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Corporate Governance in Pakistan: Corporate Valuation, Ownership and Financing

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ABSTRACT

In this study the relationship between corporate governance and corporate valuation, ownership structure and need of external financing for the Karachi Stock Market is examined for the period 2003 to 2008. To measure the firm-level governance a rating system is used to evaluate the stringency of a set of governance practices and cover various governance categories: such as board composition, ownership and shareholdings and transparency, disclosure and auditing. The sample consists of 60 non-financial firms listed on Karachi Stock Exchange and comprises more than 80 percent of market capitalization at Karachi Stock Market in 2007. The results confirms the theoretical notion that firms with better investment opportunities and larger in size adopt better corporate governance practice. The proposition that ownership concentration is a response to poor legal protection is also validated by the results. The more investment opportunities lead to more concentration of ownership and the ownership concentration is significantly diluted as the firm size expands. The findings are consistent with theoretical argument claiming that family owners, foreign owners and bring better governance and monitoring practices which is consistent with agency theory. The results suggest that firms which need more equity financing practice good governance. The results show that firms with high growth and large in size are in more need of external finance. The relationship between external financing and ownership concentration is negative. The results reveal that the firms which practice good governance, with concentrated ownership, need more external finance which have more profitable investment opportunities and are larger in size are valued higher. The interaction term of any variable with law enforcement term are not significant in any model suggesting that firm performance is not affected by rule of law in countries where legal environment is weak. These results adds an important link to the explanation of the consequences weak legal environment for external financing, corporate valuation and corporate governance. The results show that Corporate Governance Code 2002 potentially improves the governance and decision making process of firms listed at KSE.

JEL classification: G3 F3

Keywords: Ownership Concentration, Corporate Governance, Firm Performance, External Financing, Panel Data

Chapter 1: INTRODUCTION

1.1. Background

Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. In emerging markets good corporate governance serves a number of public policy objectives. It reduces vulnerability of the financial crises, reinforcement property rights; reduces transaction cost and cost of capital and leads to capital market development. Corporate governance concerns the relationship among the management, board of directors, controlling shareholders, minority shareholders and other stakeholders. In Pakistan, the publication of the SECP Corporate Governance Code 2002 for publicly listed companies has made it an important area of research of corporate sector.

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. A corporate governance system defines who owns the firm, and dictates the rules by which economic returns are distributed among shareholders, employees, managers, and other stakeholders. As such, a county's corporate governance regime has deep implications for firm organisation, employment systems, trading relationships, and capital markets. Thus, changes in Pakistani system of corporate governance are likely to have important consequences for the structure and conduct of country business.

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. In the Anglo-American system of corporate governance these owners are shareholders. The concept of corporate governance presumes a fundamental tension between shareholders and corporate managers [Berle and Means (1932) and Jensen and Meckling (1976)]. While the objective of a corporation's shareholders is a return on their investment, managers are likely to have other goals, such as the power and prestige of running a large and powerful organisation, or entertainment and other perquisites of their position. In this situation, managers' superior access to inside information and the relatively

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powerless position of the numerous and dispersed shareholders, mean that managers are likely to have the upper hand. The researchers have offered a number of solutions for this agency problem between shareholders and managers which fall under the categories of incentive alignment, monitoring, and discipline. Incentives of managers and shareholders can be aligned through practices such as stock options or other market-based compensation [Fama and Jensen (1983a)]. Monitoring by an independent and engaged board of directors assures that managers behave in the best interests of the shareholders [Fama and Jensen (1983)]. Chief Executive Officer (CEO)'s who fail to maximise shareholder interests can be removed by concerned boards of directors, and a firm that neglects shareholder value is disciplined by the market through hostile takeover[1] [Jensen and Ruback (1983)].

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.

The main focus of this study is to examine the relationship between corporate governance and corporate performance, corporate ownership, corporate financing for publicly listed Karachi Stock Exchange (KSE) firms. Therefore, we attempt to identify the relationship between corporate governance proxies and firm value in our sample of KSE firms. This emphasises the importance of legal rules and the quality of their enforcement. In Pakistan, with traditionally low dispersion of ownership, the primary methods to solve agency problems are the legal protection of minority investors, the use of boards as monitors of senior management, and an active market for corporate control. In contrast to developed markets in Pakistan corporate governance is characterised by lesser reliance on capital markets and outside investors, but stronger reliance on large inside investors and financial institutions to achieve efficiency in the corporate sector. In this case, outside (smaller) investors face the risk of expropriation in the form of wealth transfers to larger shareholders.

According to Shliefer and Vishny (1997) corporate governance mechanisms are economic and legal institutions that can be altered through the political process. As regards governance reform, product market competition would force firms to minimise costs, and as part of this cost minimisation to adopt rules, including corporate governance mechanisms, enabling them to raise external capital at the lowest cost in the long run. On this evolutionary theory of

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[1]A takeover which goes against the wishes of the target company's management and board of directors.

economic change [Alchian (1950); Stigler (1958)], competition would take care of corporate governance.

Corporate governance in agency theory perspective is referred to as separation of ownership and control [Barle and Means (1932)]. There are two most common approaches to corporate governance to protect investors' rights. First approach is to give investors power through legal protection from expropriation by managers. Protection of minority rights and legal prohibitions against managerial self-dealing are examples of such mechanisms. The second major approach is ownership by large investors (concentrated ownership): matching significant cash flow rand control rights. Most corporate governance mechanisms used in the world-including large share holdings, relationship banking, and even takeovers- can be viewed as examples of large investors exercising their power. We discuss how large investors reduce agency costs. While large investors still rely on the legal system, they do not need as many rights as the small investors do to protect their interests. For this reason, corporate governance is typically exercised by large investors. Despite its common use, concentrated ownership has its costs as well, which can be best described as potential expropriation by large investors of other small investors and stakeholders in the firm [Shliefer and Vishny (1997)].

1.2. Objective of the Study

The main focus of the study is to investigate does corporate governance matters in Pakistan equity market? What are its implications for corporate valuation, corporate, ownership and corporate financing?

The first dimension of this issue is measuring the corporate governance in Pakistan. Corporate governance is interpreted as mechanism–both institutional and market based, that induces the self-interested managers (controllers of the firm) to make decisions that maximise the value of the firm to its shareholders (owners of the firm) [OECD (1999)]. The aim of these mechanisms is to reduce agency costs that arise from principle agent problem; and they could be internal and/or external in nature [Klapper and Love (2002)]. Internal mechanism deals with the composition of the board of directors, such as proportion of independent outside directors, distinction of CEO and chairperson etc. another important mechanism is ownership structure, or the degree at which the ownership by managers obvious trade-off between alignment and entrenchment effects. External mechanism on the other hand rely on takeover market in addition to regulatory system, where as the take over market act as a treat to existing controllers in that it enable outsiders to seek control of the firm if bad corporate governance results in significant gap between potential and actual value of the firm. So given these mechanisms, it is investigated that the legal system is the only way to ensure good corporate governance. It is also examined that effective presence of these mechanisms positively associated with firm value.

The second dimension of this issue is to investigate the determinants of concentrated form of ownership structure in Pakistan and its affect on firm performance. The reason is that when the legal framework does not offer sufficient protection for the outside investors, entrepreneurs and original owners are forced to maintain large position in their companies which results in concentrated form of ownership [La Porta, Shleifer, and Vishny (1999)].

The third dimension of this study is to assess the determinants of firms to raise external finance through equity and to examine that the firms that rely more on external financing sources are performing better.

1.3. Organisation of the Study

Rest of the study is organised as follows. Chapter 2 provides overview of corporate governance in Pakistan and it also discuses the data used in the subsequent chapters. Chapter 3 measures the corporate governance by using 22 factors which constructs aggregate corporate governance index, and this index is divided in to three sub-indices. This chapter also discusses the determinants of corporate governance in Pakistan. In Chapter 5, the determinants of ownership structure are explored. The effect of ownership structure with firm performance is also investigated. The identity of owners is then related to firm value. In the Chapter 6 examines the factors that influence the need of external finance in Pakistan and its effect on firm value. Chapter 7 concludes the study.

Chapter 2: OVERVIEW OF CORPORATE GOVERNANCE IN PAKISTAN

2.1. Introduction

Corporate governance matters for the financial development by increasing the flow of capital to the capital market. East Asian financial crisis attract serious attention to importance of corporate governance in developing countries. The OECD has established a set of corporate governance principles in 1999 that have become the core template for assessing a country's corporate governance arrangements.

La Porta, *et al.* (2000) Defined, "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 comprises the private and public institutions (both formal and informal) which together govern the relationship between those who manage corporations and those who invest resources in corporations. These institutions typically include a country's corporate laws, securities regulations, stock-market listing requirements, accepted business practices and prevailing business ethics" [Omran (2004)]. Thus, changes in Pakistani system of corporate

governance are likely to have important consequences for the structure and conduct of country business.

The issue of Corporate Governance of banks has also fundamental importance for emerging Economies. SBP restructured the regulatory framework governing the commercial banking industry and issued some guidelines for corporate governance. The study of Kalid and Hanif (2005) provides an overview of development in the banking sector and measures of corporate governance in Pakistan. Their study observes that SBP organised its role as a regulator and supervisor and make the central bank relatively more effectively in recent years. Moreover, the legal and regulatory structure governing the role and functions of commercial banks has been restructured. However, as the process of corporate governance of banks in Pakistan is very recent, not enough information is available to make an assessment of the impact of these policies such as an evaluation of the improvement in bank efficiency or reduction in bank defaults.

Securities and Exchange Commission of Pakistan issued Code of Corporate Governance in March 2002 in order to strengthen the regulatory mechanism and its enforcement. The code of corporate governance 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.

The plan of the chapter is as follows. The institutional framework is presented in Section 2. Section 3 briefly reviews the code of corporate governance of Pakistan. The assessment of the code of corporate governance is provided in Section 4. Section 5 explores corporate governance under ownership structure of Pakistan. Section 6 concludes our discussion.

2.2. Institutional Framework

East Asian financial crisis and corporate failure like Enron have brought to light the importance of an effective institutional framework. In order to the improve value of the corporate governance for finance development of a country attention must be given to strengthen the institutional framework. That strong institutional framework would help in effective corporate management and for developing advanced capital markets that increases shareholder value and enhance corporate governance.

The establishment of the Security and Exchange Commission of Pakistan represents an important milestone in the development of the regulatory framework of the capital market in Pakistan. The Securities and Exchange

Commission of Pakistan (The Commission) was established in pursuance of the Securities and Exchanges Commission of Pakistan Act, 1997 and became operational on 1st January, 1999. It succeeds the Corporate Law Authority (CLA), which was a Government department attached to the Ministry of finance. It was initially concerned with the regulation of corporate sector and capital market. In accordance with the approved Corporate Plan, the Commission has been organised into the following six Divisions:

- Company Law Division.
- Securities Market Division.
- Specialised Companies Division.
- Finance and Admin Division.
- Human Resource and Training Division.
- Insurance Division.

Each of division is divided into Departments and Wings for effective administration. The Departments are headed by Executive Directors, with oversight by commissioners.[2]

The continuing challenges of the Commission include: based on the regulatory principles develop a modern and efficient corporate sector and capital market; based on international legal standards. In order to foster principles of good governance in the corporate sector and protect investors through responsive policy measure and enforcement practice develop an efficient and dynamic regulatory body.

The SECP is governed by the Securities and Exchange Commission of Pakistan Act, 1997 which encompasses the constitution of the Commission appointment and terms and conditions of the Chairman and Commissioners, functions and powers of the Commission and financial arrangements. The Securities and Exchange Commission of Pakistan is administering many laws. These includes: insurance Ordinance, 2000 (previously as Insurance Act, 1938; The Securities and Exchange Commission of Pakistan Act,1997; The company ordinance, 1984 (amended and implemented in 2002); The Modaraba Companies and Modaraba (Floatation and Control) Ordinance, 1980; The Securities and Exchange Ordinance, 1969.

The Policy Board is established by the Securities and Exchange Commission of Pakistan Act, 1997 in order to provide guidance to the Commission in all matters relating to the functions of the Commission and formulation of the policies. The Policy Board consists of maximum nine members appointed by the Federal Government. Out of nine members five members would be as ex-officio members and five members would be from private sector.

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[2]See official website of securities and Exchange Commission of Pakistan for detail; www.secp.org.pk.

A number of significant amendments in corporate laws were made with the objective of updating these laws to keep pace with developments in the corporate sector. These include: amendments in Securities and Exchange Ordinance, 1969; Modaraba Companies and Modaraba (floatation and control) Ordinance, 1980; Companies Ordinance, 1984; the securities and exchange commission of Pakistan Act, 1997.

Amendments in company ordinance, 1984, suggested by the SECP have been approved by the cabinet in 2002. The amendments mainly relates to incorporation of single member company. Because of this amendment an individual trader or manufacturer would be able to establish a company having its own separate entity and thus enjoying the privilege of limited liability. This new concept will help for expansion of a discipline corporate sector. The companies have been provided the period of four months in order to present audited account before shareholders. The private companies which convert into public companies after one year of their incorporation have been exempted to hold their statutory meetings. The new amendments make it compulsory that copies of minutes of meetings will be provided to every director within 14 days of the date of such meetings. Appointment of a whole time qualified company secretary by a listed company has been made mandatory for efficient corporate compliance. Through these new amendments a company may remove its auditors through special resolution mean by the majority of 75 percent. However, appointment of new auditors in place of removed auditors will be made with the approval of the Commission. Quorum of a general meeting of a public listed company has been increased from three members to ten members present in person representing not less than 25 percent of total voting power.

Stock markets are important as a source of investment finance for corporations in developing countries. At present, three stock exchanges are functioning in Pakistan, namely Karachi Stock Exchange (KSE), Lahore Stock Exchange (LSE) and Islamabad Stock Exchange (ISE). Trading on all the three stock exchanges is fully automated (for performance see Table 2.4). The three stock exchanges are also linked to the Central Depository System (CDS).

Since the last decade, the capital markets of Pakistan have witnessed a substantial growth leading to a manifold increase in the trading volume. The custody and safe keeping of physical certificates required maintenance of huge vaults by the individuals and institutions and the physical settlement of certificates was no longer feasible. Moreover, the manual system was also plagued by lengthy delays, risks of damage, forgeries and considerable time and capital investment. Central Depository Company of Pakistan Limited (CDC) was incorporated in 1993 and subsequently became operational in 1997 to manage and operate the Central Depository System (CDS). CDS is an electronic book entry system to record and transfer securities. Electronic book entry means that the securities do not physically change hands and the transfer from one client account to another takes place electronically. CDC provides the backbone

for smooth and efficient settlement operations of the Pakistani capital market. Almost all of the total settlement of the stock exchanges is now done through the CDS.[3]

To encourage corporate governance the institute of corporate governance of Pakistan a non-profit organisation is established under Section 42 of company ordinance, 1984. It is public private partnership. Securities and Exchange Commission of Pakistan, State Bank of Pakistan, three stock exchanges and banking and insurance institutions are founding members of this institution.

In 2006 PICG in collaboration with IFC and State Bank of Pakistan conducted a conference of banking reforms in Pakistan. The conference aspired to create increased understanding of the need for good governance among Pakistan's banking sector.

Table 2.1

Year Wise Distribution of Companies

Financial Year	Incorporated Companies	No. of Equity Issue to Public (Rs bill)
1998-99	968	0.44
1999-00	1074	0.00
2000-01	1169	2.03
2001-02	1183	1.99
2002-03	1553	5.97
2003-04	2207	0.98
2004-05	3078	48.88
2005-06	6186	24.34
2006-07	4703	9.60

Source: Annual Report of SECP 2006-07.

Table 2.2

Provincial Wise Distribution of Companies

Province / Territory	2005 (% Share)	2006 (% Share)	2007 (% Share)
Punjab	43	39	46
Sindh	39	29	34
NWFP	11	9	6
Baluchistan	1	4	1
Islamabad Territory	6	19	13

Source: Annual Report of SECP 2005, 2006, 2007.

[3]See official website of CDC www.CDCPakistan.com.

Table 2.3

Capitalisation Break Down for the Year 2007

Paid Up Capital (Rs)	Listed Com	Unlisted Public Com	Private Com	SMCs	Total	Percentage
Up to 10,000	1	448	20,607	373	24,429	42.87
100,000 to 500,000	1	343	7,037	100	7,481	14.97
500,001to1,000,000	0	105	4,566	59	4,730	9.46
1,000,001 to 10,000,000	34	343	10,804	48	11,229	22.47
10,000,000 to 100,000,000	226	662	3,168	28	4,084	8.17
1000,000,001 to 500,000,000	236	224	319	2	799	1.60
500,000,001 to 1,000,000,000	45	32	29	0	106	0.21
1,000,000,001 and above	69	36	18	0	123	0.25

Source: Annual Report of SECP 2007.

Table 2.4

KSE Performance at Glance

	2004	2005	2006	2007
KSE 100 Index	5,279.18	7,450.12	9,981.40	13,772.26
Market Capitalisation (Rs bill)	1,421.58	2,068.19	2,801.28	4,019.46
Turnover (Shares Mill)	389	343	321.10	367.96

Source: Annual Report of SECP 2004,2005,2006,2007.

2.3. Code of the Corporate Governance

Many new financial instruments are introduced by the SECP in order to enhance corporate governance. The code of corporate governance was issued in March 2002 by the Security and Exchange Commission of Pakistan in order to improve transparency, governance and protect the interest of the investors by improving the disclosure in financial reporting of companies. The Code of Corporate Governance is the results of the joint effort of Securities and Exchange Commission of Pakistan and Chartered of Pakistan in collaboration with Institute of Cost and Management Accountants of Pakistan (ICMAP) and three Stock Exchanges. The code includes many recommendations in line with international good practice.

All listed companies publish and circulate a statement along with their annual reports to set out the status of their compliance with the best practices of corporate governance. The Code primarily aims to establish a system whereby a company is directed and controlled by its directors in compliance with the best practice so as to safeguard the interest of diversified stakeholders. It proposes to restructure the composition of the board of directors in order to introduce broad based representation by minority shareholders and by executive and non-executive directors.[4,5] The Code emphasised openness and transparency in

[4]All listed companies shall encourage effective representation of independent non-executive directors, including those representing minority interest, on their Boards of Directors so that the Board as a group include core competencies considered relevant in the context of each listed company (Clause (i) of Code of Corporate governance, 2002).

[5]Implementation of the clause of non-executive directors is voluntary not mandatory.

corporate affairs and the decision making process and requires directors to discharge their fiduciary responsibilities in the larger interest of all stakeholders in a transparent, informed, diligent, and timely manner. The salient feature of the Code includes setting up of audit committees and internal audit functions by all listed companies [Code of Corporate Governance (2002)].

In August 2002 SECP launch a project on corporate governance in collaboration with UNDP and Economic Affairs Division of Government of Pakistan. This project is launched mainly for the implementation of code of corporate governance and strong regulatory frame work for the corporate sector in Pakistan.

In 2007 the Security and Exchange Commission of Pakistan, International Financial Corporation (IFC) and Institute of Corporate Governance of Pakistan (PINCG) conducted a Survey on "Code of Corporate Governance of Pakistan". The survey targeted the local listed and large local non-listed companies and financial sector institutions. Among the key findings in the survey, a major one is the need for creating awareness amongst the directors of companies about the benefits of the Code, so that they could go further than the tick-box approach to implementing the Code, and understand and implement the Code in its true spirit. Security and Exchange Commission of Pakistan developed a board development series (BDS) with the help of IFC. PICG conducted many workshops for the purpose of understanding corporate governance and responsibilities of boards of directors.

