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Impact of Corporate Governance on Firm Performance: Evidence from Sugar Mills of Pakistan

BILAL LATIF[1*], MUHAMMAD NAEEM SHAHID[2], MUHAMMAD ZIA UL HAQ[3]
HAFIZ MUHAMMAD WAQAS[4], ARBAB ARSHAD[5]

1. MS scholar in Government College University, Faisalabad
2. Lecturer in Informatics College of Science and Technology Faisalabad
3. MS scholar in Government College University, Faisalabad
4. Lecturer in Government College University, Faisalabad
5. MS scholar in Government College University, Faisalabad

* bilallatif143@gmail.com

Abstract

This paper examines the impact of corporate governance mechanisms (Board Size, Board Composition, and CEO/Chairman Duality) on firm performance (Return on Asset) in sugar industry of Pakistan. The data of corporate governance mechanisms (Board Size, Board Composition, and CEO/Chairman Duality) collected from 12 listed sugar mills of Pakistan from 2005 to 2010. Using panel data methodology as a method of estimation Arithmetic mean, ANOVA and t-test applied on data by using SPSS. The results raveled that there is a significant impact of corporate governance on firm performance. Results further reveal that there is a significant impact of board size, CEO/Chairman Duality on ROA, and there is insignificant impact of Board Composition on ROA.

Keywords: Corporate governance, Board of director, firm performance

1. Introduction

Corporate governance (CG) is concerned with governing the corporate entities. Corporate entity does not mean to just a company but it include all the business. CG focuses on the wealth of business not on the profits of the business.CG protects the interests of all the stakeholders from expropriation.

Good corporate governance contributes toward economic stability by enhancing the performance of companies and increasing their access to outside capital. Corporate governance serves a public policy objective. It reduces the vulnerability of the financial crises. Reduces cost of capital and transaction cost. CG concerns with the relationship among management, board of directors, controlling shareholders, monitoring shareholders, and other stakeholders.

There is no single definition of CG that can be applied to all situations .The various definitions that exist today largely depend on the institution or author, as well as country and legal tradition.

According to La Porta corporate governance is "a set of mechanisms with the help of which outsiders safeguard themselves against expropriation by the insiders. Insiders include both managers and controlling shareholders". Safdar.A. Butt defines corporate governance as "the mechanisms used to control and direct the affairs of a corporate body in order to serve and protect the individual collective interests of all its stakeholders".

Mechanisms indicate all the basic tools including rules, laws, code of conduct, management techniques, image building risk management strategy development that direct and effect the directions and affairs of any organization. And these are the tools which used to protect the interest of individuals and all the stake holders.

In Pakistan, the first Code of CG was finalized and issued by SECP in March 2002. Then it was subsequently incorporated in all the listed companies at stock exchanges in Pakistan. It was the first effort by the government of Pakistan. In 2004, SECP took the first step to establish the Pakistan Institute of Corporate Governance in public private partnership.

Firm performance is an important concept that relates to the way and manner in which financial resources available to an organization are judiciously used to achieve the overall corporate objective of an organization, it keeps the organization in business and creates a greater prospect for future opportunities. This study is a contribution to the ongoing debate on the examination of the relationship that exists between corporate governance mechanisms and firm performance.

1.2: Sugar industry in Pakistan

At the time of independence in 1947 there were only 2 sugar factories in Pakistan. The output of these factories was not sufficient to meet the domestic requirements of the country, and then sugar was imported from other countries

and at that time huge foreign exchange was spent on sugar. The first sugar mill was established in 1961 at TANDO MUHAMMAD KHAN in Sindh. During 1997-1998 there were 75 sugar mills in the country and produced 2.4 million metric ton sugar.

Sugarcane is an important industrial and cash crop in Pakistan. And it is 2nd largest agro –industry in Pakistan after textile. Pakistan is the 15th largest sugar producer, 5th largest in terms of area under sugar cultivation, 60th largest country in sugar yield in the world. Currently there are 83 sugar mills in Punjab, Khyber Pakhtoonkhwa (KPK), and in Sindh. In addition to sugar sugarcane also provide a number of other products like: alcohol used by pharmaceutical sector, bagasse in paper and press mud used as a source organic matter and as a source of energy for bricks makers.

