Corporate Governance and Firm Performance: A Case study of Karachi Stock Market

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Abstract

This paper seeks to study the relationship between corporate governance and firm's performance of twenty five companies listed at Karachi Stock Market. The performance of corporate governance is analyzed through whereas the performance of the companies is measured by return on assets (ROA) and return on equity (ROE). The data set is obtained from the State Bank of Pakistan Annual Reports for the year 2011-2015. The multiple regression models are applied to check the significance of corporate governance and firm profit. The result shows that leverage and growth have a positive relationship between impacts in measure performance of the firm.

Keywords: Corporate Governance, Firm Performance, Return of asset, Return of equity, Karachi Stock Market

Introduction

A sustainable economic development is carried out by the help of good corporate governance, by enhancing their capital and companies progress. In under developing or emerging new markets public policy objectives are served by the good corporate objectives. Reduces vulnerability of the financial crises, reinforcement property rights; reduces transaction cost and cost of capital and leads to capital market development. 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.

The governance is a system which is made up with the wide range of practices and institutions, from accounting standards and law concerning disclosure about finance. It also defines a person who owns a firm, and dictates the rules by which economic returns are distributed among shareholders, employees, managers, and other stakeholders. As such, a country's corporate governance regime has deep implications for firm organization, 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 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 firm performance 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.

Problem statement

There should be best performance of all sectors of Karachi Stock Exchange but there is not such good performances by Karachi sectors. However Karachi sectors have not good performance so there is need to conduct a research on it to locate an out effect of corporate governance on firm performance.

Research Question

What is the effect of corporate governance with overall performance of firm?

Hypotheses

H1_a= there is no significance relationship between firms size, leverage and firm growth with corporate governance

H1_b= there is significant relationship between firms size, leverage and firm growth with corporate governance.

Literature Review

Evidence from previous empirical study from educational literature has sought to confirm the effect of corporate governance on a firm's performance. There is a outsize body of empirical research that has assessed the impact of corporate governance on firm performance for the developed markets. Research 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.

(Mitto, 2001) Suggested 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.

(Brown, 2004) found indicate that better governed firms are relatively more profitable, more valuable and pay more cash to their shareholders. (Gompers, 2003) concluded that firms with fewer shareholder rights have lower firm valuations and lower stock returns and firms with stronger shareholders rights have higher firm value, higher profits, higher sales growth, lowest capital expenditures, and made fewer corporate acquisitions (Lipton, 1992) concluded that 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.

The relation between the proportion of outside directors, a proxy for board independence, and firm performance is inconclusive. (Fosberg, 1989) (Bhagat, 2002) find no linkage between proportion of outsider directors and return on assets, asset turnover and stock returns.

The evidence on the association between audit-related governance factors and firm performance is mixed. Brown and Caylor (2004) show that independence, (Klein, 2002) documents a negative relation between earnings management and audit committee independence, and (Anderson, 2004) find that entirely independent audit committees have lower debt financing costs. (Frankel, 2002) show a negative relation between earnings management and auditor independence (based on audit versus non-audit fees). However, (Agrawal) and (Larcker, 2004) come up with a contradictory evidence. Kinney, et al. (2004) findings show no association between earnings restatements and fees paid for financial information systems design and implementation or internal audit services, and (Agrawal, Corporate Governance and Accounting Scandals., 2005) up with similar conclusion in this regard. (Yermack, 1996) found the separation of CEO and chairman affects firms' performance because the agency problems are higher when the same person holds both positions.

In the past few years, corporate governance has become an important area of research in Pakistan. In his noteworthy work (Cheema, 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.

Rais and Saeed (2005) analyze 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.

Conceptual Framework

In this study the conceptualization is known as framework of key concepts. It shows the relationship between dependent variable and independent variables. Here the independent variables are size, leverage and growth. Two variables are dependent which are Return of Asset (ROA) and Return of Equity (ROE).

Figure # 1

(Independent Variable)
(Dependent Variable)

Methodology

For this research I have been taken secondary data of both sectors of Karachi stock exchange twenty five companies are selected. The data has been taken from State Bank of Pakistan I complied previous studies 5-years data of these sectors from (2011-2015). For this research our dependent variables are Return of Asset and return of equity and Independent variables are Size, leverage and Growth. I have used to SPSS to check the significance of the data after we apply multiple regression model for the data.