2.4. Assessment of Corporate Governance

The SECP is enforcing corporate governance regulations SECP is receiving technical assistance from Asian Development Bank to improve corporate governance enforcement programme and also from World Bank is build awareness and training. Other elements of enforcement regime are not so strong ICAP has some self regulatory function and stock exchanges are lacked the resources and expertise to effective monitor implementation of the code. Karachi Stock Exchange has set up a Board Committee on the Code of Corporate Governance and a unit in the Company Affairs Department to monitor compliance with the code.

The basic shareholders rights are protected in Pakistan at least laws in book. The registration is secure and dematerialised through Central Depository Committee (CDC). Shareholders can demand a variety of information directly from the company and have a clear right to participate in Annual General Meetings (AGM). Directors are elected using a form of cumulative voting and can remove through share holder resolution. The changes in the company articles, increasing authorised capital and sale of major corporate assets are require shareholders approval. While more effective enforcement contributed to improve compliance, some companies do not hold annual general meetings

(AGMs) or hold in places where it is difficult for shareholders to reach. The law also does not support voting by post or electronically. The concentrated control limits and influence of minority shareholders, and effectively reduce their protection from abuse. When families dominate the shareholders meeting and board, director's accountability to other shareholders become critical and currently in Pakistan this accountability is absent in many companies. The shareholder recording process for share hold in the CDC works effectively. However, although the registration's role has been reduced by the CDC's operations, some inefficiency is still there. Some companies do not pay dividend on time, and take longer than 5 days to re-register share in the name of depository. The annual reports of SECP suggest that the percentage of companies paying dividends is 35 percent and shareholders can complain SECP about non payment of dividends.

The quality of disclosure has improved over last six years due to increasing monitoring role of the SECP and the requirement of code. Shareholders owning 10 percent or more of voting capital disclose their ownership and the annual report includes the pattern for major shareholdings. However pyramid structure, cross holdings and the absence of joint action make it difficult for outsiders to understand the ownership structure of companies, especially in case of business groups.

The family owned companies are typically managed by owners themselves. In case of state owned enterprises and multinationals there is often direct relationship between state/foreign owners and management again bypassing the boards. Many important corporate decisions are not made on Board AGMs level. The code explicitly mentions director's duties to act with objective an independent judgment and in the best interest of company. In business groups boards are dominated by executive and non-executive members of controlling family and by proxy directors appointed to act on their behalf. Inter-looking directorships are often used to retain majority control. Family dominated boards are less able to protect minority shareholder's rights and risk a loss of competitiveness as other boards become more professional.

The code strengthen the role of non-executive directors by restricting the percentage of executive director to 75 percent in non-financial firms and recommending that institutional investor in 75 percent in non-financial firms and recommending institutional investor be representation. However given the dominant ownership structure, this does not present controlling families from having disproportionate representation on the board.

"The adoption of the Corporate Governance Code has improved the overall corporate structure and business environment by making the companies more responsible, and by ensuring transparency and accountability in the corporate and financial reporting framework. The inclusion of non-executive directors on the board is a big step forward as it will discourage the tendency of protecting personnel interests and motives at the expense of the minority

shareholders. Moreover, the addition of the non-executive members has improved decision-making process, which is not only slow previously, but also opaque due to the lack of interest of the board of directors to meet as and when required", Rias and Saeed (2005). In the view of Syed (2005) the publication of quarterly results by firms enables the investors to make better investment decision. Under the Code, listed companies shall share with SECP and stock exchange, all information that will affect the market price of its shares. The disclosure of material information ensures transparent trading.

2.5. Corporate Governance under Concentrated Ownership

Corporate ownership is very concentrated in Pakistan (see Table 2.5). The mean value of ownership concentration for the 60 companies for the year 2003-2007 shows that more than 50 percent of the shares are owned by top 3 shareholders.

In Pakistan the main owners are local family-controlled business groups and the families behind them, the state, and the affiliates of multinational corporations (see Table 6). According to Gani and Ashraf (2005), "The business groups in Pakistan (previously known as twenty-two families) are informal combinations of legally independent business entities run by families. The family patriarch is the dominant shareholder and manager whereas the immediate and distant family-members help operate various firms within the business group".

In many countries pyramidal ownership structures, which dominant shareholders and business groups use to enforce their control over firms within the group, are common. Pyramid ownership structures make it possible to control some firms even with a very small share of their total capital. The results of Gani and Ashraf (2005) suggest that for the perspective of external shareholder firms that are affiliated with business groups have lower transparency and weaker corporate governance mechanism. Consequently, the market participants discount the value of group firms even though they are more profitable than non-group firms. They interpret this evidence that the business-group mechanism in Pakistan makes it easier to expropriate minority shareholders than non group firms.

Table 2.5

Ownership Concentration of 50 Random Companies for Pakistan for 2003-2007

	Mean	Median	Minimum	Maximum	S.D
T3	52.0	50.70	2.5	96.8	21.0
T5	62.39	64.23	3.5	99.00	21.17

T3: Percentage of ownership shares held by top three shareholders.
T5: Percentage of ownership shares held by top five shareholders.

Table 2.6

Inventors Composition in Listed Private Companies

(Percentage Shares Owned by an Investor Type)

Investor Type	Textile	Non-Textile
Direct Holding by Family Members	29.3	9.1
NIT/ICP	8.4	11.1
Financial Institutions	5.1	8.2
Foreign Investors	1.9	14.3
Joint Stock Companies	23.2	16.9
Associated Companies of the Controlling Family	17.4	21.4

Source: Cheema, Bari, and Siddique (2003).

Table 2.7

Ownership Composition of Pakistan's Top 40 Listed Companies

	% of Top 40 Companies		% of Top 40s Market Capitalisation	
Ownership Type	All	Non-financial	All	Non-financial
Local Private Family-Based	52.5	59.0	30.2	29.8
Government	12.5	12.0	36.5	36.8
Semi-Government	22.5	14.0	16.3	15.6
MNCs	12.5	15.0	17.0	18.0

Source: Cheema, Bari, and Siddque (2003).

Cheema, Bari, and Siddique (2003) summaries the corporate growth history of Pakistan, providing an overview of the ownership, state of financial market, and market dynamics. They highlight the salient feature of ownership structure of Pakistan's top 40 listed companies in Pakistan (Table 2.6).

2.6. Corporate Governance in South Asia

The process of improving the best practice of corporate governance in South Asia is ongoing. Pakistan, Sri Lanka, and India recognise the importance of corporate governance. India issued Code of Corporate Governance in 1998, Pakistan issued Code of Corporate Governance in 2002, and Sri Lanka has also Code of Corporate Governance. Issuance of Code increased the transparency in the corporate sector of these countries.

The four country comparative analysis by Sobhan and Wendy (2003) provide an immensely rich resource which can be mined for numerous lessons of experience and critical factors for corporate governance. They draw many important lessons from the four country reports on corporate governance. In their view corporate governance cannot be introduced in isolation from a range of other reforms (macro-economic, micro-economic, accounting, legal, banking and institutional) – nor can these other reforms achieve all their objectives without corporate governance initiatives. Moreover there is the need to monitor the trends in different sectors of the markets. From the country reports they also

draw lesson that critical importance of the company and contract laws and the efficacy of the legal system should also be recognise. It is notable that all the countries have developed special commercial courts of one sort or another to handle the commercial disputes, but the reports all generate a sense of gloom, almost of despair, when it comes to the efficacy of the law, and of the need to modernise bankruptcy and liquidation proceedings.

The OECD and the World Bank Group have combined their efforts to promote policy dialogue on corporate governance and have established Regional Corporate Governance Round tables and assessment of corporate governance in close partnership with national policy-makers, regulators and market participants. It draws lessons from the 1997 Asian financial crisis, assesses progress and remaining challenges, and formulates common policy objectives and a practical reform agenda for improving corporate governance in Asia.[6]

India has a sizeable corporate sector registered as closely- or widely-held companies under the Companies Act. Table 8 gives the data for basic statistic of corporate sector of India for1997-2000. "Since the first Corporate Governance ROSC assessment dated July 31, 2000, a series of legal and regulatory reforms have transformed the Indian corporate governance framework and improved the level of responsibility/accountability of insiders, fairness in the treatment of minority shareholders and stakeholders, board practices, and transparency In particular, the securities regulator introduced a corporate governance clause in the listing agreement that clarified many issues. Recent efforts to strengthen enforcement have enhanced investors' trust in the market. The financial press is increasingly reporting violations of shareholder rights. These are positive drivers of change. However, enforcement and implementation of laws and regulations remain important challenges." ROSC (2004).

In Bangladesh lending institutions are broadly categorised into banks and non-banking financial institutions. Overall performance measures of the stock exchange show low trading volume, intermittent and very few new offerings, and declining valuations Sobhan and Wendy (2003).[7] "The Bangladesh Securities and Exchange Commission and the Institute of Chartered Accountants of Bangladesh have demonstrated a keen interest in implementing International Accounting Standards (IAS) and International Standards on Auditing (ISA) to upgrade the quality of corporate financial reporting. Various steps have already been taken; however, further results will require the design and implementation of a comprehensive action plan on accountancy reform. The accounting and auditing practices in Bangladesh suffer from institutional weaknesses in regulation, compliance, and enforcement of standards and rules. The preparation of financial statements and conduct of audits, in many cases, are not consistent with internationally acceptable standards and practices. Better-qualified

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[6]See White Papers on corporate governance in Asia, 2003.

[7]See Table 2.10.

graduates generally do not join the accounting profession because it is not viewed as a stepping-stone to a rewarding and prestigious career. The out-of-date legal requirements, widespread non-compliance with accounting and auditing standards, ineffective enforcement mechanism, poor quality accounting education and training, and inadequate adherence to professional ethics have contributed to the weakness of the financial reporting regime", ROSC (2003).

Table 2.8

Basic Statistics of Corporate Sector of India

	1997	1998	1999	2000
Number of Companies				
Closely held (Private limited)	386,841	415,954	440,997	487,111
Widely held (Public limited including listed)	64,109	68,546	71,064	76,029
Paid-up Capital (Rs Billion)				
Closely held (Private limited)	588	718	790	1,013
Widely held (Public limited including listed)	1,257	1,409	1,503	2,063
Government Companies				
Number of Companies	1,220	1,223	1,240	1,256
Paid-up Capital (Rs billion)	797	824	890	982

Source: Sobhan and Werner (2003).

Table 2.9

Types of Financial Institutions in Bangladesh

Type of Financial Institution	Number of Institutions
Non-Bank Financial Institutions	28
State-owned Commercial Banks	4
Specialised and Development Banks	11
Private Commercial Banks	26
Islamic Private Commercial Banks	02
Foreign Commercial Banks	10

Source: Sobhan and Wendy (2003).

Table 2.10

Dhaka Stock Exchange Select Statistics

	1999	2000	2001	2002
No. of Listed Companies	221	230	231	239
Market Capitalisation ($ Mill)	870	1,165	1,176	1,184
Market Cap as % of GDP	2.04%	2.65%	2.52%	
DSE All Share Price Index	647.95	853.75	829.61	848.41

Source: Sobhan and Wendy (2003).

2.7. Summary and Conclusion

The issue of corporate governance is important for developing countries because it is central to financial and economic development of a country. Pakistan has develop good corporate governance laws but with poor implementation of these laws together with political instability that adversely affect corporate governance. Code of corporate governance is issued by SECP in March 2002. The adoption of the Corporate Governance Code has improved the overall corporate structure and business environment. The quality of disclosure has improved over last four years due to increasing monitoring role of the SECP and the requirement of code.

In Pakistan the main owners are local family-controlled business groups and the families behind them, the state, and the affiliates of multinational corporations. Ownership is very concentrated in the few hands of large families. These families control ownership shares through pyramids and tunnelling. Business groups have lower transparency and weaker corporate governance mechanism. Pyramid ownership structures make it possible to control some firms even with a very small share of their total capital. The basic shareholders rights are protected in Pakistan at least laws in book. The registration is secure and dematerialised through Central Depository Committee (CDC).

Chapter 3: DETERMINANTS OF CORPORATE GOVERNANCE

3.1. Introduction

In the developed markets the subject of corporate governance is well explored as a significant focus of economics and finance research but there is also a growing interest across emerging markets in this area. In Pakistan, the publication of the Corporate Governance Code 2002 by SECP for publicly listed companies has made it an important area of research of corporate sector.

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. A corporate governance system defines who owns the firm, and dictates the rules by which economic returns are distributed among shareholders, employees, managers, and other stakeholders. As such, a county's corporate governance regime has deep implications for firm organisation, employment systems, trading relationships, and capital markets. Thus, changes in Pakistani system of corporate governance are likely to have important consequences for the structure and conduct of country business.

The plan of the chapter is as follows. Section briefly reviews the literature in this area. The measurement of corporate governance index and its sub-indices is presented in Section 3. The Section 4 examines the determinants of corporate governance in case of Pakistan equity market. Last section concludes the study.

3.2. Review of Previous Literature

The assessment of the corporate governance for developed markets is well researched area. Studies have shown that good governance practices have led the significant increase in the economic value added of firms, higher productivity and lower risk of systematic financial failure for countries. It has now become an important area of research in emerging markets as well.

For US Firms a broad measure of Corporate Governance Gov-Score is prepared by Brown and Caylor (2004) with 51 factors, 8 sub categories for 2327 firms based on dataset of Institutional Shareholder Service (ISS). Their findings indicate that better governed firms are relatively more profitable, more valuable and pay more cash to their shareholders. Gompers, Ishii and Metrick (2003) use Investor Responsibility Research Centre (IRRC) data, and conclude that firms with fewer shareholder rights have lower firm valuations and lower stock returns. They classify 24 governance factors into five groups: tactics for delaying hostile takeover, voting rights, director/officer protection, other takeover defenses, and state laws. Most of these factors are anti-takeover measures so G-Index is effectively an index of anti-takeover protection rather than a broad index of governance. Their findings show that firms with stronger shareholders rights have higher firm value, higher profits, higher sales growth, lowest capital expenditures, and made fewer corporate acquisitions.

In past few years corporate governance has become an important area of research in Pakistan. Cheema, *et al.* (2003) suggests that corporate governance can play a significant role for Pakistan to attract foreign direct investment and mobilise greater saving through capital provided the corporate governance system is compatible with the objective of raising external equity capital through capital markets. The corporate structure of Pakistan is characterised as concentrated family control, interlocking directorships, cross-shareholdings and pyramid structures. The concern is that reforms whose main objective is minority shareholder protection may dampen profit maximising incentives for families without providing offsetting benefits in the form of equally efficient monitoring by minority shareholders. If this happens the reform may end up creating sub optimal incentives for profit maximisation by families. They argue that a crucial challenge for policy-makers is to optimise the dual objectives of minority shareholder protection and the maintenance of profit-maximising incentives for family controllers. There is a need for progressive corporations to take a lead in the corporate governance reform effort as well.

Rais and Saeed (2005) analyse the Corporate Governance Code 2002 in the light of Regulatory Impact Assessment (RIA) framework and its enforcement and application in Pakistan in order to understand the dynamics of public decision making and assess the efficacy of the regulation policy of SECP in the arena of corporate governance. The analysis shows that though the listed companies are gearing themselves up to adopt the Code, there are some

constraints, and reservations about the way it was drafted and implemented. The study by Ghani, *et al*. (2002) examines business groups and their impact on corporate governance in Pakistan for non-financial firms listed on the Karachi Stock Exchange of Pakistan for 1998-2002. Their evidence indicates that investors view the business-group as a mechanism to expropriate minority shareholders. On the other hand, the comparative financial performance results suggest that business groups in Pakistan are efficient economic arrangements that substitute for missing or inefficient outside institutions and markets. The study by Ashraf and Ghani (2005) examines the origins, growth, and the development of accounting practices and disclosures in Pakistan and the factors that influenced them. They document that lack of investor protection (e.g., minority rights protection, insider trading protection), judicial inefficiencies, and weak enforcement mechanisms are more critical factors than are cultural factors in explaining the state of accounting in Pakistan. They conclude that it is the enforcement mechanisms that are paramount in improving the quality of accounting in developing economies.

Mir and Nishat (2004) and Shaheen and Nishat have done rating of corporate governance based on annual reports and survey data respectively for the year 2004 and relate this governance score with firm value. Javid and Iqbal (2007) used panel data from annual reports for 2003 to 2006 to measure factors of corporate governance. All these studies come to the conclusion that better governance practices increase the value of the firm. The International Financial Corporation (IFC), SECP and Institute of Corporate Governance, Karachi undertook a survey to awareness the corporate governance for the year 2006.

There is an increasing interest in analysing affect of corporate governance on stock market in Pakistan but many issues in this area are uncovered. In particular, firm-level corporate governance rating and its affect on the corporate valuation, corporate ownership and corporate financing are central issues of this area which needs in depth research. It is in this perspective this study aims to make contribution in the literature on corporate governance.

3.3. Corporate Governance Index

It is expected that better corporate governance is correlated with better operating performance and higher market valuation in case of KSE listed firms. 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,[8] these indicators are categorised into three main themes. The three categories or sub-indices consist of: eight factors for the board

[8]The list of these variables is given in the Appendix. Table A2.

composition and independence index seven for ownership, shareholdings and seven for transparency, disclosure and audit.

The weighting is in the construction of index 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.[9] The average is taken out to arrive at the rating of one sub-index. By taking the average of three sub-indices we obtain CGI for a particular firm.

Each sub-index comprises of series of factors leading to measure corporate governance. Board composition index captures board autonomy, structure and effectiveness. Autonomy is measured through various indicators of board independence including percentage of nominees, outside and independent directors on board, separation of CEO and chairman, a separate CFO (Corporate Financial Officer). The various measures of board effectiveness are chair CEO split, regularity of meetings, and attendance by outside board members, and creditor's nominee on board. The separation of role of CEO and chair dilutes the power of CEO and increases board's ability to properly execute the oversight judgment. It also critically evaluates executive directors and the presence of non-executive member on board reduces the influence of management on the board. Moreover a higher proportion of outside directors[10] on the board lead to higher company performance. The CEO may find a smaller board more easily dominated and more manageable due to the potential for social cohesion [Shaw (1981)]. A large group of directors would require more time and effort on the part of CEO to build census for a given course of action. Therefore if the board is large, its independence is increased in the sense that the CEO's ability to influence is diluted and it is more difficult for the CEO to dominate the board. There is also some evidence in favour of larger boards. Chaganli, Mahajam and Sharma (1983) have studied the relationship between board size and bankruptcy and have found that non-failed firms in their sample, tended to have larger boards then the failed firms. Thus larger boards may be more independent of management and that is the reason that the larger boards are associated with higher performance.

The ownership and shareholdings is the second aspect of corporate governance. The purpose of this sub-index is to measure the degree to which the board and managers have incentives that align their interest with those of shareholders. The third sub-index deals with disclosures. It attempts to measure the public commitment of the firm to good governance. Components following

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[9]This is based on the report of World Bank, Report on the Observance of Standards and Code (ROSC), Corporate Governance Country Assessment: Pakistan, June 2005.

[10]Any member of a company's board of directors, who is not an employee or shareholder in the company.

full disclosure of corporate governance practices, directors' bibliography, and internal audit committee reduce information asymmetry and it is valued by investor [Klein, *et al.* (2005)].