Measuring firm performance using accounting ratios is common in the corporate governance literature, in particular, return on capital employed and return on assets.

1.3: Problem statement

A lot of work is done to examine the relationship of the corporate Governance and Firm performance in the whole world. But work related to this field is not available for Pakistani sugar industry in abundance. In this study our focus is the sugar mills of Pakistan to examine the relationship between Corporate Governance and Firm Performance that, does the corporate governance affects the firm performance or not? Investors in Pakistan have a little information about the performance of sugar industry and how the corporate values affect the performance of firm.

1.4: The objectives of this study are

1. To make a contribution to Corporate Governance research in Pakistani industry.
2. To measure the effect of the Corporate Governance on Firm performance in the sugar industry of Pakistan.
3. To examine the impact of corporate governance on firm's profitability in sugar sector of Pakistan.

For the purpose of this study, as Independent variables, we are using Board size, Duality and Board Composition and the firm performance (Return on Assets) as the dependent variables.

2: Literature Review

Chugh, Meador & Kumar (2011) found that a larger board size creates more opportunities and resources for better financial performance. According to Ibrahim, Rehman and Raoof (2010) there is a negative correlation of ROA with board size. Coleman (2007) derived that large board size enhances corporate performance .Cheng Wu, Chiang Lin; I-Cheng &Feng Lai (2005) concluded that board size is significantly and negatively related to firm performance

Cheng Wu,Chiang Lin, I-Cheng &Feng Lai (2005) found that board composition is positively and significantly related to firm performance. Javid&Iqbal (2008) in their study concluded that the Board composition has positive & significant impact on firm performance.

According to Yasser, Entebang&Mansor (2011) there is a no significant relationship between ROA and CEO / chairman duality. Chaghadari (2011) in the results of his study provided the evidence that the CEO duality has a negative impact on ROA. In simple words, CEO duality is found to decrease the effectiveness of the board of directors. Chugh, Meador & Kumar (2011) investigated that CEO duality is negatively correlated by firm performance. According to Coleman (2007) resulted that CEO duality has a negative effect on profitability and suggested to separate the position of CEO and chairman chair. Cheng Wu, Chiang Lin, I-Cheng &Feng Lai (2005) concluded that CEO duality is negatively and significantly related to firm performance.

Lam and Lee (2012) examined that board composition is positively (negatively) related to firm performance. Such positive or negative relationship depends on the independence or non-independence of the composition of board. Ceo/chairman duality is negatively related to firm performance.

Ujunwa (2012)by using panel data regression model drive that board size, ceo/chairman duality was negatively related with firm performance, whereas board independence have positive impact on firm performance. Corporate governance and board research have mainly been influenced by agency theory, stewardship theory and resource dependency theory

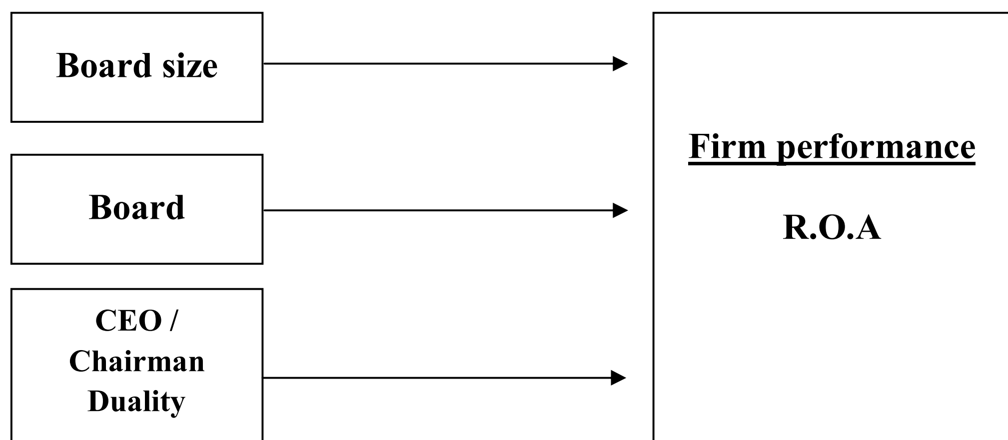
Ponnu (2008)concluded that impact of CEO Duality and proportion of independent directors on company performance has received close attention by researchers in corporate governance in recent years it was found that there is no significant relationship between duality and board independence to company performance

