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Financial Performance and Corporate Governance Attributes

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ABSTRACT

This study has investigated the impact of corporate governance mechanisms on the financial performance of refinery sector in Pakistan over the period of 2011-2015. The sample includes 10 companies listed in the Pakistan Stock Exchange(PSX).Linear multiple regression models were built to analyze the relationship between the dependent variable Return on Equity (ROE) and the independent variables i.e board size, firm performance and audit committee. Based on the results of empirical analysis, it is concluded that board size has significant impact on the ROE.The audit committee and firm size have insignificant impact on ROE.This study is significant to contribute future academicians for a better understanding of the relevant.It is also important for the firm managers to concentrate more on these factors.

Keywords:
Corporate Governance, Return on Equity (ROE), board size, audit committee, firm size.

I. Introduction

Corporate governance can be and is defined in more than one ways.The legal defintions vary from the definitions used in accountancy subjects.in general it can be deifined as mechanism used to govern the companies effectively so that all stakeholder benefit from the company.Needless to say that the shareholders are considered main stakeholder.However, this mainstage position for shareholders is based on Agency theory.In stakeholder and stewardship theories, this position is reserved for the shareholders. Board of Directors (BoD) are given a atiltle of stwerads and the Priciple-Agent relationsips is somewhat sidelined.Regarless of the agmcy followed for the CG, it is the duty of the BoD to run the company.By running they are fulifilling the requiremenrts set by the law to maximize the shareholders wealth.Indoing so, they are inderietly benefiting the other stakhoders as well.These stakeholders are (Rafique, Entebang, & Mansor, 2011).Good corporate governance enhances economic stability by increasing the performance of the companies and increase access towards outside capital.CG helps to achieve public policy objectives. Good corporate governance reduces the cost of transaction and cost of capital. (Latif, Shahid, Haq, Waqas, & Arshad, 2013)

Good corporate governance evaluates either the environment for business is fair or not and also CG ensures companies can be held liable for their actions. On the other hand, weak corporate governance indicates a waste of time, mismanagement and manipulation.

Good corporate governance leads to transparency of financial records, make easy access to the financial market, capital, and also through diversification of assets, partnership, and acquisition provide existence incompatible environment.CG provides better incentives to the shareholder in the form of security on their investment and gives sufficient information on the decision about the sale of assets and the incorporation of articles. Internationally,the codes of corporate governance were introduced by the Organization for Economic Co-operation and Development (OECD) in the year 1999.Thsoes codes addressed the concerns raised by the stakeholders across the globe.However, adherence to those codes was nonmandatory in their nature.Most of the developed nations adopted those best practices rules.Pakistan was comparatively late in the introduction of the corporate governance approach and principles. In the year of 2002, the Securities and Exchange Commission of Pakistan(SECP) finalized the codes of corporate governance. SECP introduced the institution of corporate governance in 2004 for further advancement in corporate governance practices.In 2017,Pakistan witnessed new legislation for the companies (CA 2017) and the latest rules from the SECP (2017 Code of CG).Some radical changes are seen. For Example, Indepnedence of the directors is more emphasized upon.Alos, the presence of a female director is mandatory on the board of directors. More accountability and disclosures requirements are introduced in these pieces of CG.How effective they are proved.It is too early to say.This is also the limitation of this study which have anlysed the financial results of the companies prior to these intoductions.To conduct this study the commonly used proxies for the CG are used.These include board size, chairman duality, and audit committee as the independent variables, and two firm performance measures return on equity, and net profit margin are taken as dependent variables in this research.

In Pakistan, the corporate governance field is still in the infancy stage, and more work is yet needed to be done for the effective control of corporate governance. The Securities and Exchange Commission of Pakistan is the regulatory body that directs the performance of corporate sectors. Pakistan is the country in which researches in this field has been mainly upon quantitative and conventional measures. The stakeholders interested in the financial performance of the company. So it's important to identify the variables which influence the financial performance of the company so that the management concentrates on these factors. However, profitability has become a severe challenge for companies to make their financial position stable and sound concerning meet the risk associated with globalization. This study will identify the key elements that have impact on the financial performance of the companies, and the management modifies its operations to enhance their profits.

II. Literature review

Most of the studies have been conducted around the world in many countries to analyze the impact of corporate governance mechanisms on firm performance. In previous studies Return on Assets(ROA), Return on Equity(ROE), Net Interest Margin (NIT) has been used as a dependent variable and corporate governance mechanism (Board size, Audit committee, CEO duality, Firm size, Board Independence)have been used as the independent variable.

Several studies have established that board size impacts firm performance, however, it provides the mix findings. Too small board size and too large board size have an adverse effect on firm performance. M.Guest(2009) Examine the impact of board size and firm performance of UK listed firms from the year 1918 to 2002 using the sample of 2746 listed firms. The board size was measured by the total number of members on the board the firm performance measured by the return on equity, Tobin's Q and profitability. The findings revealed that the board size has a strong negative impact on these firm performance indicators. The results suggest that negative relation of the board size and firm performance is strongest in the large firms. Some existing studies criticized the dual role of CEO, Ujunwa(2012) stated that decision-making authority with the same person CEO and chairman of the board might not working in the best interest of shareholders.

Moscu (2013) narrated that CEO Duality means two powers like the position of chief executives officers and chairman of the board are controlled by one person.so it is the responsibility of the board of directors to monitor the activities of CEO that either he is working in the best interest of the shareholder or not. Hence, it is essential to have a relationship between CEO and chairman of the board. Entirely public organizations have to decide about the leadership arrangement of the organization that one person whether or not fulfill the responsibilities of the CEO and chairman of the board. On the other hand separation of these two positions increases the additional cost like agency cost. So empirical findings indicate that CEO duality has a positive relationship with firm performance (De Oliveira Goodridge et al. 2012; Dharmadasa et al., 2014) stated that no correlation exist among CEO duality and firm performance.The study also told that CEO duality is not appropriate measure for firm performance.

