Impact Of Corporate Governance On The Profitability Of A Firm (A Case Study Of Tractor Manufacture Company) Listed In Karachi Stock Exchange
ABSTRACT

In this research, the link between four Corporate Governance mechanisms (board size, chief executive status, annual general meeting and audit committee) and two Firm Performance actions (ROE, return on equity and PM profit margin) of Karachi Stock Exchange listed firm Alghazi Tractor Limited (AGTL) is examined for the period 2005 - 2013. The test which was applied (t-test and Multiple Regression analysis) to check the significance & dependency of the noted above variables. By the use of panel methodology and OLS as a method of estimation, the results present a fact of an important effect and ROE has negative relationship with audit committee and CEO status but both have significant product on it. The CEO condition and audit committee have a negative relationship with PM but CEO position has a significant effect.

Keywords: Corporate Governance, Performance, Corporate Governance Mechanisms, Chief Executive Officer, Annual General Meeting and Return on Equity

1. INTRODUCTION

Corporate governance is the name of processes, laws, customs, policies, and institutions on the way which company affecting, directed, administered or controlled. It also includes the dealings among the many stakeholders and the goals for which the business is governed. In modern business corporations, the main group of external stakeholders is trade creditors, suppliers, shareholders, debt holders, customers involved and communities affected by the corporation’s activities. The board of directors, executives, and other employees are internal stakeholders.

The system to which companies are directed and controlled is called corporate governance. Boards of directors are accountable for the governance. The task of shareholders for governance is to appoint the directors and the auditors and to satisfy themselves and it shows the measures of corporate governance are available his place. The responsibilities of the directors are also included setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The action of Board is subjected to laws, regulations and the shareholders in general meeting.” As per the definition of Cadbury Committee the Corporate governance is “the system by which companies are directed and controlled”. A system of corporate governance is comprised of a wide range of practices and institutions, as accounting standards and laws concerning financial disclosure, to executive compensation, to size and corporate board’s composition. A corporate governance system defines who owns the firm, and dictates the rules by which economic returns are distributed among employee, shareholders, managers, and other stakeholders. As such, a county's corporate governance management system has deep implications for firm’s organization, employment systems, trading relationships, and capital
markets. Thus, changes in Pakistani system of corporate governance are likely to have important consequences for the structure and conduct of country business.

The term “corporate governance” accepted in the 1980’s to mostly explain the general principles by which the business and management of companies were directed and controlled. Although now a day its usage is common, and its objectives to be achieved are thereby generally understood, there is no commonly accepted definition of “corporate governance”. Although the utility of definitions is customarily exaggerated, definitions do have the advantage of providing a general framework for discussion and debate. For this purpose, and in view of the comparative formative years of the subject in Pakistan, a limited discussion of the definition of corporate governance is provided below.

Corporate governance’s definition which is broadly accepted was given in a report of the committee whose chairman was Sir Adrian Cadbury titled (the Cadbury Report): This definition of corporate governance has been endorsed in various other discourses on the subject, including the 1998 final report of the Committee on the Financial Aspects of Corporate Governance.

Stable and good corporate governance practices help companies to make their performance and attract investment in order to enable them strong and helps to achieve their corporate objectives, protect shareholders rights, meet legal requirements and demonstrate to a wider public how they are conducting their business. These practices have been challenge to worldwide efforts to stabilize and strengthen global capital markets and protect investors. Good corporate governance helps to increase the economic development by improving the performance of companies to outside capital. Good corporate governance plays an important role in various public policy objectives. It mainly reduces the financial crises, reinforcement property rights, reduces transaction cost and cost of capital and deals to capital market development. It deals with the relationship among management, board of directors, controlling shareholders, minority shareholders and other stakeholders.

In Pakistan, the publication of the Security and Exchange Commission of Pakistan, Corporate Governance Code 2002 for publicity listed companies has made it very important area of research of corporate sector. It has two main purposes.

- To enhance the performance of corporations by developing a corporate culture i.e It motivates directors, managers and entrepreneurs to maximize the company’s operational efficiency to achieve long term productivity growth.