3.4. Determinants of Corporate Governance

The purpose is to assess the factors that determine the corporate governance practices adopted by firms. It is expected that in case of Pakistan, variables such as concentration of ownership, need of external finance, profitable investment opportunities, and size of the firm are related to the firm's decision to comply with the code of corporate governance. Ownership concentration is a substitute of weak investor protection [La Porta, *et al.* (1999)]. The more the concentration of ownership and larger the cash flow rights of large shareholders, the more is entrenched and more the large owners influence the decision-making process [Drobetz, Schillhofer, and Zimmerman (2004)]. The concentration of ownership is negatively related to quality of corporate governance practices. In some firms the entrepreneur founders who used their own resources and retained earnings to finance their firms and have significant ownership stakes in the listed firms. This issue is addressed by using ownership concentration by top five largest shareholders. The firms with greater need of external financing practice high quality governance [Durnev and Kim (2006); Rajan and Zingales (1998)]. It is expected that there is negative association between ownership concentration and corporate governance and positive relation between external financing needs and quality of corporate governance. Further, in countries with weak legal regimes firms have difficulty in raising external finance due to investors' lack of trust in legal protection of their rights [La Porta, *et al.* (1998)]. In this study the significance of rule of law as determinant of corporate governance is analyzed. To assess influence of legal environment across the firm, this variable is introduced in interaction terms. To test the hypothesis that the quality of corporate governance is positively related to growth in investment opportunities, and negatively to concentration of ownership the model suggested by Dunev and Kim (2006) is estimated:

$$CGI_i = \boldsymbol{a} + \boldsymbol{b}_1 EF_i + \boldsymbol{b}_2 Own_i + \boldsymbol{b}_3 Inv_i + \boldsymbol{b}_4 Size_i + \boldsymbol{b}_5 Lw_i * EF_i + \boldsymbol{b}_6 Lw_i * Own_i + \boldsymbol{e}_{it} \quad \ldots \quad (3.1)$$

Where CGL_i is a vector of corporate governance index, Own_t is the concentration of ownership held by top five shareholders, EF_i is external finance that is calculated by multiplying market capitalisation of each firm with percentage of shares that are not taken by the top five shareholders of each firm, Inv_i is investment opportunities measured by the past growth in sales, Lw_i is rule of law that is used for the proxy of enforcement of law, and $Size_i$ is measured by the log of total asset. ε_i is random error term.

The model (3.1) develops the linkage between corporate governance and ownership concentration, need of external finance, quality of enforcement of law and other firm specific variables and interaction terms [Durnev and Kim (2006)]. In the set of control variables which include size (natural logarithm of assets) and investment opportunities (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 (long term debt/total assets) controls for different risk characteristics of firm. Ownership concentration is expected to improve investor protection. In case of family ownership the entrepreneur have significant ownership stakes in the listed firms and use their own resources and retained earning to finance their firms, to capture concentration of ownership the percentage of ownership by top five largest shareholders is used.

A growing firm with large need of external financing has more incentive to adopt better governance practices in an attempt to lower cost of capital [Klapper and Love (2003) and Gompers, *et al.* (2003)]. The firms with more need of external finance would be more likely to choose better governance structure because firm's insiders believe that better governance structure will further raise firm value they adopt good governance to signal that insider behave well and they can easily excess to external finances.

3.5. Estimation Technique

The panel data estimation technique is used because by pooling cross-section and time series the sample size increases. The panel data take account of the endogenity and control for the firm specific effects. The Generalised Method of Moments is also used suggested by Georgen, *et al.* (2005). To obtain consistent estimates, the model is first differenced to estimate the fixed effects, then all right hand side variables in lag are used as instruments and thus eliminating inconsistency arising from endogenity [Arellano and Bond (1991)]. The consistency of GMM model depends on the validity of both of both the instruments and the assumption that the error terms do not exhibit serial correlation. Therefore two specification tests, Sargan test of over-identifying restriction and test that error term is not serially correlated are performed. The failure to reject the null hypothesis in both tests gives support to GMM model [Arellano and Bond (1991)]. The following equation describes the relationship:

$$Y_{it} = \alpha + \beta X_{it} + \mu_{it} \quad \ldots \quad \ldots \quad \ldots \quad \ldots \quad \ldots \quad (3.2)$$

Where Y and X have both i and t subscripts for i =1.2, N firms and t = 1, 2,…T time period. Y_{it} represent the dependent variable in the model, X_{it} contain set of explanatory variables. The previous empirical studies suggest that the Generalised Method of Moment (GMM) is more suitable method [Arellano and Bonds (1991)]. The lagged dependent variable is most likely to be correlated

with the firm specific effect and estimates using ordinary least square method (OLS) provided inconsistent and biased estimates. To get the consistent estimation, the model is first difference to estimate the fixed effect and then we use the instruments on the right hand side variable using their lagged values to estimate the inconsistency which can be arising from endogenity of the regressors.

For panel data we have six years of data and 60 firms of Karachi Stock Exchange (KSE). The Arellano and Bonds (1991) suggest that the estimation from GMM is first difference; which removes the time invariant μ_i and leave the equations automatable by instrument as described by the following equation:

$$Y_{it} - Y_{it-1} = a + (y_{it} - y_{it-2}) + ß\,(x_{it} - x_{it-1}) + (\mu_i - \mu_i) + (v_{it} - v_{it-1}) \qquad \ldots \quad (3.3)$$

Which leads us to assume that there is no serial correlation in the disturbance term e_{it} and all the lagged level of variables can be used as valid instruments in the first difference equation.

3.6. Empirical Findings

The model (3.1) develops the linkage between corporate governance and ownership concentration, need of external finance, quality of enforcement of law and other firm specific variables and interaction terms [Durnev and Kim (2006)]. Table 3.1 presents the summary statistics of total corporate governance index CGI_i and its sub-indices, which are Board Composition ($Board_i$), Ownership and Shareholdings ($Share_i$) and Disclosure, Transparency and auditing ($Disc_i$).

Table 3.1

Summary Statistics of Corporate Governance Index

	Mean	Max	Min	SD	CGI	Board	Rights	Disc
CGI	54.30	70.42	30.89	7.99	1.00			
Board	55.58	87.50	25.00	16.02	0.62	1.00		
Share	46.97	78.57	7.14	16.10	0.57	0.11	1.00	
Disc	60.36	94.29	30.00	10.93	0.44	0.05	0.06	1.00

This Table 3.1 provides the summary statistics of distribution of Corporate Governance index, and the sub-indices (Board, Shareholdings and Disclosure). This table also presents the pair-wise correlation between the indices. Appendix A gives detailed information on each sub-index. The maximum score is 100, which is assigned if indicator is observed, 80 if largely observed 50 for partially observed and 0 if it is not observed. The total index consist of governance proxies in three sub-categories and is constructed using the equal weighting scheme. The average rating of CGI is 54.30 and it ranges

from 70.42 to 30.89. The sub-index with highest rating is Disc (Disclosure, Transparency and Auditing), which can be explained by the fact that this area is emphasised by regulations of SECP.

To investigate the determinants of corporate governance due to multicollenearity in ownership concentration and external finance firm corporate governance score is regressed on two set of determinants and results are reported in Table 3.2. One set includes concentration of ownership and control variable and other determinants include external finance plus control variables. Ownership structure shows negative and significant relationship with CGI and Disclosure scores however, when use interaction term of own with law the result shows no impact of legal environment. This suggests that weakness of investment protection and absence of corporate control firms rely on governance structure that is dominated by high concentration of ownership. The firm with concentrated ownership there is no reason to expect firms to disclose more. The inclusion of disclosure and transparency scores and other attributes are included in CGI scores also and they are not directly related to agency problem. In addition, this result indicates that negative relationship between corporate governance and ownership concentration is strong with weak legal regime. The Dunev and Kim (2006) have come up with same finding in case of US market.

Table 3.2

Evidence on Determinants of Corporate Governance

	Determinants of CGI		Determinants of Board		Determinants of Shareholdings		Determinants of Disclosure	
EF	0.16**		0.63**		0.20***		0.29***	
	(1.92)		(1.62)		(1.57)		(1.53)	
Own		–1.34**		–0.30***		–0.23*		–0.29
		(–1.89)		(–1.47)		(–2.44)		(–1.33)
Inv	0.05**	0.01***	0.12**	0.03**	0.11**	0.11**	0.13**	0.04***
	(1.76)	(1.57)	(1.69)	(1.52)	(1.84)	(1.82)	(1.64)	(1.58)
SIZE	0.56***	0.69**	0.62***	0.12**	0.29***	0.29**	0.18***	0.16**
	(1.54)	(1.82)	(1.47)	(1.48)	(1.67)	(1.92)	(1.43)	(1.85)
Lev	0.14**		0.05**		0.31***	0.35**	0.23***	0.17***
	(1.92)		(1.71)		(1.67)	(1.56)	(1.46)	(1.52)
*LAW*OWN*		0.12		0.17		0.11		0.25
		(1.11)		(0.11)		(0.61)		(0.83)
*LAW*EF*	0.001		0.01		0.004		0.02	
	(0.56)		(0.89)		(1.02)		(1.11)	
Constant	–0.27	0.48	0.42	1.11	–0.23	–0.14		
	(–0.31)	(1.27)	(0.27)	(1.02)	(–0.07)	(–0.71)		
R2	0.31	0.31	0.29	0.30	0.30	0.29	0.30	0.31

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

The results show positive association between need of external finance and corporate governance quality, because good practices are signal that insiders are adopting good practices. As a result the value of firm is higher and

entrepreneur can get easy and less costly access to external finance [Pistor, *et al.* (2003)]. The positive sign of the coefficient of size shows that large firms show better governance. Investment opportunities have positive impact both CGI and Disclosure scores. This confirms the theoretical notion that firms with better investment opportunities perform better corporate governance practice. The interaction terms of legal regime with external financing show positive and insignificant relationship with CGI and Disclosure scores which suggests that in legal environment which is less investor friendly firm specific factors matters more in choice of corporate governance practices.

3.7. Summary and Conclusion

The corporate governance index and disclosure and transparency index are used which are developed using the information from the annual reports of the companies. 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 categorised into three main themes. The three categories or sub-indices consist of: eight factors for the board composition and independence, seven for ownership, shareholdings and seven for transparency, disclosure and audit.

The sample firm consists of 00 firms which are active, representative of all non-financial sectors and comprises more than 90 percent of market capitalisation at Karachi stock market. In this Chapter, we presented a simple model of determinants of corporate governance. Our result shows that the strength of corporate governance systems is affected by the concentration of ownership, external financing needs of corporations, size, investment opportunities of the firm. Thus with good corporate governance standards in place; it is ultimately the financial market which rewards good governance practices and punishes bad governance. The results show that firms with high growth and large in size are in more need of external finance adopt better governance practices and are more transparent. The firms with more concentrated ownership do not follow the good quality governance and disclose less. The law does not matter in adopting good practices. Our results also generally confirm the prediction of the theory that enforcement of law does not matter in investment growth and ownership structure in weak legal regime countries like Pakistan. Thus legal protection is essential for effective corporate governance. Our results adds an important link to the explanation of the consequences weak legal environment for financial market development, external financing, corporate valuation and corporate governance.

Chapter 4: CORPORATE GOVERNANCE AND CORPORATE VALUATION

4.1. Introduction

Corporate governance is the means by which minority share holders are protected from the expropriation of the managers or controlling shareholders. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. In emerging markets good corporate governance serves a number of public policy objectives. It reduces vulnerability of the financial crises, reinforces property rights; reduces transaction cost and cost of capital and leads to capital market development. Corporate governance concerns the relationship among the management, board of directors, controlling shareholders, minority shareholders and other stakeholders.

The better corporate governance leads to better firm performance by protecting the rights of outside investors from the expropriation of controlling shareholders. In Pakistan, with traditionally low dispersion of ownership, the primary methods to solve agency problems are the legal protection of minority investors, the use of boards as monitors of senior management, and an active market for corporate control. In contrast to developed markets in Pakistan corporate governance is characterised by lesser reliance on capital markets and outside investors, but stronger reliance on large inside investors and financial institutions to achieve efficiency in the corporate sector. In this case, outside (smaller) investors face the risk of expropriation in the form of wealth transfers to larger shareholders.

The main focus of this chapter is to examine the relationship between corporate governance and firm performance for publicly listed Karachi Stock Exchange (KSE) firms. In the firm level corporate governance characteristics we considered board composition and effectiveness, ownership and shareholding rights, auditing, transparency and disclosure quality. They are summarised in an aggregate corporate governance index (CGI) which is computed as sum of three indices. It is only investigated whether corporate governance broadly defined affect firm performance, but identify whether some corporate governance factors are more important than other corporate governance indices and firm value which is measured by Tobin Q, ROA and ROE with corporate governance practices adopted by these firms.

This study extends our earlier work [Javid and Iqbal (2007)] in several ways: by updating the data, adding more variables and using panel data estimation technique. It contributes to the emerging literature in Pakistan relating indices of corporate governance to firm level performance which is measured by Tobin Q (which is market performance measure and captures market penetration) and return on assets and return on equity (accounting

performance measures). This study adds to existing literature by applying the relevance of law for corporate governance in Pakistan and emphasises that beyond the law on book, law enforcement must be credible [La Porta, *et al.* (1999); Pistor, *et al.* (2000)].

The plan of the chapter is as follows. The review of empirical findings of previous research is presented in Section 2. Section 3 briefly reviews the corporate governance policy framework of Pakistan. Section 4 provides methodological framework and a description of the data. The results for the relationship between corporate governance and firm valuation are presented in Section 5 and last section concludes.

4.2. Review of Previous Literature

"In the new and evolving international environment with a large private sector and global integration of world capital markets, corporate governance has become the prominent topic of institutional reform. For governments, encouraging better corporate governance practices in policy making enables firms to raise more domestic as well as foreign capital. For firms, an efficient market will differentiate between the firms that embrace best corporate governance practices and those who find corporate governance a distraction. Therefore firms attempting to drive their competitiveness and reduce the cost of capital will adopt best corporate governance practices. For investors, corporate governance will be put on par with financial indicators when evaluating investment decisions because corporate governance has a significant impact on equity performance and risk", FTSE (2005).

La Porta, *et al.* (1999) have shown that, for the 20 largest listed companies in 27 wealthy, industrialised countries, 36 percent are widely held, 30 percent remain family controlled, and 18 percent are state-controlled, using a 20 percent direct plus indirect ownership measure.

"There are three general corporate governance models based on ownership: the separation of company ownership and control because shareholding is widely dispersed; a dominant owner who exercises control and appoints management; and an intermediate case where a large shareholder (a blockholder in the terminology) has veto power over major management decisions. Shareholder control may be achieved through majority ownership, or indirectly through the pyramiding of share ownership through affiliated companies that are part of the (family-controlled) business group.

In Korea, Indonesia, Thailand, and indeed most developing economies there is no separation of ownership and control; owners control their companies even when they are listed. The United States, United Kingdom and Japan are cases where, for most companies, shareholding is widely distributed, with no dominant blockholders. Even so, the US and the UK's degree of emphasis on shareholder value and external market disciplines are at the other extreme from

the Japanese case. The continental European corporate governance systems are significantly different in some respects from the market-oriented Anglo-American model. Each European country has its own distinct laws, institutions and norms. Corporate governance in Germany and Japan are often compared since both have relied heavily on relationship banking and monitoring by major bank creditors, in contrast to the greater reliance on capital market finance in the US and UK", Patrick (2001).

"In recent years, there has been significant effort to understand the agency conflicts among the different agents related to the firm and the effectiveness of the internal and external control mechanisms in inducing managerial value-enhancing actions. These controls traditionally have been classified as internal or external. A recent group of studies in the area of corporate governance recognise the possible existence of interactions among the different control mechanisms. In this sense, Williamson (1983) states the substitution hypothesis between internal and external control mechanisms, according to that, when the takeover market is weak, as in the case of the Spanish market, there is a greater role for internal control mechanisms. The alternative control mechanisms are grouped forming the corporate governance system. Traditionally these systems have been classified as external (market oriented) and internal (network oriented). The external systems, dominant in Anglo-Saxon economies, are based on the control exerted by the markets. These systems are characterised by the existence of a highly developed and liquid capital market, with a high amount of listed companies.

The Spanish economy is characterised by a low proportion of listed companies compared to the US or the UK. Moreover, the stock ownership is highly concentrated in the hands of non-financial companies, financial institutions and families. This lower development of the financial markets and the stability and concentration of stock ownership suggests that the Spanish corporate governance system is an internal one based on the board of directors and the supervisory role of large shareholders", Fernandez and Arrondo (2005).

There is a large of body of empirical research that has assessed the impact of corporate governance on firm performance for the developed markets [Anderson and Reeb (2004); Bahjat and Black (1999, 2001); Black, *et al.* (2003); Bradley (2004); Drobetz, *et al.* (2004); Durnev and Kim (2005); Roe, *et al.* (1996); Gompers, *et al.* (2003) and numerous others]. These studies have shown that good governance practices have led the significant increase in the economic value added of firms, higher productivity and lower risk of systematic financial failure for countries. The studies by Shleifer and Vishny (1997) and Hermalin and Weisbach (2003) provide an excellent literature review in this area. It has now become an important area of research in emerging markets as well [Klapper and Love (2003); Javid and Iqbal (2006) and Mir and Nishat (2004)].

There are some empirical studies that analyse the impact of different corporate governance practices in the cross-section of countries. A noteworthy study in this regard is done by Mitton (2001) find the firm-level differences in variables are related to corporate governance has strong impact on firm performance during East Asian Crisis in Korean, Malaysian, Indonesian, Philippines and Thailand. The results suggests that better price performance is associated with firms that have indicators of higher disclosure quality, with firms that have higher outside ownership concentration and with firms that are focused rather than diversified.

Most of the empirical work for exploring possible relationship between corporate governance and firm performance is done for developed markets. For US Firms a broad measure of Corporate Governance Gov-Score is prepared by Brown and Caylor (2004) and their findings indicate that better governed firms are relatively more profitable, more valuable and pay more cash to their shareholders. Gompers, *et al.* (2003) show that firms with stronger shareholders rights have higher firm value, higher profits, higher sales growth, lowest capital expenditures, and made fewer corporate acquisitions.

It is expected that limiting board size is to improve firm performance because the benefits by larger boards of increased monitoring are outweighed by the poorer communication and decision-making of larger groups [Lipton and Lorsch (1992) and Jensen (1993)]. The study by Yermack (1996) provides an inverse relation between board size and profitability, asset utilisation, and Tobin's Q which conform this hypothesis. Anderson, *et al*. (2004) come to conclusion that the cost of debt is lower for larger boards, because creditors believe these firms are having more effective monitors of their financial accounting processes. Brown and Caylor (2004) find that firms with board sizes of between six and 15 have higher returns on equity and higher net profit margins than do firms with other board sizes.

The relation between the proportion of outside directors, a proxy for board independence, and firm performance is inconclusive. Fosberg (1989), Weisbach (1991) and Bhagat and Black (2002) find no relation between the proportion of outsider directors and various performance measures. Baysinger and Butler (1985) and Rosenstein and Wyatt (1990) on the other hand show that the market rewards firms for appointing outside directors; Brickley, *et al.* (1994) find a positive relation between the proportion of outsider directors and the stock market reaction to poison pill adoptions; and Anderson *et al.* (2004) show that the cost of debt, as proxied by bond yield spreads, is inversely related to board independence. The studies that using financial statement data and Tobin's Q find no link between board independence and firm performance, while those using stock returns data or bond yield data find a positive link [Hermalin and Weisbach (1991) and Bhagat and Black (2002)]. Brown and Caylor (2004) do not find Tobin's Q to increase in board independence, but they do find that firms

with independent boards have higher returns on equity, higher profit margins, larger dividend yields, and larger stock repurchases, suggesting that board independence is associated with other important measures of firm performance aside from Tobin's Q.

The evidence on the association between audit-related governance factors and firm performance is mixed. Brown and Caylor (2004) show that independent audit committees are positively related to dividend yield, but not to operating performance or firm valuation. Klein (2002) documents a negative relation between earnings management and audit committee independence, and Anderson, *et al.* (2004) find that entirely independent audit committees have lower debt financing costs.

The separation of CEO and chairman affects firms' performance because the agency problems are higher when the same person holds both positions. Yermack (1996) shows that firms are more valuable, when the CEO and board chair positions are separated. Core, *et al.* (1999) finds that CEO compensation is lower when the CEO and board chair positions are separate. Brown and Caylor (2004) conclude that firms are more valuable when the CEO and board chair positions are separate.

