

The Impact of Corporate Governance on Financial Performance and Solvency Risk of Pakistan's Cement Manufacturing Firms

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Abstract

Good corporate governance instills investors' trust in the financial market. Good governance creates goodwill, enhances firm financial performance and reduces risk. However, if the companies are not governed properly then they lose confidence of each stakeholder due to suboptimal financial performance and become more risky. The main objective of this research study is to analyze the impact of corporate governance on financial performance and solvency risk of cement sector firms on the Pakistan Stock Exchange (PSX). For accomplishment of research objective, 20 cement sectors firms listed on the PSX, Pakistan, constituting 83% of the entire cement industry was used from year 2005 to 2014. Hypotheses were tested using regression analysis. Auto-correlation and heteroscedasticity were also tested through the Best Linear Un-biased Estimator. Corporate governance is measured through the fraction of insider directors on the company's board, institutional shareholdings, board independence and audit committee, whereas, return on assets, return on equity and net income margin are used to measure financial performance, while solvency risk is measured through times interest earned. The findings reveal that corporate governance positively effects financial performance. There is evidence of the efficient monitoring hypothesis. However, corporate governance negatively affects solvency risk. This study not only contributes to understanding the effect and relationship between corporate governance, financial performance and solvency risk but at the same time prove the results of earlier research work that have shown a significant effect and relationship between corporate governance, financial performance and solvency risk. This research study is very useful for corporate policy makers and managers and especially for cement industry in understanding of corporate governance practices, its significance and impact on financial performance and solvency risk in developing economy like Pakistan.

Keywords: Corporate Governance, Financial Performance, Solvency Risk, Pakistan Stock Exchange

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Introduction

Corporate governance is one of the key areas of business which enhances the confidence of investors and allow for protecting their interest. The significance of corporate governance is realized by the investors, corporations and governments for competing domestically and internationally (Owen, 2003). In academic researches, corporate governance has got great concentration in developed and developing countries (Mallin, 2004; Reed, 2002; Solomon & Solomon, 2004; Weir & Laing, 2001). A need was felt for sound corporate governance practices especially in developing countries due to financial scandals in past (Baydoun, Maguire, Ryan & Willett, 2013). Great consideration has been devoted to corporate governance in under-developed economies as many of these lacks appropriate corporate governance practices (Ekanayake, Perera & Perera, 2010).

Corporate governance is important for economic development of Pakistan as it plays a key role in economic growth of a country. The Securities and Exchange Commission of Pakistan (SECP) has centered its regulatory measures in promoting investors confidence to uphold sound corporate governance to make sure transparency and accountability in the corporate sector and protect all stakeholders particularly minority stakeholders. Code of corporate governance for Pakistan was issued by SECP in March 2002 and it was included in the listing regulations of firms in PSX and promulgated the revised code of corporate governance in 2012.

All the firms strive to attract corporate investors in national and global financial market by paying maximum amount of wealth on invested capital. Wealth maximization occurs when stock price is increased for current shareholders. Maximization of shareholders wealth is the primary goal of every firm (Van Horne & Harlow, 2009). The goal of shareholders and other corporate stakeholders including lenders, employee, business associates, society at large and government is accomplished if there exists sound governance in companies. If companies are governed poorly, will face poor financial performance and consequently will be become more risky and there will be more chances of bankruptcy and even collapse. It is believed that practice of corporate governance is an internal mechanism for operation of corporations. It can instill investors' confidence and effect corporate financial performance. According to Ghabayen, (2012) corporate governance is a useful tool for guaranteeing excellent performance. Good corporate governance reduces the limits of risk level and thus managers are prepared for investing in riskier but beneficial projects (John, Litov & Yeung, 2005). Bankruptcy risk can be reduced by risk-averse managers in giving preference to

equity financing than debt financing (Brennan, 1995).

This research is conducted for analyzing the impact of corporate governance on financial performance and solvency risk of cement sector firms listed on Pakistan Stock Exchange (PSX) from year 2005 to 2014. Insider directors, institutional shareholdings, board independence and audit committee are used as the facets of corporate governance, whereas, financial performance is measured through return on assets, return on equity and net income margin, whereas solvency risk is calculated through times interest earned.