- It urges the conformance of corporations to laws, rules and practices that helps the directors and managers to monitor the corporate accountability in the best interest of the companies and the shareholders.
2. CORPORATE GOVERNANCE FAILURE IN PAKISTAN

**PTCL**

The privatization of PTCL was a big scandal according to an ex-senior vice president, he claimed that it was a biggest financial fraud and the deal was closed on 2.6 billion dollar including Ufone and Paktel. It was observed that only Ufone has enterprise value of more than 6 billion dollar. Supreme Court of Pakistan has already given the decision against the privatization of PSO and Pakistan Steal.

**Crescent Bank Fraud**

The entire board of director and CEO of Crescent Standard Investment Bank were legally stopped from running their offices on evidence fraud and irregular accounting. External auditors had reported missing over Rs 6 billion apart from illegal maintenance of parallel accounts. SECP took legal action against the companies officers.

**TAJ COMPANY**

It was involved in poor corporate governance practices. The company was running a scheme through which it was able to receive huge amounts of deposits illegally. The company had religious affiliations and after 15 year their practices have been stopped. The company still owes heavy liabilities to over 25000 people.

**MEHRAN BANK**

The NAB has recovered Rs 1.6 billion in the famous Mehran Bank scandal case by selling Benami property of bank chief (younis Habib) in Islamabad. NAB said that Younis Habib group will also pay Rs. 420 million. The Mehran Bank had been doing very badly from Januray 1992, and banking experts attributed this poor performance to Younis Habib Group.

The main focus of this study is to examine the relationship between corporate governance and firm performance of listed Karachi in Stock Exchange (KSE) as Alghazi Tractor Company Limited (AGTL). In the firm level corporate governance characteristic we considered CEO status, Board Size, Annual General Meetings and Audit committee. And we used indicator Return on Equity, Profit Margin, Return on Assets, Current ratios, Net assets per share and Dividend Ratio.

The plan of study is as follows. Section 2 briefly reviews the corporate governance policy framework of Pakistan. The review of empirical findings of previous research is shown in Section 3. The methodology of this research is presented in Section 4. In section 5 we discussed the relationship between corporate governance and his performance and provided a description of the data. And in section 6 results for the relationship between corporate governance and its impact.
3. LITERATURE REVIEW

Corporate Governance in Pakistan

The SEC also took over the responsibilities and powers of the Companies Act in 1999, was fully aware of the changes that occur in the international business environment, that directly and indirectly affect local businesses. He also is part of a multi-dimensional strategy for the corporate sector in Pakistan, the challenges of the changing global scenario work, capacity building, and focused the SEC, in part, to encourage companies to adopt practices of good corporate governance. It is expected to provide transparency and accountability in the corporate sector and protect the interests of stakeholders, including the protection of the rights of minority shareholders and strict compliance audit.

In recent years, the world has witnessed the financial and business major changes. In the wake of the Asian financial crisis, has highlighted the recent accounting scandals, the importance of having an effective institutional framework to help increase shareholder value management companies and at the same time protecting the interests of other stakeholders.

In March 2002, the Committee on Securities and Exchange Commission in Pakistan Blog corporate governance to develop a framework for the governance of companies listed on the stock markets in Pakistan. In the exercise of its powers under Article 34 (4) of the Act Securities and Exchange Commission, 1969, issued SEC instructions to Karachi, Lahore and Islamabad stock exchanges to incorporate the provisions of the Code of Regulations, each of the trading. As a result, regulations have been modified to trading by the stock exchanges.

To achieve this goal, the Commission on Securities and Exchange Commission (SEC) Pakistan in collaboration with the United Nations Development Programme (UNDP), and the Population Division of the Government of Pakistan has launched a project of UNDP in SEC corporate governance in August 2002. Within the scope of the project, and provided UNDP technical and financial assistance to the SEC for the development and implementation of the practices of good corporate governance and the establishment of a regulatory framework for the business sector in the country. Work involves the application of the law of corporate governance issued by the SEC in March 2002, and the creation of awareness of stakeholders, capacity building and networking with other emerging markets. Shahnawaz Mahmood of the SEC of Pakistan was working as research officer on the UNDP Project on Corporate Governance.

