Reconnecting the Ownership Structure and Independence with Financial Performance: An Empirical Evidence from Manufacturing Sector of Pakistan

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Abstract:
Debate on the corporate governance is among contemporary issues in business. In consistent with this research stream, this study aims to find the impact corporate governance elements i.e. independence (board and audit committee) and ownership structure (ownership concentration and managerial ownership with financial performance (EPS and Market to Book ratio). For this purpose, 500 firm-year observations of 50 non-financial companies (for the period of 2001 to 2010) listed at Karachi Stock Exchange (KSE) are used for analysis. The findings of the study show that corporate governance has significant impact on firm performance. The implication and limitations of the study has also been discussed.

Keywords: Corporate Governance, Firm Performance, Pakistan, Karachi Stock Exchange

I. Introduction
Sound corporate governance has emerged as a crucial success factor in national and international market. Countries all over the world are keen to encourage good corporate governance to ensure fairness, transparency and accountability in the corporate sector and safeguard the interest of all stakeholders, especially the minority shareholders. Empirical evidence also put forward that jurisdiction that adheres to good governance practices tend to attract more capital. The importance of corporate governance structure and practices has been reinforced by recent financial crises. The structure of corporate governance plays pivotal role in not only improving organizational performance but also in sustaining competitive advantage (Erickson, Park, Reising & Shin, 2005)

The separation of owners and managers gives rise to agency problem. Managers have control over the resources and they can utilize them for their self-interest. The primary aim of the organization is maximizing the shareholders wealth. To achieve this
aim, managers should behave in the ways that maximizes the shareholders wealth. However, behavioral and other social sciences provide the evidence that humans are self-interested. Therefore, the effective governance system is required which can oversee the activities of the individuals. Moreover, the effectiveness of the governance system depends on the corporate governance quality. According to Shah, Butt, & Hassan (2009), the corporate governance quality depends on the independence (board independence and audit committee independence) and ownership structure (managerial ownership and ownership concentration).

A plethora of studies provided the evidence between independence and ownership structure and organizational performance. But the results are mixed and cannot be generalized. For instance, several studies stated that opportunistic actions can be taken due to privileged information in case of stock ownership (Yermack, 1997; Bartov and Mohanram, 2004). And many other studies suggest that managerial ownership increases the shareholder wealth by removing the agency problem. Similarly, the results of the literature focusing on linkage of independence and ownership structure with firm performance are mixed (Krishnamoorthy & Maletta, 2012; Larcker, 2011).

Considerable research work has been done on the relationship between structure of corporate governance and organizational performance, particularly, in developed world. However, there is limited literature on the influence of corporate governance tools such as board independence, audit committee independence, managerial ownership and ownership concentration. Moreover, despite the great importance and well discussion on corporate governance, it is still controversial that corporate governance works to achieve its objectives. Therefore, rather than providing the theoretical consequences of the corporate governance, this study aims to provide empirical evidence from the manufacturing sector of Pakistan.

II. Literature Review
1.1. Independence (Board and Audit Committee) and corporate performance

Corporate governance has highlighted many standards in its aim to mitigate the agency problem between the management and shareholder. The objective is to safeguard the interests of the shareholder. The audit committee independence and board independence are among other measures of effective governance system. Both the audit committee independence and board independence are among other measures of effective governance system. Both the audit committee independence and board independence improves the protection of shareholder’s interests by creating effective governance environment.

According to rules of Corporate Governance of NYSE (New York Stock Exchange), the board independence means the inclusion of independent directors in the board who does not have any material relationship with the listed company. Independence of directors is evaluated by the degree to which directors are free from conflicts of interest that might limit their ability to act solely in the interest of the organization. Bathala and Rao (1995), Kaymak and Bektas (2008), Nicholson and Kiel (2007) and Zahra and Pearce (1989) suggested that boards encompassing external independent directors will mitigate the agency problem by being able to watch any self-interested activities by managers. Jensen & Meckling, (1976) argued that non-executive directors are required on boards to watch and control the actions of executive directors and balances in improving boards’ potential. Later on the studies for example by Geletkanycz & Boyd (2011), Hillman and Dalziel (2003), Peng (2004), concluded that
appointing outside independent directors has a positive impact on the performance of board of directors. Similarly recent studies on corporate governance also showed the positive effect of board independence on organizational performance.

The American Law Institute (ALI) suggested that, "an independent audit committee leads to the independence of the corporation’s external auditor, and thus assists to assure that the auditor will have free rein in the audit process" and also "an independent audit committee reinforces the objectivity of the internal auditing department (Deli &Gillan, 2000). Davidson, Xie and Xu (2003) show that audit committees with directors who are independent and have financial expertise are more efficient monitors, and thus may reduce the incentives for earning management.

