance in Pakistani manufacturing sector firms and what different characteristics do they possess?

2. Do board characteristics i.e. CEO tenure, CEO duality, CEO compensation and Board meeting affect the financial performance of manufacturing sector firms in Pakistan?

Objectives of the Study

1. To examine the relationship between board characteristics and financial performance of firms during the period of CG codes 2012 in manufacturing sector firms listed on Pakistan Stock Exchange.
2. To examine the relationship between board characteristics i.e. CEO compensation, CEO tenure, Board meetings and CEO duality with financial performance.

Literature

Corporate governance really guarantees the true performance of a firm (Meador, and Kumar, 2011). Barbu and Bocean (2007) argued that CG safeguards the rights of the stakeholders' stockholders and investors. Javed, Iqbal, and Hasan (2006) argued from their research in which they analyzed non-financial firms having great market capitalization and found that in Pakistan the CG practices are very vital for the firm performance. They found that tight control helps in improving the firm performance. As the board is not only for preventing the sort of negative practices in management which make rooms for corporate distress and failure but also seek opportunities which help to uplift the corporate financial performance of the firm.

Board structure that is very important in context of minimizing agency problem and enhancing firm performance is CEO duality. The CEO duality is a vital factor of corporate governance that might enhance or verse the firm performance. There are contradictory views of the researchers about the effect of CEO duality on the financial performance of a firm. The agency theory strongly support the first notion, that is to split the CEO and chairmanship in two positions to increase the independence of board from management, better monitoring and control and overseeing that ultimately accelerate the financial performance of firm (J.-K. Kang and Shivdasani, 1995). However from the perspective of stewardship theory, as oppose to agency theory the two position i.e. CEO and chairman should be concentrated and given to one person, therefore according to stewardship theory the CEO and chairman should be the same person and should not be split out Reyna, Vázquez, and Valdés (2012); Davis and Greve (1997). These studies against the findings of Fama and Jensen (1983) argued that CEO duality adversely affect the financial performance of a firm. While in similar studies, Kolk and Van Tulder (2010) found that CEO duality does not appear to have any impact either positive nor negative.

Board meetings means to the frequency of gatherings the board has made in a year. Steady to past investigations there is sure relationship between board gatherings and firm performance. Other school of thought

considers that quantities of executive gatherings do not help with upgrading performance or it is conversely related with the performance of firm (Rebeiz and Salameh, 2006). In like manner Vafeas (1999) reasoned that, number of board meetings in a year is negatively associated with firm performance. In Pakistan Dar et al. (2011) found that, frequencies of executive meeting have positive association with firm performance in terms of (ROA and ROE). Javed and Iqbal (2007) found that, board should meet at least four times.

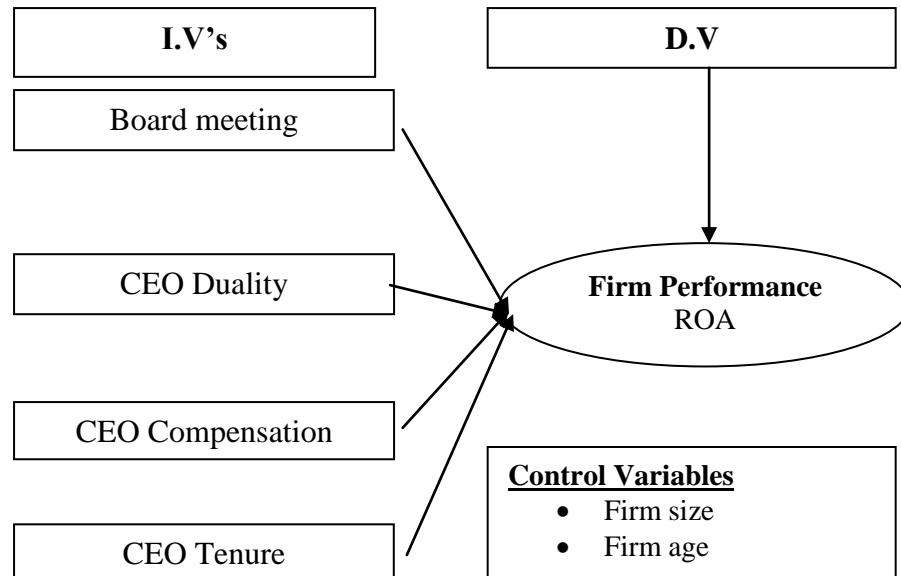
CEO tenure is considered as very vital to look into in the field of association and performance leadership (Herly). Also, CEO tenure has frequently been identified with the administration quality and power (Herly, 2011). Only a few studies have examined the relationship between CEO tenure and firm performance. These examinations directed in developed nations detailed a positive relationship between CEO tenure and financial performance (Lazarides, Drimpetas, and Koufopoulos, 2008). Few examinations revealed negative outcomes in developed nations like (Foote, Gaffney, and Evans, 2010).

