

## An Empirical Investigation on Corporate Governance: Evidence from Pakistan

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**Abstract** *This study aims to examine the association between firm performance and ownership structure. We collect the data from the annual reports of 60 random firms, which are listed in the Karachi stock exchange (KSE 100 Index), for a period of 5 years from 2007-2011. Firm performance is measured by using market and accounting based proxies, Tobin's Q, ROA, and ROE, respectively, while ownership structure is measured as a percentage of shares held by the Board of Directors. The findings reveal that ownership structure has a negative and significant association with firm performance (accounting-based proxy).*

**Key Words:** Ownership Structure, ROA, ROE, Leverage

**JEL Classification:**

### Introduction

In the changing corporate governance paradigm, ownership structure and its degree of integration and concentration are vital for the implementation of corporate governance mechanism. Concerning modern enterprise setup, there are several corporate governance structures that lead to different ownership structures.

Corporate governance is interpreted as the process and structure of conducting corporate law cases with the aim of improving the well-being of the organization and, eventually, increasing the value of stockholders and protecting the individual and collective interests of all stakeholders. Good corporate governance procedures can have a significant impact on a company's strategic decisions, such as—external financing, etc. However, the implementation of corporate governance mechanisms comes with the agency's problem ([Berle and Resources, 1932](#)).

An important issue that policymakers and social scientists do not pay sufficient attention to is the agency problem, which relates to the ownership structure and its association with organizational performance in the overall performance of the company.

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[Wright et al. \(1996\)](#) suggest that majority shareholder may affect the overall competitiveness of the company and, ultimately, its survival.

The theories which support our study include agency theory and transaction cost theory to review the theoretical background of the topic. [Coase \(1937\)](#) proposed transaction cost theory which reveals that the organizations carry out certain transaction only at a lower cost than transaction cost in the market. Later Williamson (1971) and [Alchian & Demsetz \(1975\)](#) made their contribution to the transaction cost theory by studying the failure in the market and organization inefficiency. The economic principal-agent theory reveals something about the relationship between the principal and agent ([Jensen & Meckling 1976](#)). There are several factors affecting the monitoring process of the principal, which includes the asymmetry of information and some other factors which do not let the principal monitor effectively.

In the comprehensive literature of corporate governance, a difference is made between equity and voting rights. The study examines the impact of ownership with respect to majority shareholders on financial performance.

The majority shareholding is the degree of control of shares by majority shareholders. The proxies for that are the percentage and quantity of shares of the major shareholders, the total share of shareholders and the cash rights of the major shareholders. Different types of institutional ownership, foreign ownership, public ownership, and the shareholding of parent or subsidiaries in the company.

The organization of the study is as follows; the literature review is in section two, the methodology is in section three, the results are in section four and the conclusion in section five.

## Literature Review

An important issue that policymakers and social scientists do not pay sufficient attention to is the agency problem, which relates to the importance of corporate structure in the overall profitability of the company. The majority of stockholders may affect the overall competitiveness of the firm and, ultimately, its survival ([Wright et al. 1996](#)).

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Most of the theoretical debates deal with concerns related to the agency theory. The separation of proprietorship and management ownership always leads to differences in the interests of managers and shareholder, as principal and agent. [Jensen and Meckling \(1976\)](#) estimate the costs associated with the company's agency problem. [Fama \(1980\)](#) argues that the proper functioning of the labour market will affect management's

behaviors. While if the market function properly, managers may act in line with the interest of owners ([Jensen and Ruback, 1983](#)).

Management should encourage shareholders to file claims, so when investors pay dividends to companies, it is a way to meet investors' needs, and some companies do not prefer paying dividends ([Baker and Wurgler 1963](#)). [Myers \(1984\)](#) introduced the pecking order theory, according to which companies use capital orders to invest, especially retained earnings.

[Grossman and Hart \(1982\)](#) argued that a shareholder should not be encouraged to audit managers on a regular basis in the context of a highly fragmented ownership structure since everyone felt that the potential benefits of monitoring are too small to justify oversight costs. "If the company is doing well, then management of the firms hold fewer shares and ownership because it is better for managing the company's high performance ([Loderer and Martin 1997](#)). The negative relationships suggested by their findings strongly support the argument that when the owner and management both hold the shares of the organization, the company's performance improves.