In past few years corporate governance has become an important area of research in Pakistan. Mir and Nishat (2004); Shaheen and Nishat (2004) empirically test the link between corporate governance structure and firm performance for Pakistan using one year cross firm data and find a positive relation between governance and firm performance measures. Javid and Iqbal use panel data analysis and document a positive and significant association between the quality of firm-level corporate governance and firm performance for the period 2003 to 2006.

There is an increasing interest in analysing affect of corporate governance on stock market in Pakistan but many issues in this area are uncovered. In particular, the firm-level corporate governance rating and its affect on the valuation of the firm, which is central issue of this area needs in depth research. It is in this perspective this chapter aims to make contribution in the literature on corporate governance.

4.3. Data and Methodological Framework

4.3.1. *Data*

To asses the relationship corporate governance and firm valuation at firm level, data of 60 non-financial firms listed on Karachi Stock Exchange is used.[11] The data set is obtained from the annual reports of these firms for the year 2003 to 2008. Data on rule of law has been taken from World Bank governance

[11] List of companies is provided in Appendix Table A1.

indicators. The ranking of rule of law as ranging from 0 to 1 for Pakistan is 0.34 as average of five years. That indicates very poor legal environment for Pakistan in term of enforcement of law.[12]

The Corporate Governance index and sub-indices are developed in Chapter 3. The size is defined as natural logarithm of total asset and growth of sales is taken as investment opportunities. The leverage is defined as ratio of book value of long term debt to book value of total asset. The data of all these variables are obtained from the annual reports of the listed firms in the sample. The panel data models are used and GMM is adopted as estimation technique discussed in Chapter 3.

4.3.2. *Empirical Methodology*

It is well established that country's laws of corporate governance affect firm value.[13] The objective is to examine whether variation in firm-specific governance is associated with differences in firm value, when they have different characteristics (size, investment opportunities and leverage) and doing business in poor legal environment.[14] To explore the relationship between corporate governance and firm valuation: Tobin's Q, return on assets, return on equity and dividend pay-out ratio. To test the hypothesis that the firms with good corporate governance practices are valued higher, the model proposed by Black, *et al.* (2003) is used which is as follows:

$$Perf_i = \alpha + \beta_1 CGI_i + \beta_2 Inv_i + \beta_3 Lev_i + \beta_4 Size + \beta_5 Lw_i * CGI_i + \varepsilon_{it} \qquad (4.1)$$

Where $Pref_i$ is performance measure Tobin's, D/P_i, ROA_i and ROE_i are used to measure firm performance, CGI_i is a vector of corporate governance index, Inv_i is investment opportunities measured by the past growth in sales, Lw_i is rule of law that is used for the proxy of enforcement of law, and $Size_i$ is measured by the log of total asset. ε_i is random error term. It is expected that firms that are adopting better governance practices with better investment opportunities and larger is size should have higher valuation.

In exploring that good corporate governance cause higher firm valuation, an important issue is endogenity [Black, *et al.* (2003) and others]. The firms with higher market value would be more likely to choose better governance structure because the firm's insiders believe that better governance structure will

[12]Although as Pakistan belongs to common law countries legal origin. In view of La Porta, *et al.* (1997) common law countries provide strong investor protection in term of law on books. The ranking of rule of law indicate the fact that enforcement of law is very low against high ranking on law on books.

[13]La Porta, *et al.* (2002) show that firm value is positively associated with the rights of minority shareholders. Daines (2001) finds that firms incorporated in Delaware have higher valuations than other U.S. firms.

[14]As indicated by the ranking of rule of law by World Bank.

further raise firm value. In addition, the firms adopt good governance to signal that insiders are doing well to raise the firm value. A growing firm with large need of external financing has more incentive to adopt better governance practices in an attempt to lower cost of capital [Klapper and Love (2003) and Gompers, *et al.* (2003)]. These investment opportunities are reflected in the valuation of the firm, implying a positive association between governance and firm performance. Therefore, in estimating governance-performance relation the panel data estimation technique is used to control for endogenity.

To deal with issue a set of control variables is included following Kaplan and Zingales, (1997); Black, *et al.*, (2003) and Klein, *et al.* (2005). The firm performance is regressed on corporate governance indices and other 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 investment opportunities (growth rate of sales) are used in estimation. Firm size and investment opportunities control for potential advantages of scale and scope, market power and market opportunities. The leverage controls for different risk characteristics of firm.

4.4. Empirical Findings

To investigate whether differences in the quality of firm level corporate governance also help to explain firm level difference in performance, we regress firm performance measures on index of corporate governance (CGI_i) and control variables The firm's performance is measured by Tobin Q, ROA, ROE and D/P and the results are reported in Tables 4.1, 4.2, and 4.3. The results of association between corporate governance indices and Tobin Q are presented in Table 4.1. The Tobin Q is regressed on the total corporate governance index CGI_i with each sub-index add one by one along with set of control variables There is positive and significant relationship between CGI_i and Tobin's Q supporting our hypothesis that corporate governance affects firm value. The CGI_i remains positive but significance level reduces with adding more explanatory variables. This shows that the inclusion of firm characteristics have improved the specification of the model. Therefore we find 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 in firm characteristics matters to investor in valuing firm. This result is also conformed by several studies for developing markets as well as developed markets [La Porta, *et al.* (2002) and Drobetz, *et al.* (2004)]. The financial control variables are for the most part statistically significant. Investment opportunities have positive impact aggregate corporate governance index and sub-indices. This confirms the theoretical notion that firms with better investment opportunities perform better corporate governance

practice. The firm size has positive and significant association with firm performance. The leverage is positively and significantly related to firm performance. The interaction terms of legal environment with corporate governance show positive and insignificant relationship with Tobin Q which suggests that in legal environment which is less investor friendly firm specific factors matters more in choice of corporate governance practices.

The results based on total corporate governance suggest that corporate governance does matter in Pakistani stock market. However these findings do not fully reveal the importance of each category of corporate governance to firm performance. The results regarding relationship of firm value with three sub-indices and all control variables. These results indicate that two sub-indices except disclosure have positive and some significant impact on firm performance. The board composition and ownership and shareholdings have some significant influence on firm performance. However investors are not willing to pay a premium for companies that are engaged in open and full disclosure. The results based on sub-indices reveal importance of board composition, ownership and shareholdings with firm performance and this evidence is also supported by other studies [Klein, *et al.* (2005)].

The board composition index has a positive and statistically significant effect on firm performance and when entered in model with other sub-indices it remains positive but become insignificant but coefficient of determination has improved. This past evidence generally failed to find any clear relation between board composition and firm performance. The survey of literature concludes that the evidence on this matter is ambiguous [Bahjat and Black (1999, 2000) and Hermalian and Weisbach (2003)]. The ownership and shareholdings sub-index has a positive effect on Tobin Q when it is entered into model alone however, when include with other sub-indices but this effect is turned insignificant. These results show that most of the firms have ownership with dominant block holder or have ownership concentration and in block holder firm board independence is not associated with good performance. The assumption of agency theory does not fully apply to these firms where the alignment of ownership and control is tighter thus suggesting the need of outside directors on the board of these firms. As control variables are included specification of model improves.

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 investment opportunities 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 [Rajan and Zingales (1998)].

The interaction terms of legal environment with corporate governance sub indices show positive and insignificant relationship with firm performance indicating that in weak legal regime the firm chose to adopt better governance practices.

Table 4.1

Evidence on Corporate Governance and Firm Performance (Tobin Q)

Variables	Model 1	Model 2	Model 3	Model 4	Model 5
CGI	0.03**				
	(1.97)				
Board		0.01*			0.02*
		(5.04)			(2.06)
$Share_1$			0.04**		0.01
			(3.14)		(1.41)
DIS				0.04	0.01
				(0.18)	(0.18)
INV	0.03**	0.02*	0.003*	0.003	0.002*
	(1.98)	(2.04)	(3.51)	(2.36)	(2.15)
SIZE	0.05*	0.04*	0.04*	0.05*	0.04*
	(5.27)	(4.46)	(3.85)	(4.20)	(3.05)
Lev	0.06*	0.06*	0.04*	0.06	0.06*
	(3.70)	(4.00)	(2.16)	(4.06)	(2.09)
LAW*CGI	0.003	0.05	0.01	0.02	0.001
	(0.06)	(0.71)	(0.91)	(0.99)	(0.01)
Constant	–0.07	–0.15	0.04	–0.15	–0.06
	(–0.37)	(–0.23)	(0.18)	(–0.79)	(–0.80)
R2	0.29	0.28	0.28	0.29	0.30

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

Table 4.2

Evidence on Corporate Governance and Firm Performance (ROA)

Variables	Model 1	Model 2	Model 3	Model 4	Model 5
CGI	0.39**				
	(1.52)				
Board		0.13*			0.21**
		(2.00)			(1.84)
$Share_1$			0.01		0.13***
			(1.23)		(1.52)
DIS				0.23*	0.06
				(2.71)	(1.26)
INV	0.02**	0.02***	0.01**	0.03*	0.0***
	(1.39)	(1.46)	(1.32)	(2.36)	(1.38)
SIZE	0.26*	0.29*	0.27*	0.28*	0.28***
	(6.62)	(6.29)	(5.26)	(2.85)	(1.69)
Lev	0.33*	0.33*	0.33*	0.31*	0.06*
	(5.31)	(4.26)	(3.26)	(4.88)	(2.09)
LAW*CGI	–0.11	–0.42*	–0.03	0.44*	–0.10
	(–0.51)	(–1.11)	(–0.08)	(1.26)	(0.46)
Constant	0.26	0.22	0.31	0.71	–0.06
	(0.33)	(0.29)	(0.40)	(0.91)	(–0.80)
R2	0.29	0.29	0.28	0.27	0.31

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

Table 4.3

Evidence on Corporate Governance and Firm Performance (D/P)

Variables	Model 1	Model 2	Model 3	Model 4	Model 5
CGI	0.01**				
	(1.64)				
Board		0.02*			0.01
		(2.06)			(1.13)
$Share_1$			0.01		0.01
			(1.41)		(1.37)
DIS				0.01*	0.02
				(2.44)	(0.51)
INV	0.22**	0.22**	0.17***	0.12***	0.01**
	(1.96)	(1.88)	(1.65)	(1.59)	(1.84)
SIZE	0.03*	0.04***	0.02***	0.02	0.01*
	(2.02)	(1.38)	(1.40)	(0.91)	(2.05)
Lev	0.02**	0.06*	0.03**	0.01**	0.02*
	(1.90)	(2.02)	(1.83)	(1.84)	(2.72)
LAW*CGI	0.16	0.26	0.04	0.05	0.13
	(0.81)	(1.17)	(1.02)	(1.21)	(1.11)
Constant	–0.62	–2.13	–0.77	–0.80	1.65
	(–0.71)	(–1.50)	(–0.81)	(–0.38)	(0.94)
R2	0.30	0.28	0.29	0.29	0.31

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

The results based on association between ROA and corporate governance and ROE and corporate governance are almost same. In Table 4.2 the results regarding relationship of firm value using return on assets with aggregate corporate index and three sub-indices and all control variables are presented. The evidence suggests that corporate governance affects corporate valuation in Pakistani; however, the importance of each category of corporate governance is not same in explaining firm performance. These results indicate that two sub-indices: board composition and disclosures have positive and some significant impact on firm performance. The ownership and shareholdings have no significant influence on firm performance. These results show that most of the firms have ownership with dominant block holder or have ownership concentration and in these firms the return on assets are not associated with good performance. The large sized firms with more investment opportunities and which are levered have high return on asset. As regards the quality of legal environment the interaction terms of rule of law with corporate governance show no relationship with return on asset which suggests that in weak legal environment the law does not matter in firm valuation [La Porta, *et al.* (2000)].

To investigate the relation between firm value measured by dividend pay-out ratio and corporate governance D/P is regressed on corporate governance and firm attributes: investment opportunities, size, leverage and size. Positive and significant coefficient of CGI reveals the fact that firms with higher-quality corporate governance are valued higher and distribute the dividend more. When D/P is regressed on sub-indices of corporate governance, the board composition and disclosure and transparency index have positive and significant results but positive and insignificant for shareholder and ownership indices. In general the ownership and shareholders rights that align the managers and shareholders interest are significantly valued by investors. This is also true for board composition and independence index. Both sub-indices board and disclosures have positive association with firm performance. These results are consistent with agency theory which focuses on monitoring of managers whose interests are assumed to diverge from those of other share holders. However the assumptions of agency theory are not applied to block holder owned firms. Most of the firms listed on KSE are family owned or institution owned. In these firms the alignment of ownership and control is tight and thus suggesting the need of outside directors on the board. Interaction term for CGI with law has the expected positive sign for Pakistan with poor legal environment is consisted with notion that positive relationship between corporate governance and valuation is stronger in weak legal regime. The study by Dernev and Kim (2006) also conclude that high class corporate governance is valued higher in case of US market.

Investment opportunities have positive and significant impact on corporate valuation measured by the D/P in all specifications. Our results confirm our predictions that firms with better investment opportunities have higher dividend payout ratio. 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 leverage is positive and insignificant, which is contrary with the prediction of standard theory of capital structure which says that higher leverage increase firm's value due to the interest tax-shield [Rajan and Zingales (1998)]. The result of interaction term of rule of law with corporate governance does not have any significant impact on the valuation of the firm. These results indicate that legal framework is not providing relevant information regarding firm dividend pay-out in case of Pakistan. However, these findings are consistent to some extent with the notion that positive relationship is between governance and valuation is stronger in weak legal regimes [La Porta, *et al.* (1997)]. This explains the reason of mixed relation between firm valuation and corporate governance in US firms which are subject to strongest legal framework worldwide [La Porta, *et al.* (1998) and Dunev and Kim (2006)].

When dividend pay-out is used as performance measure the aggregate corporate governance and the board composition and independence has a positive and statistically significant affect on firm's dividend payout and when entered in model with other sub-indices. The ownership and shareholdings sub-index has a positive effect on firm performance when it is entered into model alone and also when is included with other sub-indices but this affect is marginally significant or it remains positive but become insignificant but coefficient of determination has improved. These results show that most of the firms have ownership with dominant block holder or have ownership concentration and in block holder firm board independence is not associated with good performance. The assumption of agency theory does not fully apply to these firms where the alignment of ownership and control is tighter thus suggesting the need of outside directors on the board of these firms. As control variables are included specification of model improves.

The results of dividend payout regressed on corporate governance including control variables are also consistent with prior research [Arnott and Asness (2003) and Shaheen and Nishat (2004)]. There is positive association between corporate governance and dividend payouts consistent with the theoretical notion that the firms that are better governed payout more. 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 investment opportunities is significant and positive because higher profitable 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 [Rajan and Zingales (1998)]. The interaction terms of legal regime with investment opportunities show positive and insignificant relationship with CGI, board, shareholdings and disclosure scores which suggests that in legal environment which is less investor friendly firm specific factors matters more in choice of corporate governance practices. These results are consistent theoretical proposition of La Porta, *et al.* (1999) and with empirical findings by Durnev and Kim (2006) and Pistor, *et al.* (2003).

4.5. Summary and Conclusions

The relationship between corporate governance variables has been widely analysed for the developed markets but very little work has been done on how a broad range of governance mechanism factors effect the firm performance in thinly traded emerging markets. In this study we fill this gap by analysing the relationship between corporate governance and firm performance for the Karachi Stock Market. To proxy for firm-level governance we use a rating system to evaluate the stringency of a set of governance practices and cover

various governance categories: such as board composition, ownership and shareholdings and transparency. Our sample firm consists of 50 firms which re active, representative of all non-financial sectors and comprises more than 80 percent of market capitalisation at Karachi stock market.

The results document a positive and significant relation between the quality of firm-level corporate governance and various firm performance measures. In general the ownership and shareholders rights that align the managers and shareholders interest are significantly valued by investors. This is also true for board composition and independence index. Both these sub-indices have positive association with firm performance. These results are consistent with agency theory which focuses on monitoring of managers whose interests are assumed to diverge from those of other share holders. However, the assumptions of agency theory are not applied to block holder owned firms. Most of the firms listed on KSE are family owned or institution owned. In these firms the alignment of ownership and control is tight and thus suggesting the need of outside directors on the board. However, the results show that open and transparent disclosure mechanism that reduces the information asymmetry have no affect on firm performance. This is due to the reason that we have used the annual reports as data source and these reports do not reveal all the information required for rating corporate governance. As regards the quality of legal environment the interaction terms of rule of law with corporate governance show no relationship with firm performance; which suggests that even firms in weak legal environment can enjoy high valuation if they adopt better quality governance and disclose practices [La Porta, *et al.* (2000)].

Our results show that Corporate Governance Code 2002 potentially improves the governance and decision making process of firms listed at KSE. Large shareholders still have a tight grip of companies. However, one can argue that adequate firm-level governance standard 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.

Chapter 5: CORPORATE GOVERNANCE AND CORPORATE OWNERSHIP

5.1. Introduction

The nature of relation between the ownership structure and corporate governance structure has been the core issue in the corporate governance literature. From a firms' perspective, ownership structure determines the firms' profitability, enjoyed by different stake-holders. In particular, ownership structure is an incentive device for reducing the agency costs associated with the separation of ownership and management, which can be used to protect property rights of the firm [Barbosa and Louri (2002)]. With the development of

corporate governance, many corporations owned by disperse shareholders and are controlled by hire manager. As a results incorporated firms whose owners are dispersed and each of them owns a small fraction of total outstanding shares, tend to underperformed as indicated by Berle and Means (1932). Latter this theoretical relationship between a firm's ownership structure and its performance is empirically examined by Jensen and Meckling (1976) and Shlefier and Vishny (1986).

La Porta, *et al.* (1997, 1998, 1999 and 2000) have shown that the countries with weak legal environment, the original owners tries to maintain large positions in their corporations which results in concentration of ownership. Equity ownership by insiders can align insider interest with those of shareholders, thereby leading to greater firm value [Klapper and Love (2002)] In underdeveloped markets in addition to weak legal enforcement reasons, due to underdeveloped nature of financial markets that would allow limited access to external financing and result in predominance of family firms [La Porta, *et al.* (1997, 1998) and Pistor, *et al.* (2003)]. In case of Pakistan the majority of the firms are owned by the family or institution [Cheema, *et al.* (2003) and Iqbal (2006)]. Further the researchers have comprehensively studied the conflict between managers and owners regarding the functioning of the firm for developed markets, although, the research on understanding the differences in behaviour of different shareholder identities is limited for emerging markets.

Corporate Governance reforms started with the introduction of Corporate Governance Ordinance in 2003. There is little work done to examine the association between corporate governance and corporate ownership pattern in case of Pakistan. Cheema, *et al*. (2003) has identified only the nature of corporate ownership structure in Pakistan without analysing its impact on corporate performance. Iqbal (2006) has investigated the relationship between performance and ownership shares of different categories of shareholders such as family ownership foreign investors' ownership and institutional share holders but has not included the effect of other variable that might influence ownership concentration. She comes up with conclusion that the positive relationship between ownership concentrations as measured by top five shareholders and firm performance in general. We want to fill the gap of needed research area on the relation between corporate ownership and corporate governance in context of Pakistan. The association between equity ownership and firm performance is also investigated.

The focus of this chapter is to investigate whether the equity ownership structure matters in case of Pakistan and its implications for corporate governance and corporate valuation. The remaining of this chapter is organised as follows. Section 2 reviews the important empirical studies concerning the relationship between corporate governance, ownership structure. In Section 3, the empirical s1pecification of the model is described. Section 4 presents the discussion of the empirical results. Last section concludes this chapter and gives policy implications.