Executive remuneration is a point that has been under talks in the field of CG for the last two decades. Pay has its most direct impact on the fascination and retention of CEOs.

Theoretical Framework

In light of present literature, this exploration examines CG practices and firm performance in a specific business condition. This section introduces a theoretical framework suited to the context of Pakistan, based on agency, stewardship and stakeholder theories to address the relationships between corporate governance practices and firm performance in Pakistan.

The following theoretical framework has been developed on the basis of the review of literature.



Methodology

This study is causal and co relational in nature and falls in the domain of applied research. Moreover it is quantitative research. This research is co relational and exploratory. The correlation among the variables and effect of the independent variables on dependent variables has been investigated in this study. The population of the study is manufacturing sector firms listed on Pakistan Stock Exchange (PSX). The study has used random sampling techniques to select fifty firms randomly selected from Sugar, Textiles and Cement industries of Pakistan. The more the sample size the better and significance the results (Sekaran & Bougie, 2003). The Data about board of director's characteristics and firm financial performance of these fifty manufacturing firms of Pakistan for the period of 2012 to 2016 has been collected from the annual reports and Pakistan Stock Exchange sites. Therefore, panel data period for this study is from 2012 to 2016 on yearly basis has been analyzed through correlation and regression. The fixed effect and random effect models has been used in the analysis of this study.

Research hypothesis

H1: There is significant relationship between CEO duality and firm financial performance

H2: There is significant relationship between CEO compensation and firm financial performance

H3: There is significant relationship between board meetings and firm financial performance

H4: There is significant relationship between CEO tenure and firm financial performance

H5: There is significant relationship between firm size and firmage with firm financial performance

The following multiple regression model has been used.

$$Y_{it} = \beta_0 + \beta_1 X_{1it} + \beta_2 X_{2it} + \beta_3 X_{3it} + \beta_4 X_{4it}$$

Where Y is (dependent variable)

β_0 = constant

β = regression co-efficient which may be positively or negatively affecting dependent variable.

μ_{it} = error of the firm i in time t

Following are the proposed multiple regression models.

$$ROA_{it} = \beta_0 + \beta_1(BM_{it}) + \beta_2(CEOT_{it}) + \beta_3(CEOC_{it}) + \beta_4(CEOD_{it}) +$$

$\mu_{it} \dots$

ROA= Return on Assets (dependent variable)

BM = Board Meeting (Independent variable)

CEOT = CEO Tenure (Independent variable)

CEOC = CEO Compensation (Independent variable)

CEOD= CEO duality (Independent variable)

Firm age = Firm age (Control variable)

Firm size = Firm Size (Control variable)

μ_{it} = error of the firm i in time t

Firm size

Firm size is very vital to be control for the analysis. The Natural logarithm of book value of total assets will be taken to operationally define this variable.

Firm age

It has been calculated as the Natural logarithm of years since establishment.

Data analysis

The data analysis is comprised of the following

Diagnostic Statistics

The following diagnostic statistics tests have been performed to check the validity and suitability of the panel data.

Heteroscedasticity Test

To check the hetero in data Cook –Weisberg test has been performed to check whether equal variance assumed in the data. The reported value obtained is 0.210, which is insignificant at 5% level of probability. This

value shows that the data is homoscedastic and no heteroscedasticity problem.

Model Significance Test

To know that which model is appropriate for the analysis of the data Language Multiplier Test has been performed. The observed value is 0.0456, which is significant at 5% probability level that signifies that Fixed Effect Random Effect Model is an appropriate model for this study.