[Cho \(1998\)](#) studied the relationship among corporate value, ownership structure, and investment and found there that these variables are interlinked with each other. The study examined the relationship by using ordinary least square regression. [Ng, Yuce and Chen \(2009\)](#) conducted the study by using a sample of 4315 Chinese firms; the study investigated the influence of ownership structure on firm value. [Andres \(2008\)](#) noted that family businesses only perform better if they are active in the business-like board of directors or chief executives; the findings suggest that family business do not perform better if they are an only large shareholder and have no representation in the board of directors.

[Liang, Huang, and Lin \(2011\)](#) argued that the link between firm profitability and ownership structure depends on the firms' characteristics concerned with firm profitability and growth. [Haider et. al. \(2012\)](#) analyzed the ownership concentration effect on profitability. Whereas concentration ownership has negative relation with market performance and has a positive relationship with the indicators of financial performance, which are return on assets and sales growth.

## Hypothesis

**H1:** Ownership structure is related to market-based firm performance

**H2:** Ownership structure is related to accounting-based firm performance

## Methodology

We collected the data of 60 random firms from annual reports of firms listed on the Pakistan stock exchange (KSE 100 index) for a period of 5 years from 2007-2011. We applied several econometric techniques to attain robust results, including correlation and regression analysis.

## Explanation of Variables

### Firm Performance

The reason for selecting different measures is to attain robust findings, and the literature has not given priority to any specific measure.

## Accounting Based Measure

### Return on Assets

ROA is the extent to which the firm's profitability is related to the total assets. The accounting-based measure is also used because of high volatility in the stock market, where stock prices do not justify the efficiency of markets. Also, in emerging markets like Pakistan, firms use debt financing more; thus, shares markets do not reflect the actual value of the firms.

### Return on Equity

Luzhen (2012) also used accounting-based measures for firm performance and noted that ROE is a more sensitive measure of firm performance.

## Market-Based Measure

### Tobin's Q

It is calculated by the ratio of the market value of equity and book value of assets. Various researchers have used Tobin's Q as a firm performance measure and found that as a reasonable predictor of ownership structure.

## Independent Variable

### Ownership Structure

Ownership Structure is defined as the number of shares held by the Board of Directors.

## Control Variables

### Leverage

Leverage is defined as the degree to which the firm utilizes the borrowed money; leverage also provides tax advantages while the firm which is highly leveraged have more chances of bankruptcy. [Frank and Goyal \(2003\)](#) noted that debt ratio could be measured by book value or market value, as book value represents the past situation of a company and market value highlights the firm's future position.

### Size

In previous studies, different proxies have been used to measure the firm size, like a natural log of assets and a natural log of sales.

## Specification of Model

### Econometric Models

$$\text{Tobin's Q} = \beta_0 + \beta_1 \text{O.S} + \beta_2 \text{SZ} + \beta_3 \text{LEV} + \varepsilon_i \quad (1)$$

$$\text{ROA} = \beta_0 + \beta_1 \text{O.S} + \beta_2 \text{SZ} + \beta_3 \text{LEV} + \varepsilon_i \quad (2)$$

$$\text{ROE} = \beta_0 + \beta_1 \text{O.S} + \beta_2 \text{SZ} + \beta_3 \text{LEV} + \varepsilon_i \quad (3)$$

Tobin's Q refers to the market-based measure of performance, OS refers to a total number of shares held by majority shareholders, ROA refers to net profit before tax/average total assets, ROE refers net income/average total equity, SZ refers to natural log of sales, LEV refers to total debt divided by total assets, and  $\varepsilon_i$  refers to the error term.

## Results

**Table 1.** Summary of Descriptive Statistics

Variables	Mean	Median	Minimum	Maximum	S. D
Tobin's Q	1.472	0.0046	(47.08)	346.12	1.274
ROA	6.544	3.85	(40.9)	77.74	0.876
ROE	7.320	11.31	(823.35)	2.276	4.581
OS	26.069	14.290	0	88.36	1.579
SZ	14.742	14.921	0	18.510	0.131
LEV	42.88	0.625	0.00031	990.83	3.600

Table 1 shows the summary of descriptive statistics for all the variables. The mean value for Tobin's Q indicates that, on average, the market value of Pakistani firms is 1.4, while the standard deviation is 1.274. The mean values for ROA and ROE are 6.54% and 7.32%, respectively, while the standard deviation values are 0.876 and 4.58, respectively. The mean value of the Ownership structure (percentage share held by the board of director) is 26%, with a Standard Deviation of 1.579. The mean value for variable leverage is 42.88%, while the Standard deviation is 3.60, while for the variable control size, the value of mean is 14.74%, and the Standard Deviation is 0.131.

