The Impact of Corporate Governance on the Performance of the Firms: A Study of Pakistani Pharmaceutical Industry

Wasif Ammar and Saqib Ilyas

***Abstract*– This study is initiated on "corporate governance and performance of the firms" with the samples of 8 pharmaceutical companies, using the data from their annual reports- from a time period of year 2008 – 2012. Board committee, board meeting and board size including executive directors and non-executive directors were used as the determinants of corporate governance whereas return on assets (ROA) and return on equity (ROE) were used as the measures of firm performance. The study found that determinants of corporate governance are not correlated to the performance measures of the organization. Regression model showed that corporate governance do not affect companies' return on assets (ROA) and return on equity (ROE). Further recommendations are also put forwarded in the research.**

***Keywords*– Corporate Governance, Firm Performance, Board Size, Board Committee and Board Meeting**

I. INTRODUCTION

A growing number of empirical studies have examined the effectiveness and structure of corporate governance on the company's results and there has been much discussion recently about whether the corporate governance makes a difference in the bottom line, which is does good corporate governance improve business performance?

In Pakistan, the first code of corporate governance was completed and issued by SECP in March 2002. Then it was later included in all listed companies on three stock exchanges in Pakistan. In 2004, SECP took the first step to establish the Pakistan Institute of Corporate Governance in Public-Private Partnerships.

Corporate governance is the set of policies, practices, processes, laws and institutions affecting the way a company or corporation administered, directed or controlled. Corporate governance on the one hand, to establish a system to entrust the officers and directors with responsibility in relation to driving business issues and on the other hand, it is concerned with the responsibilities of the officers and directors.

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Good corporate governance contributes economic development. Past 20 years have seen an increasing intensity of research on the topic of corporate governance. According to Chuanrommanee and Swierczek (2007), corporate governance practices in financial institutions in ASIAN countries are consistent with international practice. Companies have weaker governance structures facing more agency problems and managers of the company have more private benefits, due to weak governance structures (Core et al., 1999).

Corporate governance provides the mechanism by which the problems of corporate stakeholders, including management, creditors, employees, consumers, citizens and shareholders are framed and solved. Corporate governance also includes the relationships between the many parties that are based on internal stakeholders and external stakeholders. Proper corporate governance is considered absolutely necessary for the establishment of a competitive market. Corporate governance issues strengthen and stabilize good capital markets and protect investors. They help companies to improve their performance and attract investment. Corporate governance enables companies to achieve their corporate goals and to protect the rights of shareholders.

This paper, "The impact of Corporate Governance on performance of firms: A study of Pakistani Pharmaceutical Industry" is initiated on corporate governance and corporate performance. Board committees, board size and board including directors and non-executive directors, will be used as the key determinants of corporate governance, while return on assets (ROA) and return on equity (ROE) will be used as measures of corporate performance.

Corporate governance has focused on the most important-agent problems caused by widespread ownership of the modern corporation (Berle and Means, 1932). Corporate governance has called a collective group of people united as one body with authority to control, monitor and control an organization (Ruin, 2001).

A) Objectives of the Study

- Identify the relationship between corporate governance and corporate performance
- Identify the impact of corporate governance on corporate performance
- Propose relevant industry to adopt good corporate governance practices at performance

B) Problem Statement

This study was carried out to check out whether the corporate governance impacts corporate performance or not?

This research is for the pharmaceutical industry of Pakistan, the companies registered in KSE (Karachi Stock Exchange) and the data will be taken from the annual reports from each company from 2008 to 2012.

KSE (Karachi Stock Exchange) showed eight pharmaceutical companies that are registered as of 2014. Each of these will be selected for this study. For the purpose of the empirical analysis we will use reliability analysis for the data and then a descriptive analysis, correlation and regression techniques.

II. LITERATURE REVIEW

Corporate governance is the establishment of processes, structures and mechanisms to ensure that the company is being managed and directed in a way that increases the liability of managers and improvement of organizational performance.

Lipton and Lorsch (1992) and Jensen (1993) argued that corporate performance is improved if the board size is limited because the benefits of larger boards increased control offset by decision-making and poorer communications in larger groups.

(Deakin and Hughes, 1997): Corporate governance is about the relationship between society's perception of the extent of corporate accountability and internal mechanisms of control of the company.

(Mayer, 1997): Corporate Governance explains ways to ensure that firms are run for the benefit of investors and it explains different ways to the interests of investors and executives in line.