Correlation analysis

Table 1: Correlation analyses for CG Codes 2012 Period 2012-2016 when ROA is used as dependent variable

	CEOC BM		CEOT	AgeSize	ROA	CEOD
ROA	1.00					
CEOD	-0.03	1.00				
CEOC	0.14	0.07	1.00			
BM	0.09	0.16	0.03	1.00		
CT	-0.05	0.38	0.31	0.08	1.00	
Age	0.07	0.11	0.21	0.32	0.07	1.00
Size	0.05	0.42	0.18	0.19	0.15	0.15

Table 1 shows the correlation analysis for the set of independent variables and dependent variable ROA for the data period from 2012 to 2016 reporting the data of CG codes 2012. The results showing that ROA and set of independent variables i-e As per Cohen (1988) correlation having $r=0.1$ is significant correlation and he suggested three different slabs of correlation significance level. The results showing that CEO compensation is significantly correlated with the firm's ROA Whereas CEO duality and CEO tenure have been found showing negative insignificant correlation with the financial proxy ROA. Board meetings also predicting and shows insignificant positive correlation with ROA. However both control variables i-e firm age and firm size shows positive insignificant correlation with ROA. The correlation results are in line with many previous studies, which predicts somehow similar results as this study reported (Dar et.al, 2011, Lodhi, 2013; Ahmad & Naseem, 2014)

Hausman test

Chi 2(13) = 7.67

Prob > chi 2 = 0.0954

The test value 7.67 showing insignificant probability value of 0.0954 which documents that there is random effect in the data, tabulated probability value is insignificant at 5% probability level, so random effect model is an appropriate model for data analysis of CG Codes 2012, covering period of 2012 to 2016.

Random Effect Model

Table 2: Regression analysis for the data period of CG 2012, when ROA is used as dependent variable

Variables	Co-efficient	Standard error	T-value	P-value
CEOD	-0.068	0.048	-1.404	0.098
CEOC	0.215	0.080	2.672	0.006
BM	0.083	0.061	1.351	0.098
CEOT	-0.047	0.035	-1.321	0.143
Age	0.046	0.041	1.101	0.214
Size	0.033	0.028	1.151	0.133
F-value	28.38			
R-square	0.43			

Table 2 shows the results of random effect model, when ROA is used as dependent variable for the period 2012 to 2016. The results showing a negative effect of CEO duality on the financial performance, which suggest that duality of the CEO adversely, affect the financial performance of manufacturing sector firms in Pakistan. Many other researchers have acknowledged the finding (J.S Lodhi, 2013; Ahmad & Naseem, 2014). The results also evidenced a positive significant effect of CEO compensation as its p-value is significant at 5% probability level, which determines that compensation of CEO positively associated with the financial performance. The results are consistent and in line with the findings of previous researchers (Ahmad & Naseem, 2014). The study evidenced insignificant positive effects of board meeting on the financial performance. Similar association and positive effect of board meeting was found by many researchers (Dar et.al, 2011, Ward, 1991). The results also demonstrate that CEO tenure has negative effect on the financial performance, which indicates that as the CEO tenure goes longer than it effect inversely the financial performance. Similar results were obtained by researchers previously (Herly and Sisnuhadi, 2011). Many studies conducted in past also documented variables i-e firm age and firm size showing positive insignificant effect on the firm's ROA. The F-value of the overall model is significant at 5% probability level, suggesting the fitness and significance of the model. The R-square shows the changes brought in by the independent variables in dependent variable. The R^2 0.43 means that almost 43% changes are due to the set of independent variables.

Conclusions

This study aimed to investigate the relationship of board characteristics with the financial performance. The study predicted results on the basis

of fixed effect random effect models. The results demonstrated positive significant co-efficient for CEO compensation while negative relationship found for CEO tenure and CEO duality with the financial performance proxies i.e. ROA of the manufacturing sector firms in Pakistan. These results reported in this study are in line with many previous researchers, who also confirmed similar results (J.S Lodhi, 2013; Ahmad and Naseem, 2014). This study also evidenced positive insignificant relationship of the frequency of board meetings and financial performance. The results confirm the findings of previous studies, which also argued that that board meeting is insignificantly related with the financial performance. Firm's age and size found insignificantly positive effect on financial performance of manufacturing sector firms in Pakistan.

The results have certain managerial implications for the policy makers and top management of these firms in particular and for all listed firms in Pakistan in general. The results are also worthy for the investors and other researchers perusing similar studies. This study can be extended in various ways. Similar study if conducted can comparatively analyze the same firms in the two corporate governance codes i.e. in the codes of 2002 and 2012. Similar studies can also apply the contribution of moderating and mediating variables very relevant to the context of these variables..

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