Literature Review

It is imperative for business organizations to generate maximum profit in order to survive, compete and grow in the market. Profit maximization is the primary goal of every business firm which can be accomplished by applying sound corporate governance practices. If firms will distribute sound amount of dividend amongst current shareholders, on time payment to creditors and government agencies, protect the interest of employees and act as good citizen by applying good corporate governance mechanism then firms can instill confidence of all stakeholders. Corporate governance has traditionally been related with the principal-agent problem or the agency conflict. Principal and agent relationship occurs when those who own a firm is not alike as those who manages or controls the firm. Agency theory has its heredity in theories of economic, developed by Jensen and Meckling, (1976). The agency theory analyzes that shareholders (principal) who are real owners of corporations assign the operation of corporation to managers (agents). The principals anticipate that agents will work in the best interest of corporation and will make decisions which will increase firm's value. However, the interest of agents may diverge from principal. Morck, Shleifer and Vishny, (1988) analyzed in the convergence of interest hypothesis that the problem of ownership separation and control is overcome with managerial shareholdings.

Corporate governance plays a vital role in accomplishment of organizational goal across the globe due to emergence of markets, trade liberalization, financial crises, capital mobility and technological advancement. Corporate governance is considered as mainstream concern in structure of corporations in all corporate board (Claessens, Djankov & Lang, 2000). According to Edwards & Nibler, (2000) corporate governance systems perform a significant role in financial performance as they present mechanism which effect investment's return for suppliers of finance to corporation (Edwards & Nibler, 2000). Nestor and Thompson, (2000) have categorized these systems into two kinds: Anglo Saxon Model and Continental Model. Anglos Saxon Model

inclined to depend on managers' compensation for corporate control, whereas, Continental Model inclined to rely on several stockholders to support the managers and owners behavior. The Anglo Saxon model is based on concept that ownership stake and decentralized market can perform in a self-controlled, balanced manner and is founded on notion of capitalism market (Cernat, 2004). Therefore, corporations have normally same systems of corporate governance in Anglo American countries: UK, US, Australia and Canada. In this model, management activities are monitored and controlled by one independent board of directors for maximizing wealth of shareholders. The Continental Model of corporate governance focus on analyzing on the stakes of crew, managers, clients, suppliers and community, which aid innovations and competitions (Giurca Vasilescu, 2008).

The code of corporate governance was firstly notified in 1970 in USA and emerged in the listing requirements of companies on stock exchange in March 2002 in Pakistan. Corporate stakeholders are affected by the financial performance and risk. The stake of each stakeholder mostly clash with the interest of other. Amongst them only few stakeholders possess more control in decision making. A system is needed which can serve and protect the individual and collective stake of each stakeholder and protect exploitation of each stakeholders interest and from the monopoly of individual stakeholder in decision making. Corporate governance is the system used for attaining the individual and corporate stake (Butt, 2012). According to the Organization for Economic Cooperation and Development (OECD) principles of corporate governance, (2015) corporate governance is the amalgamation of relationship in shareholders, board, management and rest of stakeholders. The process used for directing and controlling and held to account is termed as corporate governance (Australian Standard, 2003). According to Audit Commission, (2009) and Chartered Institute of Public Finance and Accountancy and the Society of Local Authority Chief Executives, (2007) emphasize the essential component of accountability and controlling in corporate governance. The fundamental objective of corporate governance measure is to direct and control in order to bring transparency in corporations which in return affect financial performance of companies. Financial performance is subjective gauge of how efficiently an organization could utilize entire resources to produce income. Financial performance could be use a common measure of the entire financial situation during particular time period and could be use to evaluate same firms across the similar industry or to evaluate aggregate sector. Barbosa and Louri, (2005) applied return on assets, earning per share, sales growth, market capitalization and dividend

earning to measure financial performance. (Davies, Hillier & McClogan, 2005; Kapopoulos & Lazaretou, 2009) support the fact that insider directors directly affect firm financial performance of firm.

Pound, (1988) analyzed institutional ownership and its effects on financial performance of the firm and proposed that Efficient Monitoring hypothesis enhances financial performance of the firm. Berle and Means, (1991) suggested that institutional shareholdings reduce cost of transaction as well as it removes agency problem to a great extent. Hermalin and Weisbach (2001) identified that more improvement in profitability is achieved by firms with more independent directors, which in turn enhance financial performance of firm. The problem of agency conflict arises due to separation of corporate ownership and control which demand for proper execution of audit committees as a mechanism of corporate governance. Audit committee is an effective subcommittee of board of directors for sound corporate governance (Abbott, Park & Parker, 2000). Cohen and Hanno, (2000) emphasize the importance of independence audit committee to assess the actions of management in risk analysis and its effect on firm performance. They conclude that audit committee positively effects performance of firm.