According to Coleman & bike pee (2006) board size is positively related to ROA but negatively related to sales growth rate as performance variables. The size of the board is on various performance measures though insignificant and surprisingly the board composition has a negative impact on firms' performance in Ghana

Board composition also plays a significant role in shaping the corporate value system of any corporation. Jones and Goldberg (1982), Even and Freeman, (1983) Leuma and Goodstein, (1997) explicitly described in their research articles that the companies that separate ownership and control, the responsibility for defining and changing corporate values is often effectively left to the management. Relationship with critical stakeholders may be internalized by having them represented on the board as non-executive members. Board members may effectively represent different ownership groups (for example founding families, large block holders or Institutional Investors as well as owner managers). In some countries employees or governments are entitle to board representation. But owners may also voluntarily choose to appoint members with links to stakeholders groups (e.g. the financial community or research institutions) that are believed to be important to firm growth or survival.

Steiner (1996); Han and Suk (1998) and Woidtke (2002) stated that the ownership decision allocates ownership rights across the relevant parties, i.e. the company's present and potential owners. This is a matching problem in which potential owners with specific characteristics are matched with firms, which have their own specific characteristics. Hart, (1995) and Hansmann, (1996) further elaborated that the owner characteristics include access to information, capital and knowledge and for given firm characteristics, the economic theory of corporate ownership predicts that the ownership will be allocated to minimize transaction costs. But regardless of the actual determinants, ownership has material consequences for the values and behavior of the firm.

3: Theoretical frame work



4: Methodology

There are 83 companies working in Pakistan presently. But the data was available for only 12 companies, so researcher chose these companies as a sample for research.

The Data on; board size, board composition, duality and ROA, needed for this research is collected from the annual reports of the companies for six years, from 2005 to 2010. And the calculated ROA is taken from the Basic Balance Sheet Analysis issued by the State Bank of Pakistan.

4.1: Model

A panel data approach is used for this research because, according to Himmelberg (1999), it facilitates removal of the unobservable heterogeneity that may exist in the different firms. Yasser (2011) concluded that, the first advantage of the panel data regression is this that by combining the time series and cross section observation panel

data provides better informative data, less co-linearity among the variable and more efficiency. And secondly, panel data minimizes the biasness that may be caused if separate firm level data are divided into broad aggregates. And finally, panel data can measure the effects that are not possible to observe in pure cross section or pure time series data.

This research is made for the purpose of evaluating the effect of corporate governance on firm performance while examining the sugar industry of the Pakistan. The Models are as under:

ROA = a + b1 (BS) + b2 (BC) + b3 (Duality) + e

Where:

ROA = Return on Asset

BS = Board Size

BC = Board Composition

Duality = CEO and Chairman Duality

e = Error

Explanation of Variables

Variable	Definition
Independent variable	
Board Size	The total number of directors in the firm.
Board Composition	It shows the number of executive directors and number of non-executive directors.
Duality	It indicates that either the post of CEO and Chairman are being held by the same person or by two different persons.
Dependent Variable	
ROA	Return on Assets. Calculated by Net Income divided by Total Assets.

(a) Board Size

In a large board size there is a problem of communication between board members, quick decision making could not possible, which causes great detriment to firm performance .Yermack (1996). According to Eisenberg et al. (1998) and Singh and Davidson (2003), board size has a negative relation with firm performance. , this article proposes the hypotheses as follows.

Ho：b1=0

Board size has no effect on ROA

Ha: b1 ≠ 0

Board size has some effect on ROA

(b) Board composition

In this research board composition is an independent variable. Independent directors are required on the board to control the activities of executive directors due to their opportunistic behavior, and make a check and balance on the board (Jensen &Meckling, 1976). Independent directors are considered as “decision experts” (Fama& Jensen, 1983). Non-executive directors can reduce managerial consumption (Brickley& James, 1987). Non-executives directors act as middleman between company and external stake holders. According to the Tricker (1984) the of non-executive directors on Boards provides “additional windows on the world” According to Pakistani Code of corporate governance (2002) boards of directors must have the proportion of executive directors must not exceed 75%.

