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## Corporate Governance and Return on Equity Evidence from Pakistan Stock Exchange

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ARTICLE DETAILS	ABSTRACT
<p><b>History</b> Revised format: February 2020 Available Online: March 2020</p>	<p>The main purpose of this paper is to study whether corporate governance aspects like board size, audit committee and board composition affect the return on equity (performance) of companies listed on Pakistan Stock Exchange. The data were gathered by purposive sampling techniques from the Balance Sheet Analysis report available on the State Bank of Pakistan website and relevant companies' websites. A regression model was incorporated to measure the available data for a sample of 50 firms, with a total of 150 years of observations for a period of 2013 -2015. The empirical results indicate that board size, audit committee and board composition are positively associated to return on equity. The result of this study suggests that each organization needs to develop good corporate practices to significantly improve the shareholder wealth in the form of return on equity. The selected sample is taken from non-financial firms with a small sample size, therefore, in future for more generalizability of the results a study may be undertaken to consider financial and non-financial firms with a large sample size.</p>
<p><b>Keywords</b> Corporate Governance, Return on Equity, Board Size, Audit Committee, Board Composition</p>	
<p><b>JEL Classification:</b> G34, D63, D69</p>	



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### 1. Introduction

Corporate governance is usually a structure through which firms are run and regulated (Ahmed Sheikh, Wang, & Khan, 2013; Ehikioya, 2009). The growth of corporate governance has been motivated by the need to gain both the stockholders and stakeholders confidence on capital markets and financial system. Efficient governance mechanisms can effectively extend companies' ability to make prompt business

decisions and improve business performance. Cadbury (1992) suggests that corporate governance is the performance of all activities and operations carried out within the organization to improve the financial position and the interests of shareholders. Similarly, the World Bank has elaborated corporate governance as rules and regulations, customs and policies that are prejudicial to and administered by companies. After the bankruptcy of two gigantic businesses Enron and WorldCom, the corporate governance scheme gained significance. Investors were discouraged from investing in any company, thereby restoring investor confidence and enhancing the corporate governance system and hence the Sarban Oxley Act (2000) was introduced.

Good corporate governance focuses on an openness, justice and accountability in the company management (Ehikioya, 2009). It protects the interests of shareholders and also helps to ensure the return of local and foreign investors. The Pakistan Security and Exchange Commission introduced the corporate governance code in early 2000, which was the first step towards its reforms. These codes include recommendations for improving businesses, such as boards of directors will be responsible to shareholders, the firm will be obliged to reveal real data to the general public, so all of these reforms will improve inner and external audit, board size and board composition. This aims to ensure the distinction of ownership and control, which often leads to principal-agent problems (Jensen & Meckling, 1976). Agency theory explains disagreements between owners and Board of Directors. The ownership and control among principal and agents has been one of the most contentious issues in financial literature (Ehikioya, 2009).

According to Ahmed Sheikh et al. (2013), analytical work into corporate governance and firm performance frameworks was largely grounded on data from advanced countries with many structural parallels. Empirical evidence does, though, show conflicting and contradictory findings. On the other side, little is documented empirically about firms with specific institutional structures in developing countries, Therefore, limited research on corporations in developing countries and equivocal findings are a number of reasons that more research need to be conducted on the connection of corporate governance and return on equity (Ahmed Sheikh et al., 2013). In Pakistan many studies are conducted on the said relationship in different organization with different parameters but In spite of attempts to establish new theoretical perspectives and to investigate behavioral variables in corporate governance, study is still required to explore such problems in various institutional environments (Westphal & Zajac, 2013). Therefore, this research is an effort to fill the gap by contributing to the literature through investigating empirically the association of corporate governance and return on equity ( firm's performance). This research will also provide a new evidence that how corporate governance influences return on equity, which will assist academics and corporate sector in decision making regarding corporate governances and performance.

## **2. Literature Review**

### **2.1 Corporate Governance**

From the point of view of agency theory , the goal of corporate governance is to ensure managers use techniques to optimize the worth of the organization and shareholders (Jensen & Meckling, 1976). Sheikh (2002) describes corporate governance as a structure whereby managers are empowered and responsible for managing their businesses. It is the way for corporate actions, agents and assets to achieve the corporate goal set by the shareholder of the corporation (Sternberg, 2004). In other words corporate governance is the system of legislation, regulations, forces controlling the company's activities and monitor organizational goals and results (Adams & Mehran, 2003; Gillan & Starks, 1998). In consequence, corporate governance distributes the rights and duties among different corporate members like board members, management, shareholders and other stakeholders, and it ensures that choices on corporate matters are clearly defined in laws and processes (Turlea, Mocanu, & Carmen, 2010). The practice of corporate governance is seen as an internal management monitoring mechanism. Good governance is an effective instrument that helps a company to achieve better performance (Chen & Rezaee, 2012).