(Shleifer and Vishny, 1997; John and Senbet, 1998): Number of studies has examined the relationship between corporate governance and company performance that shows how good management practices have increased the economic value at lower systematic risk and high performance of the company.

La Porta et al., (1999) argued that when the legal environment is stronger, an investor’s protection tends to be larger, and thus his willingness to invest tends to increase. They found strong positive relationship between corporate governance and company performance.

Rhoades et al., (2001): Conducted a meta-analysis of 22 samples and found a significant but weak relationship between governance structure and corporate performance. They found that firms with a separated structure has higher accounting rate of return compared to firms with CEO duality.

Mitton (2001): The empirical study took samples of 398 companies, including Korean, Indonesian, Malay, Philippines and Thailand; found that the differences of the level of variables were related to corporate governance have a strong impact on corporate performance during the East Asian crisis in 1997 and 1998. The results suggest that companies that had indicators of higher quality disclosure, higher outside ownership concentration had improved price performance and they were focused in instead diversified.

Coles et al., (2001): Much of the academic work in the area of corporate governance has focused on how to design governance mechanisms that will motivate managers to make choices for companies that will improve performance. Coles classified steering mechanisms into two categories, namely, CEO incentive alignment mechanisms (including the CEO compensation and ownership structure) and organizational monitoring mechanisms (including management structure and board structure).

(Agarwal et al., 1996, quoted by Kakabadse et al, 2001): A survey conducted by Institutional Investor Inc. in connection with McKinsey and Company founded that investors sought a value strategy, investing in undervalued or stable companies were willing to pay for good governance while investors pursuing a growth strategy not worry about corporate governance.

Judge et al., (2003): In Russia, he distributed questionnaires to 116 Russian managers and analyzed the relationship between board structure and corporate performance. Since 1996, the Russian Federal law prohibits CEO duality. Judge et al. argued that the president cans still "informal" affect BOD and affects company performance. They concluded that there was a strong negative relationship between "informal" CEO duality and the performance of Russia, although the relationship between CEO duality and the performance was unclear in the developed economies.

Klapper and Love (2004): On the other hand, took advantage of governance rankings provided by Credit Lyonnais Securities Asia (CLSA) to compare the performance (ROA and Tobin Q) of 374 companies across 14 emerging markets. Their results showed that the improved operating results and the market valuation are highly correlated with better corporate governance.

Brown and Caylor (2004) analyzed US companies with 51 factors, eight subcategories of 2327 companies based on data sets of Institutional Shareholders Services (ISS). Their results showed that better governed firms were more valuable, relatively more profitable and pay more money for their shareholders.

In Asia, Chen et al., (2005) analyzed 412 listed companies in Hong Kong from 1995 to 1998 to examine the performance, value and dividends in family-controlled businesses affected corporate governance mechanisms (CEO duality, the composition of the BOD, Audit Committee). They measured the performance using three different variables - ROE, ROA and market to book ratio. Their results showed that there was a negative correlation between performance (the market to book ratio) and CEO of duality. The relationship was significant even after controlling for firm and industry fixed effects. They concluded that CEO duality was associated with lower firm value i.e., companies with combined structure had a lower performance. Roberts et al., (2005) suggest that active participation by an independent board provides independent ideas to the team. And can be helpful in improving the functioning of the organization and the board.

Kang and Zardkoohi (2005) concluded regarding the study of the relationship between the chairman duality/CEO and other measures that the results were complicated. They suggested that it could lead to a positive development if such a duality exists as a reward, but if the reason was to increase the President's power than it can have a negative effect on the performance of the company.

(Krivogorsky, 2006): It has been argued that 'the empirical and theoretical literature on corporate governance considers the relationship between corporate performance and ownership structure or boards mostly only use two of these variables at a time'.

Adjaoud et al., (2007): Used 2002 rankings to examine the relationship between corporate performance and governance score. They found that the relationship between scores and measures of value creation (e.g., market value added and economic value added) were generally significantly while the relationship between accounting-based measures of performance (such as ROI, ROE, EPS, and market to book) and the score was generally not significant.

Amran and Ahmed (2009): Checked the ratio of corporate governance and corporate performance in Malaysia. They concluded that the management structure and board size has a significant impact on the performance of non-family and family-owned businesses.

Gulzar and Wang (2010): Checked the relationship between corporate governance and family-owned businesses in Pakistan. They suggested that some other well-managed organization does not differ from family-owned business structure.