Model specification

The data of the study takes from five years periods it has sample of 25 firms which are in Karachi Stock Exchange. Data collected from the annual report of all selected firms. For the estimation of result regression analysis applied on pooled sample equation.

$$Y_{it} = \beta_0 + \beta_1 X1_{it} + \beta_2 X2_{it} + \beta_3 X3_{it} + u_{it}$$

Where,

Y_{it} represents Return on Asset (ROA) and Return on Equity (ROE) for firm i and time t .

- ❖ $X1_{it}$ represents firm's size (size) for firm i and time t .
- ❖ $X2_{it}$ represents LEVERAGE for firm i at time t .
- ❖ $X3_{it}$ represents ratio of GROWTH for firm i at time t .
- ❖ $i = 1$ to 25 firms
- ❖ $t = 2011-2015$
- ❖ u = Error term.

Pooling is that reliable and satisfies method of to obtain result from model. The relationship between corporate governance and firm profitability is stable /equal across the firm there for pooled procedure best for this type of data

Result and Analysis

Return of Asset

a. Predictors: (Constant), Growth rate=Present Sale- Previous Sale/ Previous Sale * 100 , L=T. Liabilities / T.Asset, log of total assets
b. Dependent Variable: Return of Equity

Model	R	R Square	Adjusted R Square	the Estimate	Change	F Change	df1	df2	Statistics	Watson
1	.291 ^a	.084	.062	91.83885	.084	3.687	3	120	.014	1.787

In this table show the R^2 value should lie between 0 and 1. The researcher is interested in the high value of R^2 . In this particular the value of R^2 is .084 shows that 84% variation in the return on Equity is explained by the size, leverage and growth. R shows the

degree of association between ROE with size, leverage and growth. The value is .291 which shows moderate degree of association between the variables.

ANOVA ^s						
Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	2634.434	3	878.145	3.591	.016 ^a
	Residual	29342.617	120	244.522		
	Total	31977.051	123			

a. Predictors: (Constant), Growth rate=Present Sale- Previous Sale/ Previous Sale * 100 , L=T. Liabilities / T.Asset, log of total assets

b. Dependent Variable: Return of Asset

In this table shows the value of F-Statistics is 3.591 with P-Value .016 which is less than 0.05 shows that model is significant and is a good fit.

Coefficient						
Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
1	(Constant)	-27.040	11.647		-2.322	.022
	L=T. Liabilities / T.Asset	6.474	.000	-.055	-.628	.531
	log of total assets	5.224	1.703	.271	3.068	.003
	Growth rate=Present Sale- Previous Sale/ Previous Sale * 100	.016	.022	.064	.732	.466

In this table shows the β_1 is the regression coefficient of leverage and tells us that with the influence of size and growth rate held constant, the return of asset increase the 6.474.

Return of Equity

Model Summary^b

Change Statistics										
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	R Square Change	F Change	df1	df2	Sig. F Change	Durbin-Watson
1	.287 ^a	.082	.059	15.63719	.082	3.591	3	120	.016	.676

a. Predictors: (Constant), Growth rate=Present Sale- Previous Sale/ Previous Sale * 100 , L=T. Liabilities / T.Asset, log of total assets

b. Dependent Variable: Return of Asset.

In this table show the R^2 value should lie between 0 and 1. The researcher is interested in the high value of R^2 . In this particular the value of R^2 is .082 shows that 82% variation in the return on equity is explained by the size, leverage and growth. R shows the degree of association between ROE with size, leverage and growth. The value is .287 which shows moderate degree of association between the variables.

ANOVA ^b						
Model		Sum of Squares	df	Mean Square	F	Sig.
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	Residual	29342.617	120	244.522		
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Conclusion:

This research has been conducted to find out the relationship between corporate governance and firm performance of twenty five listed at Karachi Stock Exchange. Data was taken of 25 companies listed in Karachi Stock exchange. ROA and ROE two profitability ratios are used to find out the corporate governance with firms performance. After applying regression model on data of all companies listed in Karachi stock exchange the result shows that there is a positive relationship between corporate governance and firm performance.

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