Javed and Iqbal, (2006) conducted a study to appraise corporate governance and financial performance of fifty non financial firms, including more than 80% of market capitalization listed at Karachi Stock Exchange, Pakistan. They conclude that there is a positive and significant relationship between corporate governance and financial performance of firms. Good corporate governance leads to sound financial performance (Drobtz, Shillhofer & Zimmermann, 2003). Researchers' point of view is that application of sound corporate governance enhances financial performance of firms (Chugh, Meador & Kumar, 2009). Firms deliver good financial performance if governed effectively but in case of poor governance, the financial performance will become weak and bear risk.

Investors expect a return on their investments. The chances that actual return will deviate from the expected are termed as risk. Risk is about the difference in the standard deviation of the return on assets for specific time period (Saito, 2008). The term risk is linked to the expectation of human beings (Roggi, Garvey & Damodaran, 2012). Risk is grouped into systematic risk and unsystematic risk. Systematic risk cannot be controlled and minimize through diversification which is influenced by the external factors: inflation, higher rate of interest and recession, while unsystematic risk can be controlled and minimized through diversification which is influenced by the internal factors of business (Aggarwal & Samwick, 1999). According to Prasetyo, (2011) corporate governance significantly effects firm risk. Corporation with

good governance applications can reduce risk.

Corporations can improve managerial efficiency, minimize risk, increase value for stakeholders and can gain competitive advantage through effective corporate governance. Corporations with good governance practices earn comparatively high income and cash dividends to its stockholders (Brown & Caylor, 2004; Sharabati, Jawad & Bontis, 2010). (Mayers & Smith, 2010; Rogers, 2002; Sharpe & Stadnik, 2007) identify that corporate governance negatively effect solvency risk of firm. The core purpose of this research is to evaluate the impact of corporate governance on financial performance and solvency risk of cement sector firms listed on PSX and suggests measures to improve corporate governance practice in a view to minimize the solvency risk and maximize financial performance.

The corporate governance system is weak in Pakistan. This implies the following hypotheses:

H₁: Corporate governance positively effects firm performance.

H₂: There is a negative relationship between corporate governance and risk.

Model

The model has been developed on the strength of existing literature (Agyei & Owusu, 2014; Azeem, Hassan & Kouser, 2013). The different dimensions and facets of these variables have been taken from these researchers with some novelty in the form of variables used and proxies. The solvency risk of the firm is analyzed in this paper. The financial performance has been measured with more rich proxies than the previous researchers.

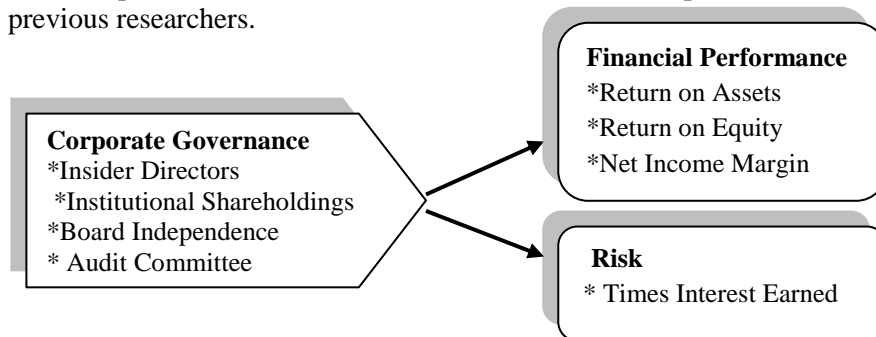


Figure No.1. Model

Data

The sample selected comprises of 20 cement manufacturing firms listed on the PSX, Pakistan from the year 2005 to 2014. Our sample accounts for 83 percent of the entire market capitalization of cement industry. Descriptive research design is employed which involves the collection, analyses and modeling of data for analyzing the hypotheses. The data collected regarding corporate governance, financial performance and risk is scrutinized using descriptive statistics: mean and standard deviation and Pearson Product Moment correlation analysis. The statistical package, Stata 13 is used to perform the analysis.

Descriptive Statistics of the Variables

Table 1 reports descriptive statistics of the variables.