According to Krishnamoorthy&Maletta (2012) the governance strength of the audit committee is increased with independent directors. Similarly, Anderson, Mansi and Reeb(2004) put forwarded that firms with independent audit committee have lower cost of debt financing. Chan and Li (2008) found the evidence that the presence of independent and expert members on board and committees improve firm value. This argument was also proposed by Rosenstein and Wyatt (1999) who found the inclusion of outsiders on the board is associated with an abnormal stock return. The effectiveness of the audit committee system may be questioned when management influences the selection of audit committee members for its interest, not for shielding stockholders’ wealth (Shivdasani and Yermack 1999; Carcello, Neal, Palmrose, and Scholz 2011).

From the above discussion, following hypothesis is proposed:

H1: Ownership structure is positively associated with corporate performance.

Ownership Structure (Executive Ownership and Ownership Concentration) and corporate performance

Ownership structure, which includes the ownership concentration and managerial ownership,is also hot topic of the corporate governance which influences the quality of the corporate governance. According to Shah, Butt, & Hassan (2009) the lower ownership concentration and lower managerial ownership increase the quality of the corporate governance. Greater ownership in few hands increases the likelihood of using the organizational resources to self-interest as they have control over organization. A wide range of research of corporate governance has focused on the ownership structure. Many recent studies aims to find the impact of ownership structure and firm performance (Chen, Hou, & Lee, 2012; Coles, Lemmon, & Felix Meschke, 2012; Drakos&Bekiris, 2010; Krishnamoorthy&Maletta, 2012; Tsonias, Merikas, &Merika, 2012)

A wide ranges of studies found that managerial/executive ownership relates to the organizational performance(Chung & Pruitt, 1996; Florackis, Kostakis, &Ozkan, 2009; Krishnamoorthy&Maletta, 2012; Rose, 2005). The Morch, Shleifer, and Vishny (1988) put forwarded a see-saw shaped relationship between managerial ownership and firm value. At low level of managerial ownership(less than 5%) there is positive relationship. When the level increases (5 to 25%) the relationship becomes negative and as it increases from 25%, the relationship becomes again positive. However, the results of the Larcker’s (2011) study on 4000 largest US firms found that equity ownership by the CEO have no generalizable relationship between equity ownership and firm performance. Moreover, recent study of Shah et al. (2009) in Pakistan found that low level of managerial
ownership of stock (less than 20%) increases the quality of corporate governance and the corporate governance quality decreases as the level of managerial ownership decreases. This corporate governance quality influences the behavior of the managers and ultimately the performance of the organization.

Similarly, the concentrated ownership affects the corporate governance quality. Higher ownership concentration leads to lower the corporate governance quality (Shah et al. 2009). The financial performance is decreased with increased ownership concentration, because this raises the firm's cost of capital as a result of decreased diversification opportunities or decreased market liquidity (Fama & Jensen, 1983). Furthermore, in the Asian perspective, the study of Claessens & Fan (2002) maintains that the risk of expropriation of minority rights is raised with high ownership concentration.

From the above discussion, following hypothesis is proposed:

**H2**: Independence in Board and audit committee is positively associated with corporate performance.

### III. Research Design

**Measurement of variables**

The ownership structure is measured through average of managerial/executive ownership and ownership concentration.

Ownership Structure = (Managerial ownership + Ownership Concentration) / 2

Similarly, the independence is measured through average of board independence and audit committee independence.

Independence = (Board Independence + Audit Committee Independence) / 2

Performance is measured on two dimensions: financial and stock market, measured by Earnings per Share and Market to Book Ratio respectively.

**Sample and data collection**

500 firm-year observations of 50 non-financial companies (from 2001 to 2010) listed at Karachi Stock Exchange (KSE) are used for analysis. Companies are selected on the basis of market capitalization. Data for the corporate governance is collected through the annual reports of respective companies. Other financial data is collected the “Balance Sheet Analysis of Joint Stock Companies Listed at Karachi Stock Exchange” published by State Bank of Pakistan. Data for share price were collected through from website of KSE.

**Research models and methodology**

Following equations are to be tested:

\[
\begin{align*}
\text{EPS}_{it} &= \beta_0 + \beta_1 \text{INDP}_{it} + \epsilon_{it} \quad \text{Eq. 01} \\
\text{EPS}_{it} &= \beta_0 + \beta_1 \text{OWST}_{it} + \epsilon_{it} \quad \text{Eq. 02} \\
\text{MB}_{it} &= \beta_0 + \beta_1 \text{OWST}_{it} + \epsilon_{it} \quad \text{Eq. 03} \\
\text{MB}_{it} &= \beta_0 + \beta_1 \text{INDP}_{it} + \epsilon_{it} \quad \text{Eq. 04}
\end{align*}
\]

Where firm performance either measured by MB or EPS. MB is Market to Book Ratio, EPS is Earnings per Share, \(\beta_0\) is the intercept, \(\beta_1\) and \(\beta_2\) are regression slope coefficients.
As data used for study is of panel type, so we used panel data estimation methods. Fixed effects model is used to test the relationships.