Cherimoya (2010) examined the relationship between corporate governance practices and solid performances. Study confirms a positive relationship between board composition, solid performance, management practices and a separate cable. Further, indicated that the company implemented corporate governance policies have led to high price performance and higher profitability.

Yasser (2011) examined the effects of corporate governance on corporate performance in Pakistan industry. He concluded that the CEO Duality chairman and board size has a significant impact on company performance.

III. METHODOLOGY

Data Collection: The secondary data is collected from Annual reports of the companies. The data representing the period of 2008 to 2012 are extracted from the company's Annual reports for the analysis.

Sample Size: The official list of companies in the Karachi stock exchange (KSE) contains 8 companies as of 2014. All those listed companies are selected for the present study.

Conceptual Framework: Fig. 1 presents the conceptual framework of our proposed system.

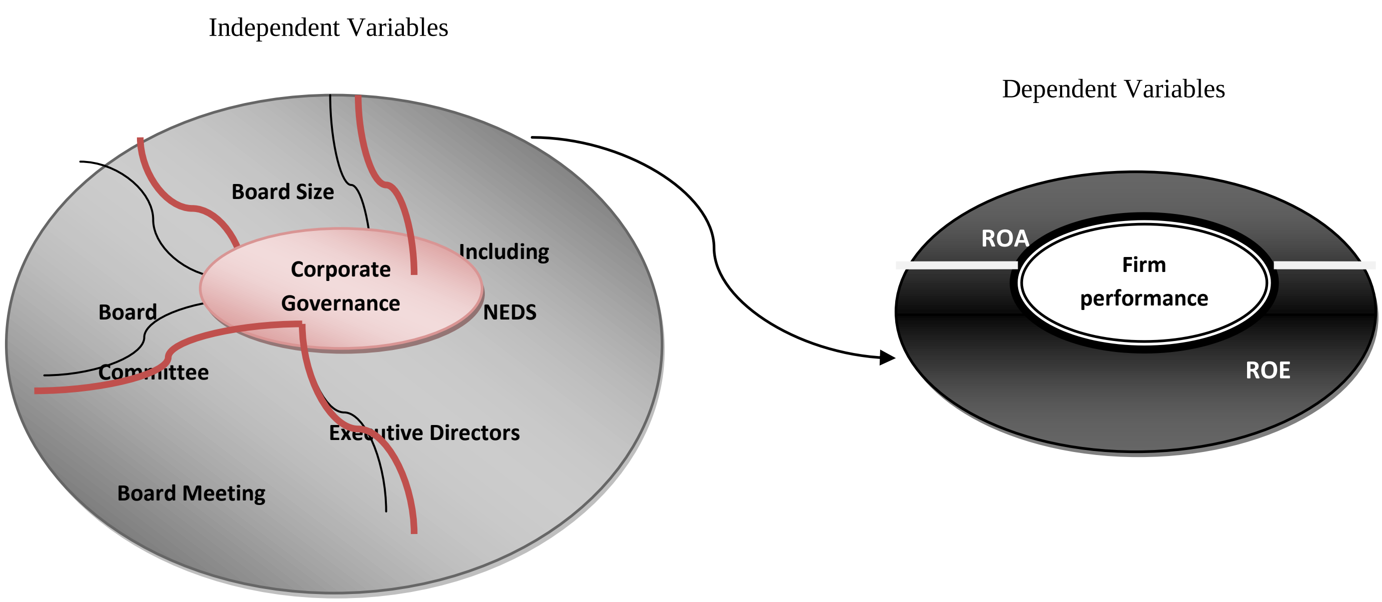

Fig. 1: Conceptual framework

Instrument: For the purpose of empirical analysis we are using correlation, regression techniques and a descriptive analysis as the statistical tests. A descriptive analysis of the data is conducted to obtain sample characteristics. The regression analysis is performed on the dependent variables, ROA and ROE to test the relationship between firm performance and independent variables. The regression model is utilized to test the relationship between the firm performance determinants such as return on assets (ROA), and return on equity (ROE) and determinants of corporate governance such as board meeting (BM), board committee (BC) and board size (BOSZ), including executive directors (ED) and non-executive directors (NED), are as follows:

$$ROA = \alpha o + \alpha 1Bc + \alpha 2Bm + \alpha 3Bosz$$

$$ROE = \alpha o + \alpha 1Bc + \alpha 2Bm + \alpha 3Bosz$$

Hypotheses:

The hypotheses formulated are:

Ho: Corporate governance and ROE are not significantly correlated

Ha: Corporate governance and ROE are significantly correlated

Ho1: Corporate governance and ROA are not significantly correlated

Ha1: Corporate governance and ROA are not significantly correlated

IV. RESULTS AND INTERPRETATIONS

To obtain sample characteristics a reliability analysis, descriptive analysis, correlation and regression test was carried out.