Table 1 Internal Consistency and Reliability (N=200)

Variables	Mean	Std. Dev	Min	Max
Insider Directors	0.56	0.30	0.00	3.97
Institutional Shareholdings	0.22	0.22	0.00	0.77
Board Independence	0.15	0.36	0.00	1.00
Audit Committee	1.46	0.23	0.00	4.00
Return on Assets	0.21	0.06	0.17	3.13
Return on Equity	0.29	0.29	0.03	2.09
Net Income Margin	0.01	0.31	1.70	1.61
Times Interest Earned	1.48	0.18	0.06	1.48

Correlation Analysis

Corporate Governance and Financial Performance

Return on assets and corporate governances. The correlation analysis reports that fraction of insider directors, institutional shareholdings, board independence and audit committee (independent variables) are positively correlated with return on assets.

Table 2 Correlation Analysis: Return on Assets and Corporate Governance Variables

	ROA	ID	IDR	BI	AC
Insider Directors	0.22				
Institutional Shareholdings	0.01	-0.04			
Board Independence	0.33	-0.05	0.14		
Audit Committee	0.01	0.06	0.01	0.11	1.00

Note. ROA= Return on Assets, ID= Insider Directors, IS= Institutional Shareholdings,

BI= Board Independence and AC= Audit Committee

Return on equity and corporate governance. The correlation analysis reports that insider directors, institutional shareholdings, board independence and audit committee (independent variables) are positively correlated with return on equity.

Table 3 Correlation Analysis: Return on Equity and Corporate Governance Variables

	ROE	ID	IS	BI	AC
Insider Directors	0.24				
Institutional Shareholdings	0.06	-0.09			
Board Independence	0.27	-0.06	0.14		
Audit Committee	0.09	-0.06	-0.01	-0.11	1.00

Note. ROE= Return on Equity, ID= Insider Directors, IS= Institutional Shareholdings,

BI= Board Independence and AC= Audit Committee

Net income margin and corporate governance. The correlation analysis reports that insider directors, institutional shareholdings, board independence and audit committee (independent variables) are positively correlated with net income margin.

Table 4 Correlation Analysis: Net Income Margin and Corporate Governance Variables

	NIM	ID	IS	BI	AC
Insider Directors	0.19				
Institutional Shareholdings	0.06	-0.05			
Board Independence	0.23	-0.06	0.14		
Audit Committee	0.14	-0.06	-0.00	-0.11	1.00

Note. NIM= Net Income Margin, ID= Insider Directors, IS= Institutional Shareholdings,

BI= Board Independence and AC= Audit Committee

Corporate Governance and Solvency Risk

Times interest earned and corporate governance. The correlation analysis reports that insider directors, institutional shareholdings, board independence and audit committee (independent variables) are negatively correlated with times interest earned.

Table 5 Correlation Analysis: Times Interest Earned with Corporate Governance Variables

	TIE	ID	IS	BI	AC
Insider Directors	-0.01				
Institutional Shareholdings	-0.11	-0.04			
Board Independence	-0.30	-0.05	0.14		
Audit Committee	-0.17	-0.06	-0.01	-0.11	1.00

Note. TIE= Times Interest Earned, ID= Insider Directors, IS= Institutional Shareholdings,

BI= Board Independence and AC= Audit Committee

Analysis and Discussions

Corporate Governance and Financial Performance

Corporate governance and return on assets. The regression results are robust and adjusted R-square is 0.31. The result indicates that fraction of insider directors, institutional shareholdings, board independence and audit committee positively effect return on assets. There is evidence of the Efficient Monitoring hypothesis that predicts that institutional shareholdings improve financial performance of firm (Pound, 1988). Hermalin and Weisbach, (2001) analyzed that independent directors on corporation's board improve profitability. Insider directors enhance financial performance of firm (Kapopoulos & Lazaretou, 2009).

Table 6 Regression Analysis: Corporate Governance and Return on Assets

	Coef.	Std. Err.	T	P	[95% Conf. Intl]	
Insider Directors	0.01	0.01	2.03	0.04	0.05	0.07
Institutional Shareholdings	0.01	0.13	1.53	0.01	-0.66	0.64
Board Independence	0.10	0.11	2.08	0.05	0.32	0.12
Audit Committee	0.01	0.06	1.10	0.02	-0.12	0.13
Number of observations	=	200				
F Value	=	5.44				
P Value	=	0.00				
Adjusted R-squared	=	0.31				

Corporate governance and return on equity. The regression results are robust. The result indicates that fraction of insider directors, institutional shareholdings, board independence and audit committee positively effect return on equity. There is evidence of the Efficient Monitoring hypothesis that predicts that institutional shareholdings positively affect financial performance of firm (Pound, 1988). Hermalin and Weisbach, (2001) analyzed that independent directors on corporation's board improve profitability. Insider directors enhance financial performance of firm (Kapopoulos & Lazaretou, 2009).