**Empirical Findings**

To test our first and basic hypothesis we tested aforementioned equations through regression analysis.

**Impact of independence on earning per share**

\[ \text{EPS}_i = \beta_0 + \beta_1 \text{INDP}_i + \epsilon_i \quad \text{Model-1} \]

The findings of model-1 indicate that independence has positive and significant impact on earnings per share \((t= 5.51; P<0.05)\). The independence determines 44.93% in the earning per share. Moreover the overall model is also fit, as the p-value of F-statistic is significant (Model-1).

<table>
<thead>
<tr>
<th>Dependent Variable Earnings Per Share</th>
<th>Model fit</th>
<th>Adj. R²</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent Variables</td>
<td>Beta</td>
<td>T</td>
<td>Sig.</td>
</tr>
<tr>
<td>Constant</td>
<td>4.643</td>
<td>1.804</td>
<td>0.071</td>
</tr>
<tr>
<td>Independence</td>
<td>.</td>
<td>7.060</td>
<td>5.508</td>
</tr>
</tbody>
</table>

**Impact of ownership structure on earning per share**

\[ \text{EPS}_i = \beta_0 + \beta_1 \text{OWST}_i + \epsilon_i \quad \text{Model-2} \]

The findings of model-2 indicate that ownership structure positive and significant impact on earnings per share \((t= 3.336; P<0.05)\). The independence determines 42.63% in the earning per share. Moreover the overall model is also fit, as the p-value of F-statistic is significant (Model-2).

<table>
<thead>
<tr>
<th>Dependent Variable Earnings Per Share</th>
<th>Model fit</th>
<th>Adj. R²</th>
<th>F</th>
</tr>
</thead>
<tbody>
<tr>
<td>Independent Variables</td>
<td>Beta</td>
<td>T</td>
<td>Sig.</td>
</tr>
<tr>
<td>Constant</td>
<td>3.393</td>
<td>0.768</td>
<td>0.442</td>
</tr>
<tr>
<td>Independence</td>
<td>5.046</td>
<td>3.336</td>
<td>0.000</td>
</tr>
</tbody>
</table>

**Impact of Ownership structure on market to book ratio**

\[ \text{MB}_i = \beta_0 + \beta_1 \text{OWST}_i + \epsilon_i \quad \text{Model-3} \]

The findings of model-3 indicate that ownership structure has positive and significant (at 90 percent confidence level) impact on market to book ratio \((t= 1.69; P<0.10)\). The independence determines 13.68% in the earning per share. Moreover the overall model is also fit, as the p-value of F-statistic is significant (Model-3).
Impact of independence on market to book ratio

\[ MB_t = \beta_0 + \beta_1 \text{INDP}_t + \epsilon_t \]

Model 4

The findings of model-4 indicate that independence has positive and significant impact on market to book ratio \((t=2.05; P<0.05)\). The independence determines 13.9% in the market to book ratio. Moreover the overall model is also fit, as the p-value of F-statistic is significant (Model-4).

IV. Discussion and Conclusion

The present study has examined the relationships among two dimensions of corporate governance i.e. independence and ownership structure and two dimensions of financial performance i.e. earnings per share and market to book ratio. It has been seen by the results that positive and supportive link exists among two corporate governance practices (independence and ownership structure) and firm performance. The present study provides empirical evidence of the association of corporate governance dimensions with firm performance by considering a 500 panel data observations (50 publicly limited companies listed in Karachi Stock Exchange for the period 2001 to 2010).

Corporate governance aims to reduce the agency cost and improve the organizational performance. The findings of present study support the association between corporate governance and firm performance. The number of independent directors in the board and audit committee is directly related with organizational performance. This is because the independent directors are free from conflicts of interest that might compromise his or her ability to act solely in the interest of the firm. Similarly, ownership structure, which consists of managerial ownership and lower ownership concentration, also improves the organizational performance. The managerial ownership reduces the agency cost and lower ownership concentration evades self-interest controls.

The organizations are now facing intense competition due to contemporary forces of globalization, technological changes and changing customer’s demands for better quality. To survive in this turbulent environment, organizations have to improve their organizational performance. The findings of this study suggests that organizations can
improve their financial and market performance through corporate governance elements, such as audit committee independence, board independence, managerial ownership and lower ownership concentration.

References