Corporate governance can be seen from the viewpoint of both the shareholders and the organization. From shareholders point of view corporate governance is usually related to maximizing shareholders wealth, while from organizational point of view, it is mostly concerned with monitoring and maintaining business operations mechanisms (Bruno & Claessens, 2007; Van den Berghe & Levrau, 2003; Zingales, 1997). In practical terms, corporate governance includes the corporation's responsibility to its shareholders and stakeholders. Corporate governance is a mechanism for framing and seeking to resolve the corporate stakeholders' agency problems, including shareholders and creditors (Abu-Tapanjeh, 2009; Hakim Sam, 2002). Even the aim of corporate governance is different from business to firm or country to country, but the main objective is to promote a good code of mechanisms to develop and regulate the organization (Abu-Tapanjeh, 2009). Hence, a good governance system helps to ensure that the management uses business resources properly for the best interests of the shareholders and reports reasonably the financial situation and performance of the business (Lin, Huang, & Chuang, 2018)

## **2.2 Corporate Governance and Firm Performance**

A good corporate governance system plays an essential role to increase firm performance, because it keeps close eye on every activity of managers, executives and administration which will reduce the fraudulent activities because of strong Audit Committee and will ultimately increase the firm performance (Bansal & Sharma, 2016; Rasheed & Nisar, 2018). In addition, it produces a transparent and accountable atmosphere in which all activities and people are accountable to their Manager (Wong, 2016). Thus, a good corporate governance scheme generates an atmosphere in which managers and executives do their work with complete efforts that are very useful to the businesses themselves and also boost investors' firm value and confidence (Carcello, Hermanson, & Ye, 2011; Narayanaswamy, Raghunandan, & Rama, 2012).

Dittmar, Mahrt-Smith, and Servaes (2003) investigate that firms with bad governance invest surplus money reserves in low-revenue investments and if the company is well governed, this adverse effect of surplus money expenditure on working results will be revoked. Further, their study results directly demonstrate how governance can increase corporate efficiency and understand the significance of governance in determining corporate policies. One of the most significant duties of directors is to supervise managers to guarantee that the interests of shareholders are protected. This connection is formalized between shareholders and their agents by Agency Theory (Jensen & Meckling, 1976). According to Agency Theory, Board of Directors work on behalf of owners of the organization, and take decision to increase their wealth. For improving the performance of a firm the organization must have proper board of directors with the required members and proper audit system to monitor agency function of an organization.

Adopting best corporate governance practices, like an improved audit committee, enhances management oversight and eliminates issues with information asymmetry (Aldamen, Duncan, Kelly, McNamara, & Nagel, 2012). High level of audit committees enhances the firm performance and is linked with improved monitoring of overall financial reporting process (Brennan & Kirwan, 2015; Klein, 2003). The convention on corporate governance adopted from advance market codes and guidelines to meet the Board's role requires the cooperation of both executive and non-executive directors (Rashid, De Zoysa, Lodh, & Rudkin, 2010). Boards lacking non-Executive Director were considered with a significant de jure power but little de facto power, controlled by the Chief Executive Officer and prone to desires clashes with principals (Weidenbaum, 1986).

Further, the association between corporate governance and performance has been examined in many studies in different countries with contradictory and inconsistency results (Arora & Sharma, 2016; Sanjai Bhagat & Bolton, 2008, 2019; Brown & Caylor, 2004; Buallay, Hamdan, & Zureigat, 2017; Detthamrong, Chancharat, & Vithessonthi, 2017; Muhammad, Rehman, & Waqas, 2016). Similarly, Guest (2009) found

no proof that organizational features that decide the board size in the UK lead to a better results connection for the board size. The negative association was found between board size and firm performance (Arora & Sharma, 2016; Dwivedi & Jain, 2005; Mashayekhi & Bazaz, 2008) and contrary a positive association in board size and firm performance was determined (Jackling & Johl, 2009; Mak & Kusunadi, 2005), whereas, in Malaysian firms Anum Mohd Ghazali (2010) found no significant association between board size and performance.

### **2.3 Board Size**

Board size refers to numbers of directors employed in an organization for the well-being of shareholders. The Board of Directors shall function as possessor of the company which shall take action and take decisions concerning the best interests of the shareholders. Fama (1980) argued that directors split authorities and tasks between employee for the best curiosity of shareholders and company. The board therefore operates on behalf of the owners and therefore the board size plays a significant part in improving company efficiency.