5.2. Review of Previous Literature

One of the earliest treatments of ownership and control issues is the seminal work of Berle and Means (1932). Early work in this area was largely descriptive [Mean (1930, 1931)]. As research became systematic in approach, researchers relied primarily on agency theory to guide their studies. The central premise of this theory is that managers, as agents of shareholders (principals), can engage in decision making and behaviours that may be inconsistent with maximising shareholders wealth [Fama and Jensen (1983); Jensen and Meckling (1976)]. As evidence of its applicability to ownership studies, agency theory has been characterised as "a theory of the ownership (or capital) structure of the firm". More resent research has also noted the dominance of agency theory as the guiding framework for corporate governance studies generally ownership studies more specifically such as Daily, *et al.* (1998) and Dalton, *et al.* (2003)].

Agency theory suggests that the corporate form of organisation characterised by a professional management with little ownership operating business on the behalf of a large number of widely dispersed shareholders represent an archetypal principal agent problem [Eisenhardt (1989)]. Managers who disregard shareholder interest may be ousted by powerful shareholders or by hostile takeovers. This presupposes that shareholders have an interest to indulge in monitoring managerial behaviour. However, shareholders differ with respect to incentives to spend resources on monitoring. Shareholders owing a miniscule proportion of shares of a firm have very little incentive to devote the necessary time and effort on voicing their view.

Resource-based theory suggests that considerable resource heterogeneity exists among various shareholders categories. For an emerging economy firm, these differences arise from shareholders being foreign or domestic and financial or non-financial. The impact on firm performance of these owners with diverse resource endowments is expected to differ as a consequence of this heterogeneity in resources and organisational capabilities.

A feasible solution to the agency problem that arises from separation of ownership and control is that managerial interests can be aligned with those of shareholders through equity ownership [Himmelberg, *et al.* (1999)].

There is another focus of the ownership studies to reduce the agency problem–institutional investors and large block-holders. Institutional investors and large block-holders control an increasing amount of corporate equity. Many shareholders in these categories will take active interest in the governance of firms in which they invest because their ownership stakes do not permit them to easily divest the equity they hold in firms not meeting their performance expectations [Lane, *et al.* (1998)]. If these individuals or groups sold their equity, given their relative large equity positions, it would trigger a precipitous decline in the value of their holdings.

Since Berle and Means (1932) the separation of corporate ownership from control has given rise to large literature devoted to elaborating, refuting or testing it. Hassen (1983) argued that if, as Berle and Mean claimed, corporate officers are promoting their own financial interests at the expense of the shareholders, then the remedy is to encourage shareholders to pay an active role in nominating and electing directors and thus influence the selection of the officers who run the enterprise. While Jensen and Meckling (1976) argue that introduction of managerial share ownership may reduce these agency problems, thus aligning the interest of managers and shareholders. The potential problems associated with the separation of ownership and control in the corporate is subject of research for many decades and have witness an evolution from concentrated ownership to increasingly diffuse ownership. This trend towards increasing separation of ownership from management is documented by Berle and Means (1932) and they argue that managers might guard their own interest at the shareholders' expense. Later Jensen and Meckling (1976), assert that firm value is reduced when ownership and control are separated rather than combined due to added costs of monitoring and the managers participate in activities that may not enhance firm value for the owners. In all other organisation configuration in which the decision-making and ownership functions are separated, costs are increased by the residual claimants since the potential exists for the different individual to pursue potentially conflicting optimisation paths [Daily and Dollings (1992)]. However, Fama (1980) and Fama and Jensen (1983a,1983b,1985) maintain that there are efficiencies to separating ownership and control into decision-making and risk-bearing functions which make dispersed ownership advantageous because the efficiency gains outweigh the agency costs. The findings of Graff (1950) and Feinberg (1975) suggest that organisations with combined ownership and control, owner-operators may choose to exchange profits for other benefits, such as choosing current over future consumption [Fama and Jensen (1985)] and on-the-job non-pecuniary consumption [Demsetz (1983)]. Consequently, such organisations will likely be undervalued by the market.

Although there is a presumption in the literature that large shareholders have power and stronger incentive to ensure shareholder value maximisation [Jensen and Meckling (1976); Zeckhouser and Pound (1990); Burkart (1997)] the theoretical relationship between large owners and firm value is ambiguous.[15] The empirical evidence on corporate governance suggests that large owners have stronger incentive and better opportunities to exercise control over manager than small shareholders. Claessen, Djankov, and Pohl (1996, 1999) find evidence of a positive relation between shareholding concentration and firm

[15] Some authors find a relationship between ownership concentration and firm value or firm performance, other find no significant relationship, no conclusion can be drawn about the real effect of ownership concentration.

performance in Czech Republic, Kocenda and Svejnar (2002) only partly confirm that observation. Block-holder ownership above a certain level may lead to entrenchment of owner-mangers that expropriate the wealth of minority shareholders [Fama and Jensen (1983); Morck, *et al.* (1989); Shleifer and Vishny (1997)]. A negative effect of market value on ownership concentration is proposed and supported by Demsetz and Lehn (1985).

In the view of Kuznetsov and Muravyev (2001) concentrated ownership has its costs. They may arise when large shareholders, capable to influence corporate decision directly, maximise value for themselves and deprive small owners of their part of residual income. Other negative consequences of ownership concentration include raised cost of capital due to lower market liquidity or decrease diversification opportunities on the part of the investors [Fama and Jensen (1983)]. Moreover, concentrated ownership prevents additional monitoring of managers by the stock market, which is available under diffused ownership with high liquidity of shares [Holmstrom and Tirole (1993); La Porta, *et al.* (1999); Claessens, *et al.* (2000) and Faccio and Lang (2002)] present ultimate control as well as the extent of concentrated ownership structure in publicly traded companies around the world. They found that publicly traded companies in most countries possess a higher level of ownership concentration. Yeh (2003) in Taiwan, Dzieranowski and Tamowicz (2004) in Poland and Cheema, *et al.* (2003) in Pakistan find that the companies' shares are common concentrated in the hand of largest shareholders.

In most of developing markets including Pakistan, the closely held firms (most often family controlled but also state-controlled firms or firms held by widely corporations and by financial institutions) dominate the economic landscape. The main agency problem is not the manager-shareholder conflict but rather the risk of expropriation by the dominant or controlling shareholder at the expense of minority shareholders. The agency problem in these markets is that control is often obtained through complex pyramid structures,[16] interlock directorship,[17] cross shareholdings,[18] voting pacts and/or dual class voting shares that allow the ultimate owner to maintain (voting) control while owning a small fraction of ownership (cash flow rights). The dominant shareholder makes the decisions but does not bear full cost. Moreover large shareholders create group structure such as pyramids that enable them to transfer assets or profits to other dominated entities. These practices called tunnelling. The negative impact that

[16]Pyramids are a particular form of inter-firm shareholding arrangement in which firm A holds a stake in firm B, which holds a stake in firm C. The distinguishing characteristic of pyramid arrangement is that firm A is attempting to exercise control over firm C while minimising its financial investment in firm C, either directly or indirectly.

[17]It occur when a firm's employee sits on other firm's board, and that firm's employee sits on the first firm's board. These employees are generally the CEO or another person high in management of their respective firms.

[18]Cross-holding means company Y directly or indirectly controls its own stock.

large family shareholders can have on firm value can be even greater when family members hold executive positions in the firm. The choice of a family member as CEO can have a significant impact if the individual does not have the talent, expertise or competency to run the business and may lack have labour market. The opportunity cost created by a suboptimal appointment will be shared by all shareholders while the private benefits accrue entirely to the family [Peres-Gonzalez (2001)]. Klein, *et al.* (2005) argue that differences in ownership structures across countries may create differences in the governance-performance relationship. Likewise, differences in the general environment (for example, competition in product and capital markets, the efficiency of the market for corporate control and managerial labour markets) may produce different governance-performance relationship in different countries. Firms with large undiversified owners such as founding families may forgo maximum profits because they are unable to separate their financial preferences with those of outside owners. Families also often limit executive management positions to family members, suggesting a restricted labour pool from which to obtain qualified and capable talent, potentially leading to competitive disadvantages relative to non-family firms [Morck, *et al.* 2000)]. Maury (2006) finds that in Western European Countries family control increase firm profitability, whereas legal environment protect minority shareholders against family opportunism. Ben-Amar and Andre (2005) find that a large proportion of Canadian public companies have controlling shareholders (families) that often exercise control over voting rights while holding a small fraction of cash flow rights. The long-term nature of the founding-family ownership suggest that external bodies, such as suppliers or providers of capital, are more likely to deal with the same governing bodies and practices for longer periods in family firms than in non-family firms. Thus, the family's reputation is more likely to create longer-lasting economic consequences for the firm relative to non-family firms where managers and directors turn over on a relatively continuous basis [Anderson and Reeb (2003)].

Since Berle and Mean (1932), the conflict between manager and shareholders has been studied extensively by researchers seeking to understand the nature of the firm. When shareholders are too diffused to monitor managers, corporate assets can be used for the benefit of the managers rather than for maximising shareholder wealth. Therefore a solution to this problem is to give managers equity stake in the firm. Doing so will resolve the moral hazard problem by aligning managerial interests with of shareholders [Himmelberg, Hubbard, and Palia (1999)]. The capability of the managers to perform mutual monitoring depends on the dispersion of managerial power, a mutual monitoring system being more difficult to establish when there is a clear concentration of power in the hands of a single manager. If a single member of the managerial team clearly dominates the others, the rest of the managers could lack the power or even the information to control the head of the organisation [Fernandez and

Arrondo (2005)]. Stulz (1988) demonstrate that sufficiently high managerial ownership, by allowing managers to block takeover bids, can lower firm value. Using U.S data, Morck, *et al.* (1988); McConnell and Servaes (1990, 1995); Hermalin and Weisbch (1991); and Holderness, *et al.* (1999) all find firm value to rise with low levels of managerial ownership and to fall with higher levels of managerial ownership.

The effects of foreign investment on economic performance have been the subject of perennial academic and popular debate. Anti-globalisation protesters have railed against the low wages paid in developing countries affiliates relative to those in developed source countries. Other has concerned themselves with the potentially negative effects of entry by foreign firms, with their global production network, on domestic suppliers of parts and component in upstream industries. On the other hand, most economists would point to higher levels of productivity and higher wages paid by foreign affiliates relative to other domestic producers in the host countries. They also emphasised the potential externalities from FDI including the knowledge spillovers from foreign affiliates to their less productive domestic counterparts. Particularly in concentrated domestic markets, another effect of entry by foreign firms may be an increase in the degree of product market competition, with attendant benefits to consumers in the form of lower price and implications for domestic firms' incentive to innovate [Griffith, and Simpson (2004)]. Griffith and Simpson (2003) find foreign-owned firms are frequently the technological leaders within UK industries and that technology transfer from these technological leaders makes a substantial contribution to productivity growth in domestic-owned establishments. Griffith (1999) and Oulton (2000) argue that reason for the observed higher productivity of foreign-owned firm at the economy-wide level might simply be that they are disproportionately concentrated in high productive sectors. Choi and Yoo (2005) show that foreign investors positively affect firm performance by active monitoring, complementing the inadequate or inefficient monitoring of domestic institutions. Khanna and Palepu (1999) also provide evidence that foreign financial institutions are a source of not only financing but also scarce monitoring skills in emerging markets like India. It is not the ownership but the factors underlying ownership that matter. Control-enabling property rights are one such factor. In term of performance, firm in which property rights devolve unambiguously to foreign shareholders outperform firm in which foreign shareholders cannot exercise effective control. With control comes a level of profitability that is not available at lower levels of share holding. If foreign investors wish to enjoy relatively superior returns in India, and consider their associates as an integral part of their global operations, they should in term of investing at the levels that will provide them the control[19] [Chhibber and Majumdar (1999)].

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[19]51 percent shareholding in Indian firms gives foreign investors unambiguous control over assets and income partitioning. An over 51 percent stake has been assumed to imply not only operational control, but also over decision-making.

There is an extensive theoretical literature on the role and incentive of financial institutions/banks monitoring non-financial corporations. Chirinko, *et al*. (1999) explain that financial institutions might be important mainly because of their role as supplier of debt but also as equity holder. Apart from their role as shareholder and creditor, both of which are mechanism of outside control, financial institution, banks and other financial institutions (pension funds etc.) are also linked with firm through their representation on supervisory board. It is generally viewed that more equity the financial institution holds, the more it is information and power to monitor the firm's management, thereby firm performance. But there is also a view that financial institution, notably banks, behave as monopolist, using their power (as the sole supplier of external finance) to extract profits from the firm at the expense of firm performance. Jensen (1989) argues that joint ownership of debt and equity by large informed investors (such as Japanese bank) results in stringent managerial monitoring and create strong incentive for managers to make value-maximising decisions. Gedajlovic and Shapiro (2002) are also of the view that financial institutions are well positioned to monitor the manager of the firm within their network. Lichtenberg and Pushner (1994) study support the proposition that equity ownership by financial Institution in Japan effectively substitute for the missing external takeover[20] market by resulting in monitoring and intervening when necessary, thus reducing the incidence and severity of lapses from efficient behaviour. Sheard (1989, 1991), Aoki and Sheard (1992), and Morck and Nakamura (1999b) propose that financial institution equity block primarily as anti-takeover barriers.

Recent literature on corporate governance also pays much attention to the issue of shareholders identity. It stress that the objective functions and the cost of exercising ownership control over managers very substantially for different types of owners. The implication is that it matters not only how much equity a shareholder owns, but also who is this shareholder—a family, a private person, worker, manager, financial institution or foreign enterprise. However much of the existing literature is based on the functioning of developed markets' firms, and therefore presumes a wider dispersion in ownership structure than one find in developing markets like Pakistan where large share holdings are common in the world, except the US and UK [La Porta, *et al.* (1999),[21] it is argued that large share-holders' incentive and ability to collect information and to monitor management reduce agency costs [Shleifer and Vishny (1986)]. Most of the works in literature have evolved around the developed economies and very little

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[20]Takeovers: if a firm is inefficiently operated, then there is scope for improved performance if an outsider (or some of current shareholders) take over the firm, replaces its management, and initiates a new business strategy [Yafeh (2000)].

[21]Recent evidence highlights a substantial degree of ownership concentration including family ownership in large firms around the world [Morck, *et al.* (2005); Burkart, *et al.* (2004)].

is known (empirically) about such issues in emerging market economies, especially for Pakistan.[22] This study tries to fill this gap.

5.3. Data and Methodological Framework

The analysis based on sample of 60 firms [23] listed at Karachi, Lahore Stock Exchange and Islamabad Stock Exchange over the time period 2003 to 2008. We confine our analysis to non-financial firms and the selection of 60 firms is primarily based on the availability of annuals reports of corporations for all sample years. Five ownership variables are included: ownership concentration (T5), family ownership (FAM), managerial shareholding (Dir), financial institution shareholding (Fin) and foreign investor's shareholding (Fore). We use top five shareholders as proxy for the ownership concentration to analysis that whether corporate ownership affects corporate governance and corporate performance or not. In top five shareholders there is no distinguish between different categories of shareholders. Any cut-off level is not used for inclusion of any shareholder in top five categories.[24]

The family ownership is defined where a family or a group of family can control shares in a target company either by owing shares directly or indirectly through associated company [Cheema, *et al.* (2003)]. Thus family ownership comes from two sources: through direct ownership, through associated companies. Direct ownership is where the founder or a member of his or her family by either blood or marriage is an officer, a director, or a blockholder, either individually or as a group. Associated companies are those companies that are associated with each other if one company controls another company, or two companies are controlled by the same person or family.

Director Ownership is the share ownership by management and board of directors varies substantially across firms.

Foreign Ownership are defined as companies which are incorporated outside Pakistan but have a place of business in Pakistan under the companies Ordinance, 1984, 'Foreign Companies'. The Ordinance also defines a foreign subsidiary as a company in which more than 50 percent of the equity is held by a single foreign company. In Pakistan there is no legal limit by the government for minimum and maximum level of equity holding by foreign investors as compare

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[22]Cheema, *et al.* (2003) provide descriptive nature of ownership structure of Pakistan' corporate sector while empirical studies on relationship between ownership and performance are on their early stages.

[23]List of sample firms is given in Appendix.

[24]The idea behind 10 percent of the shares is that the passage of special resolution under the Pakistan Companies ordinance of 1984, as a result of which alteration in a firm's activities can be made only by the 75 percent majority vote of shareholders in favour of such resolution. Only 10 percent class of shareholders have the ability to block the members' special resolutions that are necessary to make significant changes. Moreover, disclosure of the aggregate of shareholding, restriction on the sale of shares to public are all associated with more than 10 percent holding of shares.

to India where no foreign investor hold more than 51 percent equity stakes of a firm. Financial Institutions/Banks Ownership[25] is defined as financial institutions in our sample represent legal minority shareholder (holding at least 10 percent of share holders on average).[26] The GMM estimation technique is applied on panel data as discussed in Chapter 3.

5.3.1. *Determinants of Ownership Concentration*

Recent evidence suggests that In Pakistan ownership is concentrated [Chemma, *et al*. (2003); Iqbal (2006) and La Porta, *et al*. (1999)]. Most firms are closely held either by families, directors, foreign or institution owners. We distinguish among different ownership type in our analysis, we control ownership type in our ownership model and we also provide separate estimate of determinants of ownership for each ownership category. As mentioned above a block holder is defined to be any entity owning more than 10 percent of the firm equity. For robust empirical findings an alternate measure of ownership concentration such as the percentage of shares owned by the largest five block holders is also used. In the absence of adequate investor protection concentration of ownership becomes a more important tool to resolve agency conflict between controlling and minority shareholder [Shleifer and Wolfenson (2002)]. Therefore the hypothesis tested is that there is association between concentration of ownership and quality of corporate governance practices in case of Pakistani listed firms. To test this hypothesis the empirical specification of the model proposed by Pistor, *et al.* (2003), Durnev and Kim (2005) and Klein, *et al.* (2005) are used:

$$Own_i = \boldsymbol{a} + \boldsymbol{b}_1 CGI_i + \boldsymbol{b}_2 Inv_i + \boldsymbol{b}_3 Size + \boldsymbol{b}_4 Lw_i * CGI_i + \boldsymbol{e}_{it} \qquad \ldots \quad (5.1)$$

In the model Own_i is the ownership concentration of firm i at time t. CGI_i is a vector of corporate governance index, Inv_i is investment opportunities measured by

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[25]Under the financial institutions ordnance, 2001 "Financial Institution" are defined as; (i) any company whether incorporated within or outside Pakistan which transacts the business of banking or any associated or ancillary business in Pakistan through its branches within or outside Pakistan and includes a government savings bank, but excludes the State Bank of Pakistan; (ii) a modaraba or modaraba management company, leasing company, investment bank, venture capital company, financing company, unit trust or mutual fund of any kind and credit or investment institution, corporation or company; and (iii) any company authorised by law to carry on any similar business, as the Federal Government may by notification in the official Gazette, specify (The Financial Institutions Ordinance, 2001,XLVI of 2001).

[26]The Company Ordinance, 1984 and the Code of Corporate Governance do not recognise minority shareholders with a shareholding below 10 percent. The minimum threshold for seeking remedy from the Court against mismanagement and oppression requires initiation of the company by no less than 20 percent of the shareholders. Shareholders representing 10 percent can apply to SECP for appointment for inspector for investigation into the affairs of the company. See section 263 and 290 of the Company Ordenence,1984.

the past growth in sales, Lw_i is rule of law that is used for the proxy of enforcement of law, and $Size_i$ is measured by the log of total asset. ε_{it} is random error term.