The law is a collection of "best practices", and aims to provide a framework through which the companies listed on the stock exchanges in Pakistan are directed and controlled in order to protect the interests of stakeholders and to increase confidence in the market, ie, to improve performance and ensure that companies under. By doing so, Blog about experiences of other countries is based on the structuring of corporate
governance models, especially the experience of countries that have a tradition of common law similar to Pakistan.

And regulates legal persons in Pakistan mainly by the SEC under the Companies Act, and the law of the Securities and Exchange 1969, Law Commission of Pakistan in 1997 the stock market, and the various rules and regulations issued there under. In addition to the SEC. Thus, the organization listed companies also by the stock exchange on which they appear, are regulated banks also by the Central Bank of Pakistan, and companies engaged in the generation, transmission or distribution of electricity regulator, dedicated to the provision of telecommunications services companies are also organized by the PTCL, and organizes oil and gas companies also by the Regulatory Authority of oil and gas.

So the parties involved in corporate Governance

- Board of Directors
- Shareholders
- Audit Committee
- Chief Executive Officer & Management
- The Role of BOD

Council has Responsibility Make sure that the behavior of the companies in accordance with best Governance practices. This requires managers to view certain standards of behavior, including: (i) Make informed decisions and deliberative; (ii) The division of power (iii) Effective monitoring of management, and (iv) Fair performance of the duties worthy of Company and shareholders as a class

BOD’s responsibilities inherently demand

- The exercise of judgment
- Guiding business strategy,
- Determine an appropriate corporate appetite for risk
- Selecting a chief executive from a pool of candidates involves decision-making that cannot be reduced to a mechanical series of steps.
- Monitoring and supervisory functions may comprise a range of reasonable approaches.
- Ensure the integrity of accounting and financial reporting systems and oversee the process of disclosure and communications

The Role of Shareholders

Some of the important roles of the share holders are listed below:

- Shareholders nominate a Board of Directors to manage the affairs of the corporation
Shareholders make a financial investment in the corporation, which entitles those with voting shares to elect and remove the directors and auditors.

Shareholders should have effective communication with the board to understand the business, risk profile, financial condition and the operating performance of the firm.

Opportunity should be given to shareholders to ask questions about the direction of the firm and especially on the remuneration policy of key executive members and board members, this should be linked to performance.

Shareholders holding at least 20% of the issued capital of a firm should, as far as possible have a representative on the board, except they are disqualified by the virtue of their being competing business with the firm or they have other conflicts of interest.

There should be at least one director on the board representing the minority shareholders.

The Role of Committee

The audit committee (“committee”) shall assist the board of directors (the “board”) in the oversight of:

1) The reliability of the financial statements of the company
2) The worth of the internal control over financial reporting
3) The sovereign registered public accounting firm’s qualifications and Independence
4) The performance of the company’s internal audit function and independent registered public accounting firms and
5) The company’s compliance with legal and regulatory requirements

The role of the audit committee, as a central facet in the execution of first-rate corporate governance, is continually evolving. From time to time, the audit committee may be called upon to address specific issues that fall outside of its primary role. The audit committee’s main roles are elaborated in the Code principles, which can be summarized as:

- To monitor the integrity of the company’s financial statements and announcements;
- To review internal financial controls and (unless there is a separate risk committee) risk management systems;
- To monitor and review the internal audit function;
- To recommend the appointment or replacement of external auditors and to review the effectiveness of their work.
- To develop and implement policy on the use of the auditors for no audit services.
- The primary duties and responsibilities of the Committee include, amongst others,
The review of the external auditors’ audit plan, the internal auditing process, accounting standards and practices

- Financial information, system of accounting systems, internal controls and the reliability of information, financial risk management, any certifications required by regulatory authorities.
- Review of quarterly and annual financial statements and reports and budgets prior to approval by the board.
- The committee is responsible for ensuring the independence of the external auditors. The Committee must maintain a direct relationship with the board, the management as well as with the shareholders.
- External and internal auditors. The external and internal auditors must report directly to the Committee.