Table 7 Regression Analysis: Corporate Governance and Return on Equity

	Coef.	Std. Err.	T	P	[95% Conf. Interval]	
Insider Directors	0.01	0.00	2.31	0.02	0.03	0.01
Institutional Shareholdings	0.01	0.17	2.01	0.09	0.24	0.54
Board Independence	0.30	0.14	2.04	0.04	0.01	0.59
Audit Committee	0.04	0.09	1.51	0.05	-0.13	0.22
Number of observations	=	200				
F Value	=	7.54				
P Value	=	0.00				
Adjusted R-squared	=	0.37				

Corporate governance and net Income margin. The regression results are robust. The result shows that fraction of insider directors, institutional shareholdings, board independence and audit committee positively effects net income margin. There is evidence of the Efficient Monitoring hypothesis that predicts that Institutional shareholdings improve financial performance of firm (Pound, 1988). Hermalin and Weisbach, (2001) analyzed that independent directors on corporation's board improve profitability. Insider directors enhance financial performance of firm (Kapopoulos & Lazaretou, 2009).

Table 8 Regression Analysis: Corporate Governance and Net Income Margin

	Coef.	Std. Err.	T	P	[95% Conf. Interval]	
Insider Directors	0.02	0.01	2.99	0.04	0.00	0.05
Institutional Shareholdings	0.09	0.21	2.47	0.04	-0.31	0.51
Board Independence	0.24	0.10	2.32	0.02	0.03	0.45
Audit Committee	0.10	0.04	2.20	0.02	0.01	0.19
Number of observations	=	200				
F Value	=	5.61				
P Value	=	0.00				
Adjusted R-squared	=	0.37				

Corporate Governance and Solvency Risk

Corporate governance and times interest earned. The regression results are robust. The result shows that insider directors, institutional shareholdings, board independence and audit committee negatively effects times interest earned.

Table 9 Regression Analysis: Corporate Governance and Times Interest Earned

	Coef.	Std. Err.	T	P	[95% Conf. Interval]	
Insider Directors	-0.07	0.05	1.33	0.18	-0.03	0.17
Institutional Shareholdings	-10.36	4.34	-2.39	0.01	-18.92	-1.79
Board Independence	-14.11	3.39	4.16	0.00	7.42	20.80
Audit Committee	-3.72	1.84	2.02	0.04	0.08	7.36
Number of observations	=	200				
F Value	=	5.43				
P Value	=	0.00				
Adjusted R-squared	=	0.26				

Conclusion

This research study finds evidence that corporate governance positively effects firms' performance. However, corporate governance negatively affects the solvency risk of cement sector firms listed on PSX. The

corporate governance measures enhance the performance of cement manufacturing firms listed on PSX. There is considerable evidence of the hypothesis that corporate governance positively influences financial performance of firm. The empirical analysis provides evidence in support of this hypothesis. The results also indicate that all the facets of corporate governance positively effects financial performance. Managerial shareholdings improve financial performance of firm.

The analysis reveals that corporate governance plays a vital role in order to enhance firm performance. The fraction of independent director(s) in the board and audit committee positively affects the financial performance of cement manufacturing firms. The fraction of insider directors enhances financial performance of firm (Kapopoulos & Lazaretou, 2009). There is evidence of the Efficient Monitoring Hypothesis that predicts that institutional shareholdings increases financial performance of firm (Pound, 1988). Hermalin and Weisbach (2001) identify that more improvement in profitability is accomplished by corporations with more independent directors. This study documents the empirical evidence provided by (Hermalin & Weisbach, 2001) that fraction of insider directorship positively effects financial performance of firm. There is ample empirical evidence on corporate governance and financial performance of firms and the findings of the current study support the previous researchers' work (Brown & Caylor, 2004; Mitton, 2001). The analysis provides evidence of hypothesis that corporate governance negatively effects solvency risk. The presence of independent directors on company boards, institutional shareholders and proper functioning of audit committee reduce the solvency risk. There are several evidence on corporate governance and solvency risk of firms and this study supporting the preceding research on the relationship between corporate governance and firm solvency risk (Anderson & Reeb, 2003; Cheng, Evans & Nagarajan, 2008; Wahla, Shah & Hussain, 2012).

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