It is expected that shareholders with greater cash flow rights practice lower quality corporate governance. The negative relationship between ownership and quality of corporate governance is stronger is stronger in weak legal regime [Durnev and Kim (2006); La Porta, *et al.* (1998). The owner shareholders of the firm with more profitable investment opportunities divert less for outside shareholders gain and practice high quality governance [Durnev and Kim (2006); Johnson, *et al.* (2000)]. The firm level variables, we control the firm size and we expect an inverse relationship between $Size_i$ and Own_i due the risk neutral and risk averting effects because the market value of a given stake of ownership is greater in larger firm, this higher price should reduce the degree of concentration. At the same time risk aversion should discourage any attempt to preserve the concentration of ownership in face of larger capital because this would require the owners to allocate more of their wealth to single venture [Domsetz and Lehn (1985)]. Following La Porta, *et al.* (1998) the ownership concentration of the firm is related to legal environment of the country, the rule of law index as a proxy for the efficiency of the legal environment is used. We expect to find negative relationship between ownership concentration and rule of law because in countries like Pakistan with poor investor protection ownership concentration might become a substitute for legal protection as shareholders may need to own more capital in order to exercise control.

5.3.2. *Ownership Concentration and Firm Performance*

The deficiency of external governance mechanism that is weakness of investor protection and absence of well developed market for corporate control leads investor to rely on governance structure that is dominated by highly concentrated ownership. In this section the impact of ownership concentration on the firm performance is examined. The firm performance improves when ownership and managerial interest are merged through concentration of ownership [Agrawal and Mandeike (1987)]. The reason is that when major shareholdings are acquired, control can not be disputed and resulting concentration of ownership might lower or completely eliminate agency costs. In addition block holders might provide an opportunity to extract corporate resources for private benefits in a way that would have a negative effect on firm valuation. We propose hypothesis that there is positive relationship between concentration of ownership and firm performance. To test this hypothesis a regression equation linking the concentration of ownership with firm performance after controlling some firm variables as suggested by Pistor, *et al.* (2003) and Klein, *et al.* (2005) is estimated:

$$Perf_i = \boldsymbol{a} + \boldsymbol{b}_1 Own_i + \boldsymbol{b}_2 CGI_i + \boldsymbol{b}_3 Inv_i + \boldsymbol{b}_4 Size_i + \boldsymbol{b}_5 Lw_i * Own_i + \boldsymbol{b}_6 Lw_i * CGI_i + \boldsymbol{e}_{it}$$

Where $Perf_i$ is measure of performance for firm i at time t, return on assets ROA, return on equity (ROE) and Tobin's Q, remaining variables are same as defined for model (5.1). When profitable investment opportunities are there, the controlling shareholders divert to concentrated ownership and corporate valuation become higher. The positive relationship between ownership and firm value is higher in weak legal environment [La Porta, *et al*. (2002), Durnev and Kim (2006)]. It is expected that firms with better investment opportunities, better corporate governance practices should have higher valuation.

5.3.3. *Ownership Identity and Firm Performance*

Since the type of ownership concentration might vary across firms according to the identity of large shareholders, we postulate that the relationship between larger shareholder and firm performance depends on who the large shareholders are. The concentration of ownership split into four separate groups, director ownership, family ownership, institutional ownership, foreign ownership. The separate analysis for each ownership type is performed as well. The hypothesis is that the identity of ownership matters in determining the firm performance. The following model is estimated to determine the relationship between ownership identity and firm performance.

$$Perf_i = \beta_0 + \sum_j \theta_j Own_{ijt} + \beta_1 Inv_i + \beta_3 Size_i + \beta_4 Lw_i * Inv_i + \beta_5 Lw_i * Own_i + \varepsilon_{it} \quad (5.3)$$

Where Own_{ijt} is the percentage of share held by owner of type j of firm i at time t. Fur ownership variables are included to see the impact of different categories of ownerships: family ownership (Fam), the managerial shareholding (Dir), financial institution shareholding (Fin) and foreign investor's shareholding (Fore).Other variables are the same as used in model (5.1) and (5.2).

5.4. Empirical Findings

The analysis begins by exploring the determinants of ownership concentration. The ownership concentration is measured as percentage of share owned by the largest five shareholders in a firm, and a block is defied as to be any entity owning more than 10 percent of the firm's equity. The panel data estimation to estimate model (5.1) for five specifications with aggregate CGI_i index and with sub-indices that are board composition, shareholdings and audit, disclosure and transparency. The results are presented in Table 5.1.

The results suggest that there is negative relationship between ownership concentration and quality of corporate governance as indicated by negative and significant coefficient of CGI_i. The study of Duenerv and Kim (2006) suggest there is positive relation between cash-flow rights and corporate governance, however, Morck, *et al.* (1996) and McConnell and Servaes (1990) argue that

Table 5.1

Determinants of Concentration of Ownership by Top Five Shareholders

Variables	Model 1			Model 2			Model 3	Model 4	Model 5
CGI_i		–0.07**	–0.01**						
		(–1.74)	(–4.02)						
$Board_i$				0.01	0.08*			–0.01	0.05**
				(0.75)	(2.14)			(0.57)	(1.68)
Dis_i						–0.01*	–0.05**	–0.01*	–0.04
						(3.33)	(1.66)	(3.29)	(1.03)
Inv	0.54*	0.50*	0.50*	0.46*	0.59*	0.47*	0.49*	0.27**	0.57*
	(4.14)	(2.59)	(2.59)	(2.29)	(3.02)	(2.43)	(2.56)	(2.31)	(2.90)
Size	–0.01**	–0.03**	–0.03**	–0.02**	–0.02*	–0.01***	–0.03***	–0.01**	0.03**
	(1.89)	(–1.75)	(–1.73)	(–1.86)	(–1.82)	(–1.64)	(–1.47)	(–1.67)	(–1.60)
Lev	0.01	0.01***	0.01***	0.03***	0.01***	0.01	0.01**	0.01***	0.03***
	(1.79)	(1.62)	(1.62)	(1.35)	(1.54)	(1.65)	(1.61)	(1.44)	(1.55)
*Lw*CGI*			–0.03		–0.07*		–0.03*		–0.06*
			(–0.32)		(–4.51)		(–2.78)		(–3.21)
Constant	4.14	5.21	5.22	4.25	5.25	4.73	5.31	0.55	5.30
	(23.74)	(16.46)	(16.49).	(18.28)	(16.65)	(19.19)	(16.54)	(–2.67)	(16.58)
R^2	0.23	0.25	0.27	0.26	0.25	0.25	0.25	0.27	0.27

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

greater ownership concentration may align their interest with minority shareholders, but it results in greater degree of managerial entrenchment. The transparency scores ($Disc_i$), board composition score ($Board_i$) and shareholding scores ($Share_i$) when included in the model 2, 3, 4, 5 the relation becomes insignificant and shows that these governance indicators do not effect the concentration of ownership. There is no reason to expect that firms where ownership is concentrated they disclose more, or board has any role etc. This negative coefficient of law variable with corporate governance index suggests that the relationship between ownership concentration and quality of corporate governance is stronger in weak legal regime and. This suggests in the absence of adequate legal protection for investor, concentration of ownership become an instrument to resolve agency conflict between controlling and minority shareholders. This result suggests that ownership concentration is indeed a response of poor legal protection [La Porta, *et al.* (1999); Durnev and Kim (2005)]. The leverage is not a significant determinant of ownership concentration in all cases. The effect of Inv_i is always positive and significant in all our models, which shows that more investment opportunities leads to more concentration of ownership and when firm suffers from a substantial drop in profitable investment opportunities, the controlling shareholders divert more corporate resources. Johnson (2000) documents such behaviour by Asian firms before the East Asian crisis. The positive relationship between investment opportunities and concentration of ownership is stronger in weak legal environment. The impact of $Size_i$ on OWN_i is negative indicating that ownership concentration is significantly lower as the firm size expands and Boubakri, *et al.* (2003) have also documented a negative association between the size and ownership concentration.

As regards the results of effect of ownership concentration and firm valuation, the regression results are based on two accounting measures (ROA and ROE) and market measure that is Q-ratio for firm performance. We estimate different specifications for each performance measure and Tables 5.2.1 and 5.2.2 presents the results.. Our results are consistent with several empirical findings that document a positive and significant relationship between ownership concentration and firm performance implying that ownership concentration matters in determining firm's value. Another important finding is the favourable effect that market bestows on firms that follows good practices and is transparent. The positive corporate governance index and disclosure and transparency score imply that the firm that practice good governance and disclose more achieve superior performance compared to other firms. However, firm level variable show significant relationship with firm performance. We find that large size firms are more likely to achieve better performance. The reason might be that the competition effects and the market power of large-sized firms enable them to out-perform small-size firms in Pakistan. The firms with more

Table 5.2.1

Relation between Tobin Q and Ownership by Top Five Shareholders

	1	2	3	4	5	6	7	8	9
Owni	0.04*	0.06*	0.09*	0.03**	0.10*	0.07**		0.05	0.10*
	(1.98)	(1.95)	(3.38)	(1.86)	(2.36)	(1.67)		(1.58)	(2.36)
CGI_i		0.05**	0.05						
		(1.85)	(0.28)						
Board				0.04*	0.01*			0.04*	0.09*
				(3.15)	(5.68)			(3.33)	(5.30)
$Disc_i$						0.05*	0.01**	0.05*	0.06
						(2.57)	(1.86)	(2.80)	(0.27)
Inv	0.06**	0.05***	0.04**	0.01**	0.12	0.05***	0.01**	0.09**	0.11**
	(1.66)	(1.55))	(1.54)	(1.76)	(1.97)	(1.42)	(1.84)	(1.75)	(1.94)
Size	–0.03**	–0.02**	–0.02**	0.04	–0.02**	–0.03	–0.04**	0.04**	–0.12**
	(–2.41)	(–1.86)	(–1.84)	(.–2.90)	(–1.78)	(–2.51)	(–1.78)	(–3.04)	(–1.81)
Lev	0.08**	0.09**	0.10**	0.07***	0.08**	0.08	0.04	0.08***	0.09
	(1.61)	(1.77)	(1.78)	(1.36)	(1.70)	(5.22)	(1.71)	(1.49)	(1.71)
LawCGI_i*			–0.10		0.05*		0.01		0.04*
			(–0.17)		(5.03)		(1.05)		(4.12)
Intercept	0.59	0.19	0.19	0.91	–0.02	0.21	0.08	0.53	–0.01
	(3.07)	(0.66)	(0.65)	(4.27)	(–0.01)	(0.86)	(0.28)	(2.07)	(–0.05)
R Square	31	0.32	0.34	0.32	0.32	0.31	0.32	0.33	0.33

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

Table 5.2.2

Relation between ROA and Ownership by Top Five Shareholders

	1	2	3	4	5	6	7	8	9
Owni	0.04*	0.04*	0.03*	0.03**	0.03*	0.03 **	0.03*	0.03**	0.03**
	(2.14)	(2.18)	(2.17)	(1.92)	(1.84)	(2.02)	(2.04)	(.1.78)	(.1.79)
CGI_i		0.12	0.03						
		(1.13)	(0.03)						
Board				0.13*	0.15*			0.13*	0.12**
				(2.47)	(2.26)			(2.61)	(1.77)
$Disc_i$						0.12**	0.18*	0.15**	0.15**
						(1.60)	(2.24)	(1.74)	(1.74)
Inv	0.13*	0.13*	0.13**	0.15*	0.15*	0.13*	0.13*	0.14*	0.15*
	(2.83)	(2.04)	(2.03)	(3.31)	(3.34)	(2.84)	(2.86)	(3.303	(3.24)
Size	0.03	0.03**	0.03*	0.03*	0.03	0.03	0.03*	0.15	0.03
	(5.63)	(5.72)	(5.71)	(.6.13)	(5.94)	(5.26)	(5.59)	(5.80)	(5.78)
Lev	–0.05*	–0.04*	–0.05	–0.04**	–0.04	–0.04	–0.04	–0.04*	–0.04*
	(–7.03)	(–7.02)	(–7.00)	(–7.07)	(–7.06)	(–6.84)	(–6.87)	(–6.84)	(–6.84)
LawCGI_i*			0.26		–0.22		0.63**		0.12
			(0.12)		(–0.56)		(1.92)		(0.27)
Intercept	–10.69	–20.81	–18.66	–19.63	–16.24	–1.82	–11.85	–10.19	–11.29
	(–1.67)	(–1.76)	(–1.96)	(–2.69)	(–1.72)	(–0.21)	(–1.20)	(–1.14)	(–1.14)
R Square	0.30	0.31	0.32	0.31	0.32	0.31	0.32	0.33	0.33

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

investment opportunities outperform compared to those which have less investment opportunities. Nevertheless we fail to find any impact of leverage on the firm value. The interaction term of any variable with law enforcement term are not significant in any model suggesting that firm performance is not affected by rule of law in countries where legal environment is weak.

The type of ownership concentration varies across firms according to the identity of large shareholders, we explore the relationship between firm performance depends on who are the large shareholders. For deeper analysis we split the split the concentration of ownership into four separate groups of owners: director ownership, family ownership, foreign ownership and institutional ownership. Different specifications are estimated in a system of equation given in model (5.3) to determine the relationship between ownership identity and firm performance after controlling for firm level variables. The results reported in Tables 5.3.1, 5.3.2, and 5.3.3. The results in Table 5.3.1. Indicates that all type of ownership concentration have positive and significant effect on firm performance. The family ownership results in better firm value relative to other type of ownership, as indicated by higher coefficient significance level. The family's historical presence, large equity position, and control of management and director posts place them in an extraordinary position to influence and monitor the firm.

The results of foreign ownership support our prediction that foreign ownership shares positively impact firm performance. The fact that foreign shareholders use their ownership stakes as a means to foster their strategic interest, which securing access to new markets, location specific resources and low cost production facilities. These findings are consistent with theoretical argument claiming that family owners and foreign owners bring better governance and monitoring practices.

There is insignificant positive effect associated with financial institution ownership. These results can be attributed to the dominance of government owned financial institution in corporate equity holding. The corporate governance index and disclosure and transparency have positive effect on performance. The results support our previous findings that size and investment opportunities have significant effect in most of our model. The interaction of corporate governance with legal term has no impact.

The results of Tables 5.3.2 and 5.3.3 also indicate that ownership identity matters for the firm performance. Different agents play their role while determining firm performance. In Tables 5.3.2 and 5.3.3 the results of foreign ownership support our hypothesis that foreign ownership shares positively impact firm performance. One reason for the higher productivity of foreign-owned multinational might simply be that they are concentrated in high productivity sectors. Moreover, in domestic market, they tend to select investments in companies, which are large, familiar and actively traded.

Table 5.3.1

Evidence on Performance and Ownership Identity

	Tobin Q			ROA			ROE		
Fam	0.18*	0.16*	0.22*	0.12**	0.21*	0.17*	0.31*	0.08*	0.05*
	(3.09)	(2.57)	(3.41)	(2.27)	(2.01)	(1.98)	(1.95)	(1.88)	(1.77)
Fore	0.02**	0.02**	0.02*	0.25	0.13**	0.04**	0.11***	0.04***	0.01
	(1.63)	(1.74)	(2.04)	(1.41)	(1.86)	(1.77)	(1.67)	(1.82)	(1.73)
Fin	0.17	0.10	0.01	0.04	0.11	0.03	0.02	0.01	0.12
	(1.00)	(0.44)	(1.13)	(1.33)	(0.44)	(1.04	(0.51)	(0.51)	(0.97)
CGI_i		0.19 **			0.15**			0.21***	
		(1.98)			(1.89)			(1.73)	
$Disc_i$			0.18**			0.02**			0.01***
			(1.66)			(1.74)			(1.54)
Inv	0.06**	0.06**	0.05**	0.02	0.02*	0.01*	0.001	0.02*	0.01**
	(1.62)	(1.74)	(1.66)	(1.40)	(1.91)	(1.89)	(0.95)	(1.98)	(1.69)
Size	0.03	0.03 *	0.04*	0.33	0.21**	0.07**	0.92*	0.92*	0.432*
	(4.12)	(4.24)	(4.31)	(1.83)	(1.84)	(2.01)	(2.72)	(2.72)	(1.98)
Lev	0.01	0.01	0.02***						
	(1.01)	(1.03)	(1.57)						
$Law*CGI_i$		0.29	0.49		–0.12	0.01	0.004	0.02	0.11
		(0.08)	(0.15)		(1.04)	(1.11)	(0.88)	(1.06)	(0.49)
Intercept	0.26	0.14	0.19	–0.77	–0.80	–0.54	1.65	–2.15	–1.11
	(2.93)	(0.97)	(1.29)	(–0.81)	(–0.38)	(–1.55)	(0.94)	(–2.31)	(–2.24)
R^2	0.30	0.31	0.31	0.29	0.30	0.30	0.30	0.31	0.31

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

Table 5.3.2

Evidence on Performance and Ownership Identity

	Tobin Q			ROA			ROE		
Dir	0.26*	0.20*	0.30*	0.17**	0.19**	0.20*	0.18**	0.18**	0.19**
	(3.85)	(3.37)	(4.16)	(1.95)	(1.87)	(2.00)	(1.97)	(1.89)	(1.96)
Fore	0.20**	0.21**	0.10	0.09**	0.08**	0.07**	0.10**	0.11**	0.10*/
	(1.87)	(1.92)	(1.74)	(1.74)	(1.87)	(1.77)	(1.89)	(1.87)	(1.74)
Fin	0.10	0.09	0.16	0.10	0.10	0.12	0.09	0.10	0.11
	(0.90)	(0.96)	(0.44)	(1.01)	(0.42)	(0.63)	(0.59)	(0.87)	(0.67)
CGI_i		0.01			0.01			0.01	
		(1.24)			(1.13)			(1.11)	
$Disc_i$			0.52*			0.49			0.41*
			(3.55)			(2.65)			(2.04)
Inv	0.06**	0.06**	0.05**	0.03**	0.02**	0.02*	0.02***	0.03***	0.02**
	(1.72)	(1.73)	(1.67)	(1.66)	(1.69)	(1.67)	(1.61)	(1.63)	(1.60)
Size	0.31*	0.31*	0.33*	0.29*	0.27*	0.27*	0.30*	0.28*	0.28*
	(3.99)	(4.02)	(4.13)	(2.87)	(3.01)	(3.00)	(2.66)	(2.97)	(2.88)
Lev	0.01	0.01	0.02	0.01	0.01	0.02	0.11	0.01	0.10
	(0.90)	(0.92)	(1.47)	(0.87)	(1.02)	(1.10)	(0.86)	(0.90)	(1.11)
$Law*CGI_i$		0.01	0.01		0.01	0.01		0.01	0.01
		(0.16)	(0.26)		(0.23)	(0.25)		(0.20)	(0.21)
Intercept	0.23	0.15	0.20	0.23	0.16	0.21	0.24	0.14	0.25
	(3.11)	(1.20)	(1.60)	(2.12)	(1.23)	(1.45)	(2.02)	(1.12)	(1.49)
R^2	0.28	0.29	0.29	0.28	0.29	0.29	0.28	0.29	0.29

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

Table 5.3.3

Evidence on Performance and Ownership Identity

.	Tobin Q			ROA			ROE		
Fore	0.25*	0.14*	0.14	0.20*	0.10*	0.11	0.21*	0.13*	0.12*
	(4.69)	(2.11)	(2.06)	(3.15)	(2.01)	(2.02)	(3.03)	(2.01)	(2.00)
Fii	0.05	0.03	0.14	0.07	0.03	0.16	0.03	0.02	0.14
	(0.78)	(0.93)	(0.13)	(0.84)	(0.86)	(0.24)	(0.94)	(1.03)	(0.47)
CGI_i		0.36***			0.34***			0.35***	
		(1.55)			(1.54)			(1.60)	
$Disc_i$			0.32*			0.31*			0.32*
			(3.07)			(2.98)			(3.01)
Inv	0.06**	0.09*	0.09*	0.10**	0.07*	0.07*	0.11**	0.08*	0.08*
	(1.75)	(2.22)	(2.28)	(1.74)	(2.11)	(2.21)	(1.81)	(2.13)	(2.17)
Size	0.08**	0.01	–0.01	0.38**	0.01	–0.01	0.38**	0.01	–0.01
	(1.68)	(2.69)	(–2.84)	(1.68)	(2.69)	(–2.84)	(1.68)	(2.69)	(–2.84)
Lev	0.02	0.06*	0.06*	0.02***	0.04*	0.05*	0.02	0.05*	0.05*
	(1.00)	(2.42)	(2.51)	(1.54)	(2.39)	(2.44)	(1.33)	(2.23)	(2.41)
$Law*CGI_i$		0.02	0.02		0.02	0.02		0.02	0.02
		(1.01)	(0.40)		(1.00)	(0.54)		(1.01)	(0.47)
Intercept	0.62	0.44	0.39	0.60	0.45	0.37	0.60	0.41	0.35
	(15.02)	(4.67)	(3.96)	(12.13)	(4.66)	(3.84)	(13.13)	(4.05)	(3.75)
R^2	0.25	0.27	0.27	0.25	0.27	0.27	0.25	0.27	0.27

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

Financial institutions have positive and insignificant influence on firm performance that indicates ineffectiveness of financial institution in Pakistani corporate sector.