Table 1- Reliability analysis:

This table shows a Cronbach Alpha reliability test on data. Reliability test concludes whether the data is internally consistent or not. The value should be at least 0.4 for the validity of data and further application of tests on it. Our result shows the value to be 0.609 which means the data is 60.9% internally consistent and valid to be used for applying different statistical tests.

Table 2- Descriptive analysis:

The descriptive statistics in Table 2 for the independent variables indicate:

The return on equity in the selected companies on average is about 18% however it has been observed that some companies have a return on equity up to a maximum of 131.2% and down to minimum of -9%.

The return on assets in the selected companies on average is about 9% however it has been observed that some companies have a return on assets up to a maximum of 26% and down to a minimum of -6%.

The board committees in the selected companies on average are about 3 however it has been observed that some companies have up to a maximum of 5 committees and down to minimum of only 1 committee.

The board meetings in the selected companies on average are held 4 times per year however it has been observed that some companies have up to a maximum of 6 meetings per year too.

The board size of the selected companies on average contains 8 directors both executive and non executive however it has been observed that some companies have up to a maximum of 10 board members and down to a minimum of seven.

Table 3- Correlation:

Correlation analysis was carried out to find out the relationship between the measures of firm performance and determinants of corporate governance. The results of the correlation analysis in table 3 show that ROA and ROE have a positive or direct relation with each other while ROA has negative or indirect relation with Board committee, Board meeting and Board Size. It shows a positive or direct relation with executive directors but negative or indirect relation with non executive directors.

On the other hand ROE shows a negative or indirect relation with Board meeting and Board committee but a positive or direct relation with Board size, executive directors and non executive directors. Determinants of corporate governance such as board committee, board meetings, executive directors, non executive directors and board size are not significantly correlated with ROA and ROE as the measures of firm performance. It means companies are still not properly practicing corporate governance guidelines; therefore companies should pay an attention on the role of corporate governance measures.

Regression Analysis:

Regression analysis was performed to see the impact of corporate governance on firm performance. The results of this analysis are shown in Table 4 and Table 5.

Table 4 and Table 5 (Regression analysis of ROA and ROE):

Interpretation of model summaries' results

The three variables i.e., board size, board committee and board meeting in the model revealed the ability to predict performance. R^2 value of .043(table 4a) and .037(table 5a) which are in the models denote that 4.3% and 3.7% of the observed variability in performance can be explained by the differences in the independent variables namely board committee, board size and board meetings.

Remaining 95.7% and 96.3% of the variance in performance is related to any other variables which are not explained because they are not depicted in the model. R^2 values of 4.3% (table 4a) and 3.7% (table 5a) indicate that there may be number of variables which can have an impact on performance, which need to be studied and implemented. Precisely, this area is indicated as a scope for future research.

Interpretation of Coefficients' results

The results of regression analysis in table 4b and 5b show that the coefficient for all three variables such as Board size, Board committee and Board meetings are not significant. It can be interpreted that the companies should have regular meetings to discuss and monitor the activities of the firms and the board size including the executive and non executive directors should have an effective and complete role in controlling the opportunistic behaviour in management.

Further t values for all 3 variables of corporate governance are insignificant even at 5% confidence interval. It means that these variables are not contributing to the performance measures of ROA and ROE.

V. CONCLUSION

To conclude it can be stated that listed companies under the Karachi Stock Exchange (KSE) are practicing corporate governance system. The results of the study provide evidence that the corporate governance measures are not significantly correlated with ROE and ROA as the performance measures.

From hypotheses stated earlier we accept Ho and reject Ha. R^2 Value of 0.043 and 0.037 which are in the summary models deduce that 4.3%, and 3.7% of the observed variability in performance can be explained by the differences in the independent variables namely board committee, board size and board meeting.

Furthermore it can be stated that hypotheses Ho and Ho1 is accepted as corporate governance measures did not have any impact on performance measures ROE and ROA.

Limitations/Recommendations

The analysis examined whether there were correlations between elements of corporate governance and corporate performance among listed companies in Pakistan. Data for analysis were collected mainly from the company's annual reports.

The sample in this study consisted only eight companies, indicating the sample is relatively small. Larger sample size would contain more "power" and might have revealed the hypothesis to be significant.