The audit committee is an essential aspect of corporate governance that oversees the financial reports and disclosure and keeps in check the faulty conduct of mangers.Cohen et al.(2011) stated that independent audit committee keeps checking on the manipulated and self- centered activities of managers and provides the reliability of the financial reporting. (Arslan et al.(2014) suggested that firms that have more independent members of their audit committee have lesser chance of frauds and the independent audit committee improve the quality of audit reports and enhance the firm performance.

The theoretical framework has been shown below the three predictors of firm's performance refinery sector were selected that include, board size, audit committee and firm size to check their effect on Return on equity(ROE) which is dependent variable in this study.

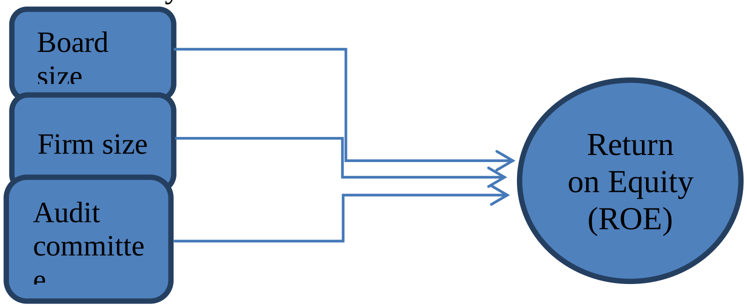

Table 2.1: Measurement of Variables

Variables	Calculation/Definition
Board size	Total members on the board
Firm size	Log of total assets
Audit committee	The composition of the audit committee that is, outside as a proportion of the total directors.
Return on equity	Net income/Total equity

III. Methodology

All companies of the refinery sector listed in Pakistan stock exchange are the population of study. The sample size of the research consists of 10 companies for the period of 2011-2015, covering period of 5 years.

The study employs the secondary data that is annual accounting data of refinery sector collected for the period of five years for 2011 to 2015.Data of variables collected from different sources. Corporate mechanism (board size, audit committee, and firm size) collected from the annual reports of the companies. The dependent variable data Return on equity collected from the state bank of Pakistan database. Multiple regression models have been applied through SPSS (Statistical Package for Social Science) software to determine the relationship between the dependent & independent variables. Return on equity (ROE) is taken as dependent and firm size, Board size, and audit committee are independent variables.

The model used for this study captured the above mentioned variable that may affect firm performance the model is:

$$Y_1 = \beta o + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + e$$

$$ROE = \beta_o + \beta_1 \text{ (Board size)} + \beta_2 \text{ (audit committee)} + \beta_3 \text{ (firm size)} + e$$

Table 3.1: Regression Analysis

Model	Unstandardized Coefficients		t	Sig.
	B	Std. Error		
(Constant)	223.983	187.108	1.197	.238
Board Size	-22.651	7.508	-3.017	.004
Firm Size	2.811	21.454	.131	.896
Audit Committee	1.674	9.944	.168	.867

In the above table, the result shows that β_1 is the partial regression coefficient of board size and tell us that with the influence of, firm size and audit committee held constant, as board size decreases by 1rupee, the return on equity of the refinery sector firms will decrease by 22 Paisa is on average. The β_2 tells us that holding the influence of board size, and audit committee constant, as firm size increases by 1 rupee; the ROE will also increase by 2 Rupees on average. The β_3 shows that holding the influence of board size and firm size constant audit committee increases by 1 Rupee, the ROE will increase by 1 Rupee on average. The value of constant is also meaningful; it shows that if the board size, firm size, and audit committee remain constant the value of Return on Equity is still 223.983.

Table 3.2: Summary Statistics

R	R Square	Adj. Square	Std. Error	D.W
.433[a]	.187	.131	50.383	2.140

The value of R^2 should lie between 0 and 1. The researcher is interested in the high value of R^2. In this particular case, the value of R^2 is 0.433 shows that 43% variation in the return on equity is explained by the board size, firm size and audit committee which is moderately low and it looks like some more variable should be the part of study to increase the explanatory power of the model. R shows the degree of association between ROE with board size, firm size, and audit committee. The value is 0.187 which shows low degree of association between the variables.

Table 3.3: ANOVA

Model	Sum of Squares	Df	Mean Square	F	Sig.
Regression	25175.872	3	8391.957	3.306	.029[b]
Residual	109156.972	43	2538.534		
Total	134332.844	46			

The value of F-statistics is 3.306 with P-value 0.029 which is less than 0.05 shows that the model is good fit.

IV. Conclusion

This study has investigated the impact of corporate governance mechanism on the financial performance of refinery sector in Pakistan throughout 2011-2015.The sample includes ten companies listed in the Pakistan stock exchange. Linear multiple regression models were built to analyze the relationship between the dependent variable Return on Equity(ROE) and the independent variables board size, firm performance and audit committee. Based on the results of empirical analysis, it is observed that board size has significant impact on the ROE. The audit committee and firm size have insignificant impact on ROE.

- Secondary data is used this study, which is obtained from the annual financial reports of the firms.
- Model is developed from the variables that are obtained from the prior studies no new factor is entered.
- The time duration of the study is also very small from 2011-2015 that may influence the results.
- Further research can be conducted by expanding it to other sectors of the economy.
- Further research can be conducted by comparing before and after the introduction of the new codes of CG in Pakistan .y including more variables such as board composition, leverage, shareholders return etc.
- Addressing a longer period of time with having a broader selection of financial and corporate governance conditions.

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