Table 5.4 shows Director Ownership (Dir) have positive and significant impact on the firm performance. The results are in agreement with our prediction that block-holdings by directors' increase firm value. Managers have a strong incentive to manage their companies well and generate wealth as their fortunes are tied to the well being of the company.

Table 5.4

Evidence on Performance and Manager-Ownership

	Tobin Q			ROA			ROE		
Dir	0.46**	0.24*	0.11**	0.12**	0.21*	0.27*	0.33*	0.08*	0.05*
	(3.20)	(1.88)	(1.97)	(2.27)	(2.01)	(2.08)	(1.95)	(2.11)	(1.98)
CGI_i		0.11**			0.04**			0.11***	
		(1.74)			(1.89)			(1.84)	
$Disc_i$			0.01*			0.02**			0.01***
			(1.96)			(1.74)			(1.63)
Inv	0.01*	0.03***	0.02**	0.02***	0.02*	0.01*	0.01	0.02*	0.04**
	(1.98)	(1.77)	(1.82)	(1.64)	(1.91)	(1.89)	(0.95)	(1.98)	(1.69)
Size	0.04	0.27*	0.13**	0.04	0.21**	0.10**	0.25*	0.03*	0.02*
	(0.90)	(2.02)	(1.82)	(1.83)	(1.84)	(2.01)	(2.72)	(2.72)	(1.98)
$Law*CGI_i$		0.02	0.001		–0.12	0.01	0.004	0.02	0.11
		(0.97)	(1.02)		(1.04)	(1.11)	(0.88)	(1.06)	(0.49)
Intercept	–0.62	–2.13	–2.77	–0.77	–0.80	–0.54	1.65	–2.15	–1.11
	(–0.71)	(–1.50)	(–2.01)	(–0.81)	(–0.38)	(–1.55)	(0.94)	(–2.31)	(–2.24)
R^2	0.30	0.29	0.29	0.28	0.29	0.30	0.29	0.30	0.30

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

5.5. Summary and Conclusion

This chapter determines the factors influencing the ownership concentration, and the effect of this on the other aspects such as firm performance using representative sample of 60 firms. The results reveal that in Pakistan corporations has more concentration of ownership which is the response of weak legal environment and this result validates the La Porta, *et al*. (1997, 1998, 1999, 2000) findings. The concentration of ownership seems to have positive effect on firms' profitability and performance measures. There is negative association between corporate governance practices and disclosures and transparency with concentration of ownership. The identity of ownership matters more than the concentration of ownership. The results indicate that firm specific factors matters more in concentration of ownership. The findings reveal that more investment opportunities provides greater opportunity to for ownership concentration, however size has opposite effect and leads to delusion of ownership. It results in diverse ownership to get wider access to funds and share ownership. These results are consistent with studies Boubakri, *et al*. (2003).

Chapter 6: CORPORATE GOVERNANCE AND EXTERNAL FINANCING

6.1. Introduction

Corporate governance is a mechanism in which the supplier of finance to corporations assures themselves of getting return on their investment. It makes

supplier of finance get manager to return some of the profits to them, and make sure that managers do not use for their interest the capital they supply or invest it in unprofitable projects, above all how do the supplier of finance control managers [Shleifer and Vishny (1997)]. The enterprises need finance for investment and acquire it either by internally generated finance or externally generated finance, which are closely related to the ownership structure, financial market development and enforcement of law of a country. In companies with foreign owners have an advantage in their access to external finance as compare to domestically owned companies because their financial resources coming from abroad.

The access to external finance is an important factor to determine the ability of a firm to operate and expand. The economic researchers have studied how various macroeconomic and microeconomic factors influence such access; for example, the empirical literature shows that the need of external finance depends on the macroeconomic environment because the availability of external financing varies with the change in the business cycle conditions and change in monetary policy in particular. This credit channel research argues that corporate access to credit is the principal mechanism linking monetary policy and the real economy [Kashyap, *et al.* (1993, 1995) and Oliner and Rudebusch (1996a, 1996b). At the micro level, research has shown that characteristics specific to a firm influence the degree to which macroeconomic changes affect its access to external financing; specifically, firms that are more vulnerable financially—such as smaller, younger, riskier, and more indebted firms—are found to be more affected by tighter monetary policy [Atanasova and Wilson (2004) and Bougheas, *et al.* (2006)].

This is conformed by empirical evidence that firms with high dependence on external finance grow faster in countries where external finance is readily available [Pistor, *et al*. (2003) and La Porta, *et al.* (1999)]. Corporations with limited access to external resources may still operate in the informal sector and at a reduced scale in under developed countries [Pistor, *et al.* (2003); Rajan and Zingler (1998); Livine and Zervos (1998)]. La Porta, *et al.* (1999) argue that in countries where legal environment provides protective to the rights of outside investors, investors are willing to finance firms by equity and debt and financial markets become expanded and valuable. On the other hand in countries where legal environment is weak investors' rights are not protected the financial markets remains under-developed.

Many studies show that to promote economic growth attention has shifted to the capital markets due to the limited conventional sources of raising finance. In capital markets, corporate governance plays important role in determining external financing sources provided by outside investors. Corporate governance institutions appear to be weaker in developing than in developed countries and thus provide less of a check on managers in developing countries who wish to

issue equity to finance low return investments. Managers who wish to undertake low return investments in countries with strong corporate governance systems accordingly prefer to rely on internal cash flows to finance these investments, managers making similar investments in countries with weak corporate governance systems are freer to use the equity market as a source of finance [Pistor, *et al.* (2003)]. Thus, differences in corporate governance structures will be seen to explain both differences in the sources of finance for investment across countries and differences in the returns on investment [Gompers, *et al.* (2003)]. Corporate governance has recently received much attention for this purpose the impact of corporate governance practices on access to external financing is investigated in case of Pakistan.

This empirical analyses is extension of our earlier study [Javid and Iqbal (2007)] which identify the determinants of external finance resources The firm with profitable investment opportunities lead to more diversification due to need of more external financing. The firms with greater external financing reliance are better performing firms. This study contributes to existing literature by exploring the firms which rely more on external finances have higher value. In addition in this study panel data estimation technique is applied. To establish the empirical framework on the basis of theory which suggests that with better legal environment of country investors are more willing to provide external funds debt and equity, the rule of law is used as indicator of enforcement of law in Pakistan. The effects of ownership is captured by focusing only on the concentration of ownership in the hand of top five shareholders and this restriction is in line with the previous literature that reveal the fact that in countries like Pakistan with weak governance practices, it is efficient for the corporations to retain control of their firms in hand of few investors.[27]

The rest of this chapter is organised as follows. Section 2 of the chapter presents review of the literature. Section 3 describes the data and methodology. Section 4 presents empirical finding. Section 5 concludes the chapter.

6.2. Review of Previous Literature

"Corporate governance rules, norms and procedures have evolved gradually over times as firms and economies develop and grow. This is reflected in the industrial and financial histories of the advanced industrial nations: the U.K., the U.S., continental Europe, and Japan. The prototypical pattern is that a firm is founded by an entrepreneur and his family who own, control, manages and finances it. Over time, the successful firm grows and becomes large, and evolves over generations from family to professional management, from family to more or less dispersed share ownership with public listing of the company on the country's stock exchange, and from informal to extensive, formal external

[27] See Jensen and Meckling (1977), Zingales (1995), Bebchuk (1999).

finance. While this may be the general pattern, or at least the stereotype, there are considerable national and firm-specific variations in the nature and degree of separation of ownership and control, and some large firms remain under inherited family control. And of course there are always new firms which have grown rapidly and remain under founder control", Patrick (2001).

A large body of empirical literature suggests that financial market underdevelopment and limited availability of bank credit is serious barrier for the establishment of new enterprises and constraint to economic growth.[28] The literature on law and finance shows that investor protection plays an important role in shaping the financial structure of an economy, by affecting the relative importance of equity and debt financing [La Porta, *et al.* (1999)].

In the view of Patrick (2001) the sources of corporate governance change and improvement lie not only within the firm, but particularly in the financial markets, where lenders, bondholders, and shareholders condition the cost and availability of funds on good corporate governance and performance, supported by government changes in relevant legal rules and their implementation, including those of standards-setting organisations of accountants and other professionals.

"Under the agency view, managers over invest to reap private benefits such as "perks", large empires, and entrenchment. Since the external capital market limits the extent to which managers can pursue self-interested investment, an influx of cash flow enables the manager to invest more and increases investment distortions. Under asymmetric information, the managers themselves (who act in the interest of shareholders) restrict external financing in order to avoid diluting the (undervalued) shares of their company. In this case, cash flow increases investment, but reduces the distortion", Malmendier and Tate (2004).

In Hyytinen and Pajarinen (2005) study the relation between firm-level disclosure quality and the availability of external finance to Finnish firms. They estimate excess growth is made possible by external finance and the excess growth is associated with the quality of disclosure which seems to be strongest for financially constrained firms. Their empirical analysis identify the firms in need for external finance voluntarily look for good disclosure quality, because it reduces barriers to external finance.

Durnev and Kim (2006) in their study using firm-level governance and transparency data on 859 firms in 27 countries, find that firms with greater growth opportunities, greater needs for external financing, and more concentrated cash flow rights practice higher-quality governance and disclose more. Moreover, firms that score higher in governance and transparency

[28] Rajan, and Zingales (1998), Levine (1999), Cetorelli, Nicola, and Philip Strahan (2006), De Soto, Hernando (2000), Beck, Levine, and Loyaza (2000), Black, Sandra and Strahan (2002), Beck, Demirguk-Kunt, and Levine (2005).

rankings are valued higher in the stock market. All these relations are stronger in countries where investment environment is less investor friendly, demonstrating that firms do adapt to poor legal environments to establish efficient governance practices.

The findings of La Porta, *et al.* (1997, 1998) show that weak investor protection limits excess to external finance. While De Soto (2000) suggests that poor legal enforcement of corporate laws and unclear property rights limit individuals' ability to commit contracts and thus their excess to external resources. Shleifer and Wolfenzon (2002) argue that better transparency and disclosure of information to the shareholders, and the enforcement of laws that protect their rights, reduce the costs of external finance. Perotti and Volpin (2007) provide evidence that better investor protection not only favour competition and entry into the financial developed sector, it is also better for the politically accountable countries. The paper also suggests that improving formal investor protection laws while ignoring its enforcement may not improve access to finance.

In view of Bekaert, Harvey, and Lundblad (2005) financial liberalisations are most successful in countries with good political institutions. Bebchuk and Neeman (2006) provide evidence that block-holders by using corporate resources protect their control benefits and may undermine good corporate governance. La Porta, *et al.* (1997, 1998) in their study conclude that differences in the structure of laws and quality of their enforcement, such as legal origin of their laws, play important role for the differences in financial development among different countries. Empirical results of Beck and Levins (2005) also show that legal origin[29] has very significant impact on firm's abilities to raise external finance. Their data indicate that firms in French Legal Countries face higher obstacles in contracting for external finance than firms in other countries. Firms in countries with common law face lower financial obstacle than firms in civil law countries. Moreover their result also indicate that foreign-owned firms and large firms face lower financing obstacles than domestic, or small firm, whereas family owned firms particularly face high obstacle in raising external finance. Countries with high GDP face lower obstacle in raising external finance than countries with lower GDP.

González, Lopez, and Saurina (2007) examine access by Spanish firms to external financing from bank and non-bank sources over the period from 1992 to 2002 and their results provide insights into the determinants of firms' borrowing efforts in Spain and more broadly. For example, they find that Spanish firms are quite dependent on short-term, non-bank financing, which is less sensitive to firm characteristics than bank financing. Yet, short-term bank financing is accessed more frequently during economic expansions, suggesting that firms

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[29] La Porta, *et al.* (1998) identify mainly two legal families around the world, common law origin and civil law origin.

substitute away from more expensive forms of non-bank financing as their conditions improve. The authors confirm that smaller, younger, riskier, and more indebted firms rely more on external credit than on internal financing, such as retained earnings and other equity, and they expand these results by showing that the nature of firms' banking relationships, such as the number of banks borrowed from and whether collateral is required for the loans, also influences access to external finance.

This work is extension of our earlier study Javid and Iqbal (2007) in which we investigate the determinants of external financing and conclude that the firms with greater growth opportunities, greater needs for external financing practice higher-quality governance and disclose more. In this chapter we explore firms that rely more on external financing sources are valued higher in the stock market.

6.3. Data and Methodological Framework

6.3.1. *Data*

To analyse determinant of external recourses, and linking access of external finance with corporate governance, corporate and corporate valuation at firm level, the data of 60 non-financial firms listed on Karachi Stock Exchange is used. Any direct measure of external finance is not available therefore; following La Porta, *et al.* (1998), the ratio of the stock market capitalisation held by minorities to sales is used as proxy for external finance for all 60 non-financial firms. The financial variables are obtained from the annual reports of the firms. The GMM estimation technique is applied to estimate panel data model as discussed in Chapter 3.

6.3.2. *Methodological Framework*

The purpose is to examine the factors that influence the need of firms for external finance through equity, when they have adopted different level of corporate governance and doing business in poor legal environment.[30] The firms which rely on external financing are higher valued firms. The empirical evidence suggest that the firms with greater need of external financing for a given level of profitable investment opportunities practice high quality governance [Durnev and Kim (2006) and Rajan and Zingales (1998)]. The contrary evidence comes from the study by Demirgue-Kunt and Maksimovie (1998) which argues that profitable firms have more internally generated funds and hence rely less on external financing. It is expected that there is positive relation between external financing needs and quality of corporate governance. Further, in countries with weak legal regimes firms have difficulty in raising external finance due to investors' lack of trust in legal protection

[30] As indicated by the ranking of rule of law by World Bank.

of their rights [La Porta, *et al*. (1998)]. In this study the significance of rule of law as determinant of external financing is analysed. Since the influence of legal environment across the firm is assessed, therefore it is introduced in interaction terms. To test the hypothesis that the firms which are in need of greater external finance practice higher level of corporate governance, following La Porta, *et al.* (1997) and Pistor, *et al.* (2003) the empirical specification of the model becomes:

$$EF_i = \alpha + \beta_1 CGI_i + \beta_2 Own_i + \beta_3 Inv_i + \beta_4 Size + \beta_5 Lev_i + \beta_6 Lw_i * CGI_i + \varepsilon_{it} \quad (6.1)$$

Where EF_i is external finance that is calculated by multiplying market capitalisation of each firm with percentage of shares that are not taken by the top five shareholders of each firm, CGI_i is a vector of corporate governance index, Inv_i is investment opportunities, Lw_i is rule of law that is used as the proxy of enforcement of law, $Size_i$ is the size of firm and Lev_i. ε_i is random error term.

To investigate that the firms, which rely more on external finance are valued higher. The firm performance is regressed on external finance, corporate governance and control variables. The model is given below:

$$Perf_i = \alpha + \beta_1 EF_i + \beta_2 CGI_i + \beta_3 Inv_i + \beta_4 Size + \beta_5 Lev_i + \beta_6 Lw_i * CGI_i + \varepsilon_{it} \quad (6.2)$$

Where $Pref_i$ is performance indicators measured as ROA, ROE and Tobin's Q. and other variables are same as defined for model (6.1). It is expected that firms with better investment opportunities, better corporate governance practices should have higher valuation.

A growing firm with large need of external financing has more incentive to adopt better governance practices in an attempt to lower cost of capital [Klapper and Love (2003) and Gompers, *et al.* (2003)]. These growth opportunities are reflected in the valuation of the firm, implying a positive association between more reliance on external sources and firm performance. The firms with more need of external finance would be more likely to choose better governance structure because firm's insiders believe that better governance structure will further raise firm value they adopt good governance to signal that insider behave well and they can easily excess to external finances.

In the set of control variables which include size (natural logarithm of assets) and investment opportunities (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 (long term debt/total assets) controls for different risk characteristics of firm. Ownership concentration is expected to substitute the weak investor protection and lack of financing due to underdevelopment of the financial markets. In some firms the entrepreneur founders who used their own resources and retained earning to finance their firms and have significant ownership stakes in the listed firms, this issue is addressed by using ownership concentration by top five largest shareholders.

6.4. Empirical Evidence

To investigate whether differences in the quality of firm level corporate governance help to explain firm level financial needs in a cross-section of companies the external financing need is regressed on index of corporate governance score and control variables and Table 6.1 reports the results. The results indicate that there is positive association between need of equity financing and quality of corporate governance taken as aggregate corporate governance index and also with board, transparency and disclosure scores of these firms, though the significance level is marginal. This suggests that firms which need more equity financing practice good governance. The interaction term of law with corporate governance have no significant impact. As regards the concentration of ownership it is negatively associated with reliance on external financing sources. This result is consistent with Shleifer and Vishny (1997) results who argue that countries with stronger shareholder protection, investors can afford to take minority position rather than controlling stakes. As a result firms tend to dispersed shareholders as owners and capital market are rather liquid. By constrict where shareholders rights are not well protected, the investor compensate this deficiency of financing by taking controlling stakes in a firm. The investment opportunities are positively related to external finance and suggest that firms with high growth are in more need of external finance. These results suggest the firm specific factors matters more in influencing the need of external financing when the legal environment is less investor friendly.