**The main role of CEO and Management are**

- Operating the firm in an effective and ethical manner.
- Preparing the strategic plans and annual operating plans and budgets for the board’s approval.
- The integrity of the firm’s financial reporting system that fairly presents its financial position.
- The financial reports are expected to comply with relevant statutory and professional pronouncements.
- Establishing an effective system of internal controls to give reasonable assurance that the firm’s books and records are accurate, its assets safeguarded and applicable laws complied with.
- Approving the Audit Committee Charter; Endorsing the internal audit work program;
- Reviewing internal audit reports submitted;
- Requesting audits be conducted as may assist senior or other management in discharge of their responsibilities.

**Corporate Governance Mechanisms**

For measuring corporate governance and Firm performance different variables are used by the researchers such as Audit Committee and the Status of CEO.

**1) Audit Committee**

Audit committees serve as a bridge in the communication network between internal and external auditors and the board of directors, and their activities include review of nominated auditors, overall scope of the audit, results of the audit, internal financial controls and financial information for publication (FCCG, 1999). Indeed, the existence of an audit committee in a company would provide a critical oversight of the company’s financial reporting and auditing processes (FCCG, 1999; Walker, 2004)

Klein (2002) reports a negative correlation between earnings management and audit committee independence. Anderson, Mansi and Reeb (2004) find that entirely independent audit committees have lower debt financing costs.
2) CEO Status

A widely debated corporate governance issue is whether the two most important positions in a company the Chairman of the Board and the CEO—should be held by two different individuals (a dual leadership structure) or one person may be assigned both portfolios (a unitary leadership structure).

Many studies addressed the CEO duality-performance relationship; with inconsistent results (Brian K. Boyd 1994). There is only weak evidence that duality status affects long-term performance, after controlling the other factors that might impact the performance. (B. Ram Baliga et al. 1995). Berg et al. (1978) and Brickley et al. (1997) concluded that there is a chance of agency cost when CEO performs dual role. Therefore, the separation of the two positions enhances shareholder value. Fama et al. (1983) also argued that concentration of decision management and decision control in one individual reduces a board’s effectiveness in monitoring top management. For example, when a CEO doubles as board chairman, this results in conflict of interests and increases agency costs.

The separation of CEO and chairman affects firms’ performance because the agency problems are higher when the same person holds both positions. Yermack (1996) shows that firms are more valuable when the CEO and board Chair positions are separate by analysing a sample of 452 U.S. public firms between (1984 and 1991). Core, et al. (1999) finds that CEO compensation is lower when the CEO and board Chair positions are separate. Brown and Caylor (2004) conclude that firms are more valuable when the CEO and board chair positions are separate. Botosan and Plumlee (2001) find a material effect of expensing stock options on return on assets.

4. METHODOLOGY

Sample/ Research Design

The data used for this study is originated from Audited Financial Statements of the listed firms and Balance Sheet Analysis of company listed on Karachi Stock Exchange (2005-2013). The method of analysis is that of multiple regressions and estimation is Ordinary Least Squares (OLS).

Model Specification

The economic model used in this study is given as:

\[ Y = \alpha + \beta X_i + \varepsilon_i \]

Where, \( Y \) is the dependent variable. \( \alpha \) is constant, \( \beta \) is the coefficient of the explanatory variable (corporate governance mechanisms), \( x \) is the explanatory variable and \( \varepsilon \) is the error term (assumed to have zero mean and independent across time period). By adopting the economic model as in equation (1) above specifically to this study, equation (2) below Evolves.
PERF  =  α + β(BSIZE) + β(AGM) + β(CEO) + (AUDCOM) + ε
ROE  =  α + β(BSIZE) + β(AGM) + β(CEO) + β(AUDCOM) + ε
PM  =  α + β(BSIZE) + β(AGM) + β(CEO) + (AUDCOM) + ε