### **2.4 Audit Committee**

The Sarbon Oxley Act (2000), make it compulsory for all businesses to maintain one professional audit committee managers who have the financial, audit and management understanding and autonomy of all other employees. According to the report of the blue ribbon committee (1999) the Audit Committee shows an central role in monitoring all business transactions, the audit process, the utilization and use of funds, when and where and from where funds are obtained, All these actions will therefore bring transparency and prevent fraudulent practices that will eventually boost the return on equity.

### **2.5 Board Composition**

The Board Composition implies the proportion of executive and non-executive directors operating an organisation to shareholders ' best interests. Dare (1998) asserts that non-executive directors have an important role to play to resolve all issue and monitors all the strategy of the company which will result higher firm performance. Moreover they feel free to make judgment while dealing with executive directors regarding appointing and dismissal of executive directors. O'Sullivan and Wong (1999) says that non-executive directors decrease their effect if they worked in the same board for long time. Similarly, Klein (2003) affirms that there is an insignificant relationship between the proportion of external managers and firm performance, but Fosberg (1989) performed a survey and discovered no relationship in the percentage of external managers and company performance measures. The connection between company performance and the percentage of external managers has therefore blended outcomes. The relationship between external directors' proportion and firm performance is mixed (Yasser, Entebang, & Mansor, 2011). The organizational performance is insignificantly correlated to a higher proportion of outsiders on the executive board (Baysinger & Butler, 1985). While on the other hand S Bhagat and Black (2002) established no significant link between board composition and firm performance. In Pakistan, the Corporate Governance Code limited all registered companies that the fraction of executive directors should not surpass 75% of the complete size of the board, as well as encouraging and cheering the representation of minority shareholders and autonomous directors.

### **2.6 Hypothesis**

One of the most significant duties of directors is to supervise managers to guarantee that the interests of shareholders are protected. This connection is formalized between shareholders and their agents by Agency Theory (Jensen & Meckling, 1976). According to Agency Theory, Board of Directors work on behalf of owners of the organization, and take decision to increase their worth. For improving the performance of a firm the organization must have proper board composition with the required board size and proper audit system to monitor agency function within organization. Therefore, on the basis of this we hypothesize that:

H1: “A significant association exists between corporate governor facets (Board Size, Audit Committee and Board Composition) and Return on Equity (Performance)”

### 3. Research Methodology

The population of this research was the entire non-financial firms registered with PSX from 2013 to 2015. A purposive sampling technique was used and only 50 firms were randomly selected whose data were available to perform the statistical analysis. The data was congregated from Balance Sheet Analysis available at State Bank of Pakistan Website. The data was analysed by the following statistical model.

$$Y = \alpha + \beta \text{Fit} + \epsilon_i \dots\dots\dots (1)$$

Where, Y= Independent Variable,  $\alpha$  = Constant,  $\beta$  = Coefficient of variable (Corporate Governance Facet i.e. Board Size, Audit Committee and Board Composition”), Fit = explanatory variable and  $\epsilon_i$  = error term.

Return on Equity was used as a representative of Firm Performance for a time space of 2013 to 2015. More specifically, by adopting econometric model mentioned in equation (1), equation (2) evolve, which is as under

$$\text{Firm Performance} = \beta\alpha + \beta_1 \text{BSIZ} + \beta_2 \text{AUDCOM} + \beta_3 \text{BCOMP} \dots\dots\dots (2)$$

### 3.1 Measurement of Variables

#### 3.1.1 Dependent Variable

In the literature, there is no consensus on the measure that is the best financial performance predictor. However, each measure has its own strengths and weaknesses, so there is no metric to be the best representative for financial performance (Haniffa & Hudaib, 2006; Marashdeh, 2014). Many studies analyze the firm performance using a number of financial indicators such as Tobin’s Q (Kiel & Nicholson, 2003), Return on Assets (Rashid & Lodh, 2008) and Return on Equity (Adjaoud, Zeghal, & Andaleeb, 2007). In this research, the firm’s performance is measured through Return on Equity. According to Ping, Chang-qing, and Li (2011) Return on Equity measure is the best indicator of firm’s performance. It not only shows the profitability of equity capital and its accumulation as an significant economic indicator, but also captures the greatest attention of investors

$$ROE = \frac{\text{Net Income}}{\text{Shareholder's equity}}$$

#### 3.1.2 Independent Variable

The important determinants of CG are taken to measure the overall Corporate Governance. These are:

Board Size: BSIZ = Total number of Directors

Audit Committee Size: AUDCOM = Total number of directors in the audit committee

Board Composition: BCOMP = Proportion of managers and non-managers sitting on the board

### 3.2 Analysis

#### 3.2.1 Descriptive Statistics

In the given Table 1 the normal board size of the firms is 9, and the percentage of external director (Board Composition) is about 7. Audit committee has the largest value (91) which means that 91% of the companies have audit committee members collected on non-executive directors. According to the code of corporate governance (2002) of Pakistan it’s mandatory for every firm to have at least 3 “audit committee” members comprising of non-executive boards having knowledge of accounting and auditing discipline.

**Table 1:** Descriptive Analysis

	ROE	BSIZE	AUDCOM	BCOMP''
Mean	0.24	9.4	0.91	7.5
Median	0.2	9	1	7
Std.Dev	0.17	2.50	0.26	3.8
Minimum	-0.05	6	0	0.25
Maximum	67.5	15	1	15
N.Valid	150	150	150	150

### 3.2.2 Regression Analysis

The correlation between all of the study variables is shown in Table 2 below. The results of the Pearson Correlation assessment indicate that ROE correlates positively and significantly with the board size. Likewise, the audit committee and the members of the board also have the same results.

**Table 2:** Correlations

	ROE	BSIZE	AUDCOM	BCOMP
ROE	1			
BSIZE	0.23	1		
AUDCOM	0.16	0.29	1	
BCOMP	0.14	0.59	0.55	1
Sig	0.000	0.000	0.000	0.000
N	150	150	150	150

The result of ANOVA shown in Table 3 depicts that the F- values of ROE which is used as a proxy for performance measure is  $F = 0.941$  ( $p = 0.000$ ), which shows that a robust relation exist between ROE and corporate governance (Three corporate governance facets i.e. Board Size, Audit Committee and Board Composition)

**Table 3:** ANOVA

Model	Sum of Square	Df	Mean Square	F	Sig
Between Group	0.12	4	0.029		
Within Group	1.68	55	0.04	0.941	0
Total	1.79	59			

The estimates of the coefficient are presented in Table 4. The board size ratio is 0.0219, indicating a favorable connection between board size and ROE, and the statistical significance level is 5% and 10%. As a consequence, the connection between the Audit Committee, the Board of Directors and the ROE is positive and substantial at a rate of 5%. Statistically, the average size of the board is about 9, which is very low in the context of Pakistan. This statistical outcome is therefore comparable to the outcomes of prior scientists (Sanda et al., 2005; Bokpin et al., 2006). There is also a beneficial and important connection between board structure and ROE. It means that firm financial performance and outside directors of the board have strong association with each other. The same result is also investigated by Bhagat and Black (2002) and Sanda et al. (2005)". The outcome also demonstrates that there exist positive and significant relation between audit committee members and firm performance.

**Table 4:** Regression Analysis

Independent Variables	ROE
BFSIZE	0.0219
BCOMP	0.0141
AUDCOM	0.0487
R2	0.6391
Adjusted R2	-0.0042
F Statistics	0.9384
Sig.	0.000
No of Observations	150

#### 4. Discussion and Findings

In this research study, researcher has used three “Corporate Governance Facets (Board Size, Audit Committee and Board Composition) as independent variables and ROE” as dependent construct used as proxy of financial performance measure. A sample size for this study is 50 firm enlisted in PSX for the time period of 2013 to 2015.

The findings of the study are as following

- ROE and Board size have significant positive association with each other”
- Positive and significant association was found between audit committee and ROE(Firm performance)”
- ROE and Board Composition are also positively and significantly interlinked to one another”.
- Based on these statistical results and findings we accepted the assumption "Corporate Governance Facet (Board Size, Audit Committee and Board Composition) and Firm Performance (ROE) have an important connection.

#### 5. Recommendations and Limitations

For future research, it is recommended that researchers should increase numbers of firms, time period and also include maximum variables of corporate Governance facets for robustness of result. This research has certain constraints. The first limitation is selection of small sample size. The second limitation is short span of time. Third limitation is consideration of very few facets of corporate governance facets. The fourth and final limitation is that the selected companies are taken from non-financial sectors which are enlisted in Pakistan Stock Exchange. The area for additional and future researchers is in-depth examination of all financial and non-financial sectors of Pakistan which are enlisted in Pakistan Stock Exchange (PSX) and inclusion of some moderating and mediating variables.

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