Table 6.1

Determinants of External Financing through Equity

Independent Variables	1	2	3	4
CGI	1.27**			
	(1.90)			
Dis		0.08**		0.56*
		(1.67)		(1.98)
Board			0.31	0.78
			(0.30)	(1.03)
Own	–0.01***	0.12***	0.001**	0.04
	(1.76)	(1.53)	(1.72)	(1.32)
Inv	0.12*	0.03*	0.10***	0.02***
	(3.02)	(3.09)	(1.61)	(1.56)
Size	0.14*	0.13*	0.13***	0.12*
	(3.30)	(3.11)	(1.52)	(2.21)
Lev	0.11*	0.12*	0.11***	0.03**
	(3.50)	(3.47)	(1.36)	(1.90)
*Lw*CGI*	–0.03	–0.01	–0.03	0.20
	(–0.90)	(–1.07)	(–1.49)	(0.03)
Constant	–0.50	–0.48	0.49	0.55
	(–2.86).	(–2.75)	(–1.92)	(–2.67)
R^2	0.28	0.27	0.27	0.29

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

To investigate the relation between firm value and access to external financial resources, the three performance measures Tobin's Q, ROA and ROE. Performance indicators are regressed on external finance, corporate governance and firm attributes: investment opportunities, size and interaction of enforcement of law with external and corporate governance and Table 6.2 presents the results. The firm that adopt better governance practices and disclose more in order to access less costly financing sources and these factors adds to their performance. Positive and significant coefficient of aggregate governance score and disclosure score indicate this fact that firms with higher-quality corporate governance and which are transparent are valued higher. In general the firms that align the managers and shareholders interest and are transparent are significantly valued by investors. These results are consistent with agency theory which focuses on monitoring of managers whose interests are assumed to diverge from those of other share holders. The study by Dernev and Kim (2006) also conclude that firms in need of external finance follow high governance practices and high class corporate governance is valued higher in case of US market. Investment opportunities have positive and significant impact on corporate valuation in all the models. These results confirm the predictions that firms with better investment opportunities have higher valuation. The coefficient of size is positive and significant in most of the cases. This shows that the large-sized firms that are likely to grow faster usually rely more on external resources and they adopt better corporate governance practices. The results of interaction term of rule of law with corporate governance and external financing do not have any significant impact on the valuation of the firm. These results indicate that legal framework is not providing relevant information regarding firm valuation in case of Pakistan. However, these findings are consistent to some extent with the notion that positive relationship is between access to external finance, governance and valuation is stronger in weak legal regimes [La Porta, *et al.* (1997); Pistor, *et al.* (2003); Durnev and Kim (2006)].

Table 6.2

Evidence on Firm Performance and Need of External Finance

	Tobin Q			ROA			ROE		
EF_i	0.10**	0.13*	0.11*	0.04**	0.03*	0.02*	0.04***	0.11	0.12**
	(1.87)	(3.51)	(2.87)	(1.86)	(1.93)	(1.71)	(1.57)	(1.36)	(1.58)
CGI_i		0.23**			0.11**			0.03**	
		(1.94)			(1.88)			(1.97)	
$Disc_i$			0.04*			0.11**			0.01**
			(2.00)			(1.96)			(1.87)
Inv	0.13**	0.23**	0.02**	0.09*	0.17***	0.12***	0.16**	0.04**	0.12
	(1.77)	(1.96)	(1.88)	(2.01)	(1.65)	(1.59)	(1.54)	(1.88)	(0.05)
Size	0.09*	0.05*	0.15*	0.12	0.01**	0.03***	0.09**	0.36**	0.12
	(1.95)	(2.21)	(2.11)	(1.69)	(1.71)	(1.59)	(1.69)	(1.97)	(0.72)
Lev	0.01*	0.02**	0.03**	0.12**	0.10**	0.16**	0.12**	0.02**	0.07***
	(1.78)	(1.52)	(1.87)	(1.86)	(1.74)	(1.97)	(1.75)	(1.92)	(1.54)
$Law*CGI_i$			–0.68			0.–70			0.92**
			(–1.27)			(–1.49)			(–1.74)
Intercept	–2.36	–0.24	–3.10	–0.57	–0.73	–0.80	0.87	–2.01	–1.65
	(–1.47)	(–2.50)	(–1.87)	(–1.22)	(–2.43)	(–2.38)	(–1.98)	(–3.54)	(0.94)
R^2	0.30	0.31	0.32	0..29	0.30	0.30	0.30	0.31	0.31

Note: The *, ** and *** indicates the significance levels at 1 percent, 5 percent, and 10 percent respectively. Values in parenthesis are *t*-statistics.

6.5. Summary and Conclusion

The factors that influence access to external finance are investigated widely for the developed markets but very little work has been done on how factors effect access to external finance in case of emerging markets. In this study the gap is filled by analysing an important issue of our times that the firms that are growing faster and need more external finance are one that practice good governance and are transparent in case of Pakistani Market. To address this issue empirically two models are estimated. First, the determinants of external financing through equity are investigated. Second, it is examined that firms that are more in need of external finance are valued higher in the stock market. Our sample firm consists of 60 non-financial firms which are listed on the Karachi Stock Exchange and comprises more than 80 percent of market capitalisation at Karachi stock market.

The results show that the strength of corporate governance systems affects the access to external financing of corporations. This suggests that firms which need more equity financing practice good governance. The results show that firms with high growth and large in size are in more need of external finance. The results also generally confirm the prediction of the theory that positive relationship between more access to external financing and valuation is strong in weak legal regime countries like Pakistan. Thus legal protection is essential for effective provision of financing. One implication that comes out from these findings that pro-growth polices generate more profitable investment opportunities and stimulate the external financing needs of the corporations. These results adds an important link to the explanation of the consequences weak legal environment for financial market development, external financing, corporate valuation and corporate governance.

Chapter 7: CONCLUSION

The relationship between corporate governance variables has been widely analysed for the developed markets but very little work has been done on how a broad range of governance factors effect the corporate performance, corporate ownership, and corporate access to external financing in thinly traded emerging markets. In this study this gap is filled by analysing the relationship between corporate governance and corporate valuation, its ownership structure and its ability to access to external financing for the Karachi Stock Market. To measure the firm-level governance we use a rating system to evaluate the stringency of a set of governance practices and cover various governance categories: such as board composition, ownership and shareholdings and transparency, disclosure and auditing. The sample consists of 60 non-financial firms listed on Karachi Stock Exchange and comprises more than 80 percent of market capitalisation at Karachi Stock Market in 2007.

The corporate governance index and disclosure and transparency index are used which are developed using the information from the annual reports of the companies. 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 categorised into three main themes. The three categories or sub-indices consist of: eight factors for the Board, seven for ownership, shareholdings and seven for transparency, disclosure and audit. The weighting is in the construction of index 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 at all. The average is taken out and we arrive at the rating of one sub-index.[31] By taking the average of three sub-indices we obtain CGI for a particular firm.

After measuring the corporate governance index, the analysis begins by estimating a simple model of determinants of corporate governance. To investigate the determinants of corporate governance the individual firm corporate governance score is regressed on ownership concentration, access to external finance, investment opportunities, firm size, leverage and interaction term of rule of law with external finance and ownership concentration. Ownership structure shows negative and significant relationship with aggregate corporate governance and disclosure scores however, when the interaction term of ownership with law there is no impact of legal environment. The concentration of ownership is negatively related with corporate governance. This suggests that weakness of investment protection and absence of corporate control firms rely on governance structure that is dominated by high concentration of ownership. The firm with concentrated ownership there is no reason to expect firms to disclose more. The inclusion of disclosure and transparency scores and other attributes are included in corporate governance index scores also are not directly related to agency problem. In addition, this result indicates that negative relationship between corporate governance and ownership concentration is strong with weak legal regime. Investment opportunities and firm size have positive impact both aggregate corporate governance score and disclosure scores. This confirms the theoretical notion that firms with better investment opportunities and larger in size adopt better corporate governance practice. The interaction terms of legal regime with external finance and concentration of ownership show insignificant relationship with corporate governance index and disclosure scores which suggests that in

[31] Sub-Index include (i) Board composition index, (ii) The ownership and shareholdings Index, (iii) Disclosure and Transparency.

legal environment which is less investor friendly firm specific factors matters more in choice of corporate governance practices.

In exploring the relationship between corporate governance and corporate valuation, the firm performance is linked to corporate governance, investment opportunities, firm size, and leverage and interaction term of law enforcement with corporate governance. The results document a positive and significant relation between the quality of firm-level corporate governance and firm performance. The firm performance is measured by two market level measures: Tobin Q and dividend payout ratio and two accounting measures: return on assets (ROA) and return on equity (ROE). In general the ownership and shareholders rights that align the managers and shareholders interest are significantly valued by investors. This is also true for board composition and independence index. Both these sub-indices have positive association with firm performance. These results are consistent with agency theory which focuses on monitoring of managers whose interests are assumed to diverge from those of other shareholders. However, the assumptions of agency theory are not applied to block holder owned firms. Most of the firms listed on KSE are family owned or institution owned. In these firms the alignment of ownership and control is tight and thus suggesting the need of outside directors on the board. However, the results show that open and transparent disclosure mechanism that reduces the information asymmetry have no affect on firm performance. This is due to the reason that we have used the annual reports as data source and these reports do not reveal all the information required for rating corporate governance.

The factors which determine the ownership concentration are explored, and the results suggest that there is negative relationship between ownership concentration and quality of corporate governance practices. The results reveal that in Pakistan corporations has more concentration of ownership which is the response of weak legal environment and this result validates the La Porta, *et al.* (1997, 1998, 1999, 2000) findings. This result suggests that ownership concentration is a response to poor legal protection [La Porta, *et al.* (1999)], Durnev and Kim (2006)]. The leverage is not a significant determinant of ownership concentration in all cases. The affect of profitable investment opportunities .is always positive and significant in all our models, which shows that more investment opportunities leads to more concentration of ownership and when firm suffers from a substantial drop in profitable investment opportunities, the controlling shareholders divert more corporate resources. The impact size on concentration of ownership is negative indicating that ownership concentration is significantly lower as the firm size expands.

The concentration of ownership seems to have positive effect on firms' profitability and performance measures. Our results are consistent with several empirical findings that document a positive and significant relationship between ownership concentration and firm performance implying that ownership concentration matters in determining firm's value. There is negative association

between corporate governance practices and disclosures and transparency with concentration of ownership. The results indicate that firm specific factors matters more in concentration of ownership. The findings reveal that more investment opportunities provides greater opportunity to for ownership concentration, however size has opposite effect and leads to delusion of ownership. It results in diverse ownership to get wider access to funds and share ownership. The interaction term of any variable with law enforcement term are not significant in any model suggesting that firm performance is not affected by rule of law in countries where legal environment is weak.

For deeper analysis the concentration of ownership is split into four separate groups of owners: director ownership, family ownership, foreign ownership and institutional ownership. The results indicate that all type of ownership concentration have positive and significant effect on firm performance. The results indicate that family ownership concentration results in better firm value relative to other type of ownership, as indicated by higher coefficient significance level. These findings are consistent with theoretical argument claiming that family owners and foreign owners bring better governance and monitoring practices. The corporate governance index and disclosure and transparency have positive effect on performance. The results support our previous findings that size and investment opportunities have positive and significant effect in most of our model.

In this study the determinants of external finance are also examined. The results show that the strength of corporate governance systems affects the excess to external financing by corporations. This suggests that firms which need more equity financing practice good governance. Thus with good corporate governance standards in place, it is ultimately the financial market which rewards good governance practices and punishes bad governance. The results show that firms with high growth and large in size are in more need of external finance. Thus legal protection is essential for access to less costly external financing. The relationship between external financing and ownership concentration (percentage shareholding by top five shareholders) is negative; however, investment opportunities and size both have positive impact on firm value. This confirms the theoretical notion that firms with better investment opportunities and more intangible assets perform better corporate governance practice. The interaction terms of legal regime with corporate governance have no insignificant relationship which suggests that in legal environment which is less investor friendly firm specific factors matters more in choice of corporate governance practices.

In investigating the relation between firm value and access to external financial resources we come to the conclusion that the firms need more external finance which have more profitable investment opportunities and are also valued higher. These firms adopt better governance practices and disclose more in order to access less costly financing sources and these factors adds to their

performance. The fact that the firms with higher-quality corporate governance practices and which are transparent; investors are more willing to provide finance to them. These results are consistent with agency theory which focuses on monitoring of managers whose interests are assumed to diverge from those of other share holders and investor feel protected and expect to get returns of his investment. The results investigating the relationship between corporate governance and corporate ownership reveal that in Pakistan corporations has more concentration of ownership which is the response of weak legal environment and this result validates the La Porta, *et al*. (1997, 1998, 1999, 2000) findings. The concentration of ownership seems to have positive effect on firms' profitability and performance measures. There is negative association between corporate governance practices and disclosures and transparency with concentration of ownership. The identity of ownership matters more than the concentration of ownership. The results indicate that firm specific factors influence more in concentration of ownership. The findings reveal that more investment opportunities provides greater opportunity to for ownership concentration, however size has opposite effect and leads to delusion of ownership. It results in diverse ownership to get wider access to funds and share ownership. These results are consistent with studies Boubakri, *et al.* (2003).

The results show that Corporate Governance Code 2002 potentially improves the governance and decision making process of firms listed at KSE. Large shareholders still have a tight grip of companies. However the results show that the firm level factors are more important indicate that adequate firm-level governance standard can not replace the solidity of the firm. The implication that the results suggests is that the low production and bad management practices can not be covered with transparent disclosures and transparency standards. Other implication that comes out from these findings that pro-growth polices generate more profitable investment opportunities and stimulate the external financing needs of the corporations. In Pakistan corporations has more concentration of ownership which is the response of weak legal environment. These results adds an important link to the explanation of the consequences weak legal environment for external financing, corporate valuation and corporate governance.

One can argue that a good corporate governance system should combine some type of legal protection of both the rights of large investors and those of small investors. Indeed, corporations in successful market economies, such as the United States, Germany, and Japan, are governed through somewhat different combinations of legal protection and concentrated ownership. In Pakistan there is lack of mechanisms for legal protection of investors and ownership concentration is substitute for this. The analysis suggests that the in revising corporate governance regulations SECP should adapt the international code of corporate governance according to the needs of Pakistani corporations.

APPENDIX

A1: Corporate Governance Index (CGI) Components

Sub-Index 1: The Board of Directors

(i) Board Size (number of directors).
(ii) Board Composition (Clear cut job description of all board members).
(iii) Chairman CEO Separation (if not any lead director).
(iv) Outside directors available to board (independent directors, nominee directors).
(v) Board attendance (board meetings).
(vi) Outside director attendance in Meetings.
(vii) Existence of the position of CFO.
(viii) Directors representing minority shareholders.

Sub-Index:2 Ownership and Shareholdings

(i) Presence of outside block holder (more than 10 percent shareholdings).
(ii) Does the CEO own shares.
(iii) Directors ownership (block ownership) other than CEO and Chairman.
(iv) Chairman or CEO is Block Holder (10 percent).
(v) Concentration of ownership (Top five).
(vi) Dividend Policy.
(vii) Staff benefits other than wages and salaries.

Sub-Index 3: Transparency, Disclosures, and Auditing

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

Table A1

Description of Variables

Variable	Symbol	Definition
Firm Value	*Q*	Tobin Q defined as sum of the book value of long term debt and market value of the equity divided by the book value of the total asset. Source: Annual Reports of Corporations.
Return on Assets	*ROA*	A performance measure. It is measured by operating profit divided by the book value of total asset. Source: Annual Reports of the Corporations.
Return on Equity	*ROE*	A performance measure. It is measured by operating profit divided by the equity capital. Source: Annual Reports of the Corporations.
External Equity Finance	*EF*	Market capitalisation of each firm multip ly with percentage of shares that are not taken by the top three shareholders. Source; Market capitalisation from Business Recorder's website: (www.brecorder.com.pk), percentage of shares are not held by top three shareholder is from annual reports of corporation.
Investment Opportunities	*Inv*	Average Sales Growth. Source: Annual Reports of Corporations.
Corporate Governance	*CGI*	Score of Corporate Governance Index. Source.
Disclosure	*Disc*	Disclosure and Transparency Scores. Source:
Shareholding and Ownership	*Share*	Shareholding and Ownership Scores.
Board Composition	*Board*	Board Composition Score.
Ownership Concentration	*Own*	Percentage of share ownership of first Five largest shareholders. Source: Annual Reports of Corporations: Annual Reports of Corporations.
Family Ownership	*Fam*	Percent Share held by Family: Annual Reports of Corporations.
Director Ownership	*Dir*	Percent Share held by Directors: Annual Reports of Corporations.
Foreign Ownership	*Fore*	Percent Share held by Foreign: Annual Reports of Corporations.
Financial Institution Ownership	*Fin*	Percent Share held by Family: Annual Reports of Corporations.
		Percent Share held by Financial Institution ICP, NIT: Annual Reports of Corporations.
Size of the Firm	*Size*	Ln(Assets). Source: Annual Reports of Corporations.
Law	*Lw*	Rule of Law. Source: World Bank.
Profit	*Pr*	Net income/total assets. Source: Annual Reports of Corporations.
Leverage	*Lev*	Book value of Long-term Debt/Book value of total asset. Source: Annual Reports of Corporations.

Table A2

List of Companies Included in the Sample

Name of Company	Symbol	Sector
Abbot Pakistan	ABBOT	Chemicals and Pharmaceuticals
Aruj Garments	ARUJ	Textile Composite
Agriauto Industries Ltd.	AGIL	Engineering and Allied
Al-Ghazi Tractors	AGTL	Auto and Allied
Azam Textiles	AZTL	Textile Composite
Ayesha Textile	AYTL	Textile Composite
Brother Textiles Ltd.	BRTL	Textile Composite
Bata Pakistan	BATA	Leather and Allied
Cherat Cement	CHCC	Cement
Crescent Textile Mills	CRTM	Textile Composite
Crescent Steel	CSAP	Engineering
Dadabhoy Cement	DBYC	Cement
Dar Es Salaam Sugar	DSSL	Sugar and Allied
Din Motors	DEEN	Auto and Allied
Fuji Fertiliser Bin Qasim	FFCL	Chemicals and Pharmaceuticals
Dawod Hericules	DHML	Chemicals and Pharmaceuticals
Engro Chemical Pakistan	ENGRO	Chemicals and Pharmaceuticals
Faisal Spinning	FASM	Textile Spinning
Emco Industries Ltd.	EMIL	Glass and Allied
Fauji Fertiliser	FFCL	Fertiliser
Fateh Textile	FTHM	Textile Composite
Ferozson Ltd.	FZML	Chemicals and Pharmaceuticals
Ellcot Spinning Mills	ESML	Textile Spinning
Gul Ahmed Textile	GULT	Textile Composite
Honda Atlas	HONDA	Auto and Allied
Hub Power Co.	HUBC	Power Generation & Distribution
I.C.I. Pak	ICI	Chemicals and Pharmaceuticals
Indus Motors	INDU	Auto and Allied
Indus Polyester Company	IDML	Auto and Allied
Japan Power	JPPO	Power Generation & Distribution
Karachi Electric Supply Co.	KESC	Power Generation & Distribution
Lever Brothers Pakistan	LEVER	Food and Allied
Metropolitan Steel	MMSL	Engineering and Allied
Mandviwalla Mauser Ltd.	MMPL	Plastic and Allied
Merit Packing Ltd.	MPL	Paper and Board
Maple Leaf Cement	MPLC	Cement
Mohammad Farooq Textiles	MFTL	Textile Composite
Mitchell's Fruit	MFFL	Food and Allied
Mirpurkhas Sugar Mills	MPKS	Sugar and Allied
National Refinery	NATR	Fuel and Energy
Nestle Milk Pak Ltd.	NESTLE	Food and Allied
Oil and Gas Development Corp Ltd.	OGDC	Fuel and Energy
Packages Ltd.	PACK	Paper and Board
Pakistan PVC Ltd.	PVCL	Cables and Electric Goods
Pakistan Tobacco Company	PAKT	Tobacco
Pakistan Hotel Development Ltd.	PHDL	Service
Pakistan Services	PKSL	Leather
Pakistan Gum and Chemicals Ltd.	PAKG	Chemicals and Pharmaceuticals
PTCL	PTC	Fuel and Energy
Pakistan Petroleum Ltd.	PPL	Fuel and Energy
Pakistan Papaersack Corporation	PPCL	Paper and Board
Sitara Chemicals	SITC	Chemicals and Pharmaceuticals
Sui Southern Gas Company	SNGC	Fuel and Energy
Sui Northern Gas Company	SSGC	Fuel and Energy
Shahtaj Sugar Mills	SSML	Sugar and Allied
Sindh Abadgar Sugar	SASL	Sugar and Allied
S.G. Fibre Ltd.	SGFL	Textile Composite
Suzuki Motorcycles	SMCL	Auto and Allied
Southern Electric	SELL	Fuel and Energy

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