The accounts of companies in the sample do not present much about the governance information required for the study. All this information should have been published in the annual report for the reference of the stakeholders; there is a mandatory requirement in Pakistan yet.

The study does not consider all aspects of corporate governance, which affects the performance of the company. When using the results of this research, these concepts limit to be taken into account.

It is clear that much remains to be done when it comes to understanding the role and impact of management structures in Pakistani companies. It is also important to recognize that an appropriate structure for a company may not be suitable. Greater flexibility in acceptable governance structures may therefore be necessary if the interests of shareholders shall be promoted. Therefore, further research essential is recommended.

It may be suggested that the Board should concentrate on its important role properly to manage the operations of businesses and they should also eagerly advise companies to have more independent directors within the benchmark for the number of directors. This would maintain an air of independence and a degree of discipline would be maintained by managing directors and employees.

It is better to have all the relevant committees such as the Nomination Committee, Remuneration Committee and an Audit Committee. This would keep to all the activities and mission of the firms monitored and controlled in an excellent manner.

The companies should have a regulated meeting schedule. Moreover, the decisions taken at the meetings are very important for business success. Companies can focus on the division of responsibility for their efficient operation.

An effective board is one that facilitates the effective discharge of the obligations under the law of Directors and adds value in a way that is appropriate for the particular company's circumstances.

The structure of the board should be in such a way that it:

- Can effectively review and challenge management performance.
- Exercise independent judgment and empowerment.
- Have a good understanding and can compete for addressing current and emerging issues in the business.
- Encouraging business performance.

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Table 1: Reliability Statistics

Cronbach's Alpha	N of Items
.609	7

Table 2: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std. Deviation	Variance	Skewness		Kurtosis	
	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Statistic	Std. Error	Statistic	Std. Error
Return on Equity (%)	40	-8.84	131.20	18.0405	20.54387	422.050	4.482	.374	24.509	.733
Return on Assets (%)	40	-5.98	26.03	9.3240	6.50423	42.305	.620	.374	.665	.733
Board Committee	40	1	5	2.95	1.037	1.074	-.332	.374	-.690	.733
Board Meeting	40	4	6	4.18	.446	.199	2.639	.374	6.869	.733
Board Size	40	7	10	8.08	.971	.943	.198	.374	-1.303	.733
Valid N (listwise)	40									

Table 3: Correlations

Correlations								
		Return on Assets (%)	Return on Equity (%)	Board Committee	Board Meeting	Board Size	Executive Directors	Non Executive Directors
Return on Assets (%)	Pearson Correlation	1	.732**	-.042	-.024	-.199	.159	-.287
	Sig. (2-tailed)		.000	.796	.884	.218	.328	.073
Return on Equity (%)	Pearson Correlation		1	-.128	-.089	.098	.068	.002
	Sig. (2-tailed)			.431	.585	.546	.675	.988
Board Committee	Pearson Correlation			1	-.147	.004	-.078	.077
	Sig. (2-tailed)				.366	.981	.631	.638
Board Meeting	Pearson Correlation				1	-.031	.422**	-.421**
	Sig. (2-tailed)					.849	.007	.007
Board Size	Pearson Correlation					1	.283	.417**
	Sig. (2-tailed)						.077	.007
Executive Directors	Pearson Correlation						1	-.754**
	Sig. (2-tailed)							.000
Non Executive Directors	Pearson Correlation							1
	Sig. (2-tailed)							
**. Correlation is significant at the 0.01 level (2-tailed).								

Table 4: Regression analysis of ROA

(a) Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.207[a]	.043	-.037	6.62367

a. Predictors: (Constant), Board Size, Board Committee, Board Meeting

(b) Coefficients

Model		Un standardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	23.256	14.261		1.631	.112
	Board Committee	-.295	1.034	-.047	-.285	.777
	Board Meeting	-.537	2.403	-.037	-.223	.825
	Board Size	-1.340	1.093	-.200	-1.227	.228

Table 5: Regression analysis of ROE

(a) Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.193[a]	.037	-.043	20.97874

a. *Predictors:* (Constant), Board Size, Board Committee, Board Meeting

(b) Coefficients

Model		Un standardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	30.756	45.168		.681	.500
	Board Committee	-2.859	3.276	-.144	-.873	.389
	Board Meeting	-4.935	7.610	-.107	-.649	.521
	Board Size	2.021	3.461	.096	.584	.563

a. *Dependent Variable:* Return on Equity (%)