Variables

Dependent Variable Description

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description/ Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>ROE = Return On Equity</td>
<td>(Profit after tax)/ Total Equity share in issued</td>
</tr>
<tr>
<td>PM = Profit Margin</td>
<td>(Profit after Tax)/ (Sales= Turnover)</td>
</tr>
</tbody>
</table>

Independent Variables Description

<table>
<thead>
<tr>
<th>Variable</th>
<th>Description/ Measurement</th>
</tr>
</thead>
<tbody>
<tr>
<td>CEO = Chief Executive Status</td>
<td>Value zero (0) for if the same person occupies two or more posts among chairman, MD, GM and the Chief Executive and one (1) for otherwise.</td>
</tr>
<tr>
<td>AC = Audit Committee</td>
<td>The composition of audit committee</td>
</tr>
</tbody>
</table>

Hypothesis

H₁: CEO has significant impact on ROE?
H₂: Audit Committee has significant impact on ROE?
H₃: CEO has significant impact on PM?
H₄: Audit Committee has significant impact on PM?

Correlation analysis

<table>
<thead>
<tr>
<th>Model No.</th>
<th>Dependent variables</th>
<th>Independent variables</th>
<th>Co-efficient (β)</th>
<th>T-statistic</th>
<th>P-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>PM</td>
<td>AC</td>
<td>-2.04</td>
<td>-2.04</td>
<td>0.04</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CEO</td>
<td>-1.93</td>
<td>-1.93</td>
<td>0.06</td>
</tr>
<tr>
<td>2</td>
<td>ROE</td>
<td>AC</td>
<td>-8.96</td>
<td>-1.92</td>
<td>0.06</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CEO</td>
<td>-17.01</td>
<td>-1.93</td>
<td>0.06</td>
</tr>
</tbody>
</table>

From table above using Pearson Correlation Profit margin has a negative relationship with audit committee and CEO status and CEO status has significant (sig.0.06). The intercept and slope co-efficient are same in different time periods and for individual above table also shows that ROE is also positively co-related with two of the corporate governance Variables as firm’s board size and annual general meeting except for audit committee and CEO status but they are significant (sig.0.06).
### ANOVA Analysis

#### Profit Margin as a dependent variable

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum Sq</th>
<th>df</th>
<th>Mean Sq</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>4255.18</td>
<td>4</td>
<td>1063.79</td>
<td>2.22</td>
<td>0.08</td>
</tr>
<tr>
<td>Residual</td>
<td>34526.19</td>
<td>72</td>
<td>479.53</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>38781.37</td>
<td>76</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Predictors :( constant), Bsize, CEO status, AGM, Aud Com

#### ROE as a dependent variable

<table>
<thead>
<tr>
<th>Model</th>
<th>Sum of Sq</th>
<th>df</th>
<th>Mean Sq</th>
<th>F</th>
<th>Sig.</th>
</tr>
</thead>
<tbody>
<tr>
<td>Regression</td>
<td>35606.74</td>
<td>2</td>
<td>1587.31</td>
<td>3.3</td>
<td>0.04</td>
</tr>
<tr>
<td>Residual</td>
<td>38781.37</td>
<td>74</td>
<td>481.17</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Total</td>
<td>38781.37</td>
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<td>-</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Predictors :( constant), Bsize, CEO status, AGM, Aud Com

Dependent variable: PM

The tables indicate the analysis of variance (ANOVA) of the variables with F-values of 2.2184 (sig.0.08) & 3.2988(sig.0.04) for Profit Margin and ROE as performance proxies respectively. It clearly indicates that there is a strong relationship between the dependent variables as PM and ROE and the independent variables as CEO status and Audit committee at 1%, 5% and 10% levels.

### 5. RESULT AND CONCLUSION

The study discloses the following results:

There is a negative relationship between ROE, CEO status and audit committees but they have significant effect. Also a negative relationship between PM and CEO status and audit committee, but CEO status has a significant effect on PM. So according to the results our all hypothesis are accepted.

### 6. REFERENCES


Akhtar, Shamshad (2006) Syariah Compliant Corporate Governance. Keynote address by the Governor of the State Bank of Pakistan at the Annual Corporate Governance Conference, Dubai, United Arab Emirates.