Ho： b2=0

Board composition does not affect ROA

Ha: $b2 \neq 0$

Board size may be taken as causal factor of ROA

(c) Duality

The board of directors can lose its independence and monitoring power when the chairman is working as a decision-maker as well as also as a supervisor and consequently performance is being affected in a negative way. It is attested by the Bally and Dalton (1993), Bahya (1996) that CEO duality deteriorates firm performance. So following the above stated attestation we proposed the hypotheses as under:

Ho： b3=0

Ceo/chairman duality has no impact on ROA

Ha: $b3 \neq 0$

Ceo/chairman duality has some impact on ROA

4.2: Results

Table 1. Descriptive Statistics

	N	Mean	Std. Deviation
Size	72	26.25	13.960
Bcom	72	20.83	8.681
Duality	72	.42	.496
ROA	72	6.25	14.274
Valid N (list wise)	72		

The results have shown that he mean of board size, board composition and Duality, independent Variables, is 26.25, 20.83, and 0.42 respectively. And the Standard Deviation is 13.960 for board size, 8.681 for board composition and for duality standard deviation is 0.496. On the other hand the mean of dependent variable ROA (Return on Assets) is 6.25 and 14.274 is standard deviation for Return on assets.

Table 2. ANOVA[b]

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	3480.350	3	1160.117	7.642	.000[a]
	Residual	10322.619	68	151.803		
	Total	13802.969	71			

a. Predictors: (Constant), Duality, Size, BCom

b. Dependent Variable: ROA

Table 3. Model Summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.506(a)	.256	.223	12.58046

a Predictors: (Constant), duality, size, comp

Results of table 2 research show that all the independent variables have highly significant impact on ROA. As it is significant at .000 which shows collectively Board size, Board Composition, CEO/Chairman Duality have significant impact on firm performance. Results of table 3 show the value of coefficient of determination which is 25.6%. Its means that 25.6% change in ROA is due to change in corporate governance mechanisms.

Table 4. Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients	t	Sig.
		B	Std. Error	Beta		
1	(Constant)	2.189	5.650		.387	.700
	Size	.245	.112	.246	2.189	.032
	BCom	.073	.194	.045	.375	.709
	Duality	-9.539	3.427	-.340	-2.784	.007

a. Dependent Variable: ROA

Results of table 3 show that board size has some significant impact on ROA. As it is significant at .032 which shows that it has a significant impact on firm performance. Unitary change in board size will bring change in ROA by 0.245 These results are in line with(Mollah, Al Farooque, & Karim, 2012). Board composition has insignificant impact on firm performance which is being measured by ROA. Board composition has insignificant impact on firm performance. It explains that when more independent directors sit on the board, the firm's performance decreases. Thus, companies do not fully utilize the roles of the independent directors. The directors may sit on the board to fulfill the board composition requirements or to show that the board is "*independent*", but in reality it is not CEO/Chairman Duality has a significant impact on ROA it is significant at .007 which shows that CEO/Chairman Duality has an impact on firm performance. t_{cal} for Board Size, Board Composition, and CEO/Chairman Duality is respectively as 2.189, .375, and 2.784 . This means that in family firms when chair of ceo and chairman is held by same person performance of firm will increase these results supports by Yasser, Entebang, and Mansor (2011) (Lam & Lee, 2012).

5. Conclusion

Corporate governance is now a global issue. The first code of Corporate Governance in Pakistan was issued in March 2002 by Security and Exchange Commission Pakistan (SECP).SECP established an institution for corporate governance in2004. This research conducted to evaluate the effect of corporate governance on firm performance in Pakistan. For this purpose we chose sugar sector in Pakistan to cheek the impact of CG on firm performance. CG measured by ROA.

As the results shows that CG has significant impact on firm performance. Board size has significant impact on firm performance, Board Composition has an insignificant impact on ROA and CEO/Chairman Duality has a significant impact on ROA. And collectively all independent variables have significant impact on CG.

6: Limitation of the Study

For the purpose of this study we have chosen 12 sugar companies of Pakistan out of total of 84 sugar companies because of the reason that the data needed for the purpose of this research was not available for most of the companies.

7: Recommendations:

- Code of corporate governance should be followed.
- There should be an optimal board size say, seven directors on board
- Board should have a composition of Executive and non-executive directors
- CEO and chairman's chair should be separate

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