**Table 2.** Correlation among Variables

	O.S	SZ	LEV
O.S	1		
SZ	0.091	1	
LEV	0.034	0.014	1

The table show correlation among variables, and from the table, it is evident that there is a positive correlation between ownership structure, firm size and leverage, and the relationship is stronger for ownership structure and firm size as the value of  $r = 0.091$ .

**Table 3.** Regression Analysis with Market-based measure

Dependent Variable	Variables	Coefficient	T-stat	Sig.	R-Square
Tobin's Q	Intercept	-7.234	-0.805	0.421	0.080
	O. S	-0.041	-0.852	0.394	
	SZ	0.665	1.129	0.259	
	LEV	-0.001	-0.066	0.946	

The value of R-Square is (0.082) in Table 3, which shows that our independent variable explains about 8% of variation in the dependent variable. The relationship between firm performance measured as market-based and ownership structure is insignificant. The relationship is also insignificant with the control variables as size and leverage. This finding is in line with the study of [Demsetz and Villalonga \(2001\)](#). The findings do not support the agency theory, so it implies that the owners exercise their hold in the firm decisions and does not trust the managers.

**Table 4.** Regression Analysis with Accounting based measure

Dependent Variable	Variables	Coefficient	T-stat	Sig.	R-Square
ROA	Intercept	-8.670	-1.439	0.151	0.580
	O. S	-0.082	-2.504	0.012	
	SZ	1.178	2.985	0.003	
	LEV	-0.001	-0.087	0.929	

The table shows that the value of R-Square is (0.580), which is very high compared to model 1. Also, firm performance, when measured through ROA, which is an accounting-based measure, has a significant negative relationship with the ownership structure at a 1% level. Thus, the firm needs to adopt corporate governance practices to ensure the better viability of its business. This finding is in line with the entrenchment hypothesis that majority shareholders try to dilute the interest of minority shareholders by increasing their hold in the management, and the consequence of this is the decline in firm performance. Similarly, the variable size also has a significant relationship, and it is positive. Thus, it implies that when the size of a firm increases, the firm performance increases as well. The reason for this positive relationship can be that as the firm size increases, the majority shareholders try to seize their hold on the corporation to make decisions favorable for them.

**Table 5.** Regression Analysis with Accounting based measure

		Coefficient	T-stat	P-value	R-Square
ROE	Intercept	-16.835	-0.519	0.603	0.021
	O. S	0.0217	0.122	0.902	
	SZ	1.598	0.753	0.452	
	LEV	0.007	0.093	0.925	

In table 5, the value of R-Square is 0.021, which means our independent variable explains only 2% variation in dependent variables; also, the relationship is insignificant between firm performance measured as ROE and ownership structure.

## Conclusion

An important issue that policymakers and social scientists do not pay sufficient attention to is the agency problem, which relates to the ownership structure and its association with organizational performance in the overall performance of the company. [Wright et al. \(1996\)](#) suggest that majority shareholder may affect the overall competitiveness of the company and, ultimately, its survival.

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This paper examines the relationship between firm performance and ownership structure by using 60 firms listed on KSE in non-financial structure. Because of limited studies in the Pakistani context, the paper seeks to fill the gap on the time and geographical basis by using the most recent data and to see the effect of some variables by using different proxies as of previous studies. From the results, it can be concluded that firm performance, when measured as ROA, has a significant negative relationship with ownership structure, while the relationship is insignificant with the other proxies ROE and market based variable Tobin's Q, which show that the majority shareholder of firms try to expropriate the firm resources for their own benefits, and this affects the performance of firms.

This study highlights some important policy implications for the managers and corporations that this concentrated ownership structure does not fulfil the objective of the firm, which is to maximize the wealth of shareholders, similarly, in Pakistan, a lot of businesses are family-owned; thus the siphoning of revenues and understatement of expenses is a common practice for them. Therefore, it is important that these firms should ensure compliance with the corporate governance structures to ensure the long-term viability of the business.

As far as future research is concerned, this finding may be more robust if the sample size is increased and some other variables for firm performance like earning per share (EPS) and Gross Profit margin (GPM) are considered. Similarly, the effect of the industry can be considered in future studies.

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