DOES BOARD MECHANISM MATTER IN AUGMENTING THE FINANCIAL PERFORMANCE OF FIRMS IN PAKISTAN?

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ABSTRACT: *This study intends to explore that whether the board mechanism has any impact on the performance of the corporation or not and objective is to probe the relationship between board mechanisms and corporate performance of 127 Pakistani listed firms on Karachi stock exchange (KSE) from the year 2005 to 2011. The results revealed that Board size has significant and positive impact on Return on assets whereas Board leadership status is showing significant but negative effect on Return on assets. On the other side, Board size and Board leadership status affecting Tobin's Q significantly and positively which means that these are the only factors those are increasing the confidence of investors for future investment which ultimately increases the firm performance. In case of ROA, the most significant factors of Board mechanism are Board size, Board leadership status. Whereas in case of Tobin's Q, only Board size and Board leadership status are found to be more significant measures but the Board Composition other variables remain insignificant in case of both ROA and Tobin's Q.*

Key words: Board size, Board composition, Board leadership status, Return on assets, Tobin's Q

1. INTRODUCTION

The mixture of various mechanisms governs the firm. These include the ownership structure, compensation structure, audit structure and board structure etc. The key mechanism of the governance system is the board of directors. Board of directors is elected by the shareholders of the company. Board of directors functions like the most important part among the owners of the company and the persons who control the company. Making available the resources for the firm and overseeing the managers are the two essential functions performed by the Board of directors. Due to the complex and diverse nature of the association of performance of the firm and board of directors could not be enclosed in one theory of corporate governance. The progress of the firm and board of directors is improved and moved in the upward direction by the Implication of CG practices [1].

Even though, various researches have been carried out in the field of corporate governance in developed countries and developing countries but no particular research according to available literature and to the best of research knowledge had been conducted at the same time which investigate the impact of board mechanism on the firm performance in Pakistan and other South Asian countries. The current research would make contribution to large amount of available knowledge with regard to practices of corporate governance and firm performance. This research would not just give advantage to the corporations of Pakistan, but it would also have a great importance for the further countries of South Asia those who are alike in culture and politics of Pakistan. The findings of this research will make contribution for the analysts, mangers of the companies, regulators and researchers who have interest in the study of practices regarding good corporate governance and want to encourage those practices. The aim of this research is to explore that whether the difference board mechanism has any impact on the performance of the corporation or not Pakistani listed firms on Karachi stock exchange (KSE).

2. LITERATURE REVIEW

Generally, it is claimed that performance of the firm is enhanced by good corporate governance. Despite the well-recognized view that firm performance is enhanced by effective corporate governance, inverse link between the performance of the firm and corporate governance has been accounted by other researches [2, 3] or found insignificant association [4, 5, 6]. However, due to the variances prevailing in the organizational structures, institutional settings and cultural values of the developing and developed countries, so there is a need to examine the correlation between the firm performance and the corporate governance in developing and developed countries separately. It has been strongly assumed that board effectiveness as the mechanism of governance is fundamental for the enhancement of the profitability and performance of the firm [7, 8, 9]. As stated by the researchers that due to the reason of the domination of the unclear results of the researches conducted with regard to the association of corporate governance with the performance of the firm, up till now justify the above belief. Size, composition, and leadership status have been reviewed in the literature here.

Yermack [10] found out the negative correlation was found between size of the board and value of the firm. In consistent with above, Eisenberg et al. [11] ascertained an inverse relation between size of the board and the profitability for the 94 insolvent and 785 solvent Similarly, significant and direct link of board size with the performance of the firm was documented by the [12, 13, 14]. Along with the Cheng [15], negative association of size of board with accounting and market measures of performance was also indicated by the Mashayekhi and Bazaz [16]. Similarly, negative relation was found by Eklund [17] and also Switzer and Tang [18] argued that performance of the small cap firms is harmed by the larger board size.

Bhagat and Black [9] surveyed the proof on the connection between the performance of the corporation and composition of the board. Kiel et al. [19] implicated that composition of the board might have greater significance with regard to the measures of market as compared to performance based on accounting. Similarly, no impact was observed between the corporate performance and Board independence by the Mir and Nishat [20] in the Pakistani firms. Positive associations were found by Abor and Biekpe [13] and Javid and Iqbal [21] but Cho and Kim [22] found weak positive in China while [23] evidenced no direct and significant association between the firm performance and outside directors.

Baliga *et al.* [24] ascertained that the enduring performance was affected by the status of duality as provided by the weak evidence. On the contrary, Sridharan and Marsinko [25] provided that higher performance of the firms having duality of CEO is indicated in the superior market value but negative association was demonstrated by the studies of [26] and [20]. In the same way, Kang and Zardkoohi [27] tested the link between the performance of the firm and leadership structure by taking publicly listed firms as sample. Overall, the gap has been witnessed in the literature regarding the research undertaken related to the influence of board mechanism on the performance of the corporation in the context of Pakistan. With the intention to cover this literature gap, the tool of different board mechanism has been used to examine the effect on corporate performance in Pakistan.

3. RESEARCH DESIGN

Our target population was all 652 companies listed on the All-share index of Karachi Stock Exchange. We selected only 129 companies for our proposed sample based upon the data availability and appropriateness for the period of 2005-2011. The source of data collection for this study is secondary data. The data has been extracted from the Annual reports of nonfinancial firms quoted on the Karachi Stock exchange and following models have been estimated:

$$ROA_{it} = \gamma_0 + \gamma_1 BODSZ_{it} + \gamma_2 BODCMP_{it} + \gamma_3 BODLDR_{it} + \gamma_4 FRMSZ_{it} + \gamma_5 FRMLVRG_{it} + \varepsilon_{it} \;\ldots\ldots (i)$$

$$Q_{it} = \gamma_0 + \gamma_1 BODSZ_{it} + \gamma_2 BODCMP_{it} + \gamma_3 BODLDR_{it} + \gamma_4 FRMSZ_{it} + \gamma_5 FRMLVRG_{it} + \varepsilon_{it} \;\ldots\ldots (ii)$$

4. RESULTS AND DISCUSSION

Accounting measure such as Return on assets is put in to use for examining the past performance of companies. Return on assets is not influenced by the attitude and psychology of investors in the market. It only assists in the assessment of future happenings. The value of R square is *0.074* and adjusted R^2 is *0.069* but Adjusted R^2 is the more precise measure than the R^2 because it is unaffected by the number of independent variables. So *0.069* of adjusted R^2 is pointing towards the fact that about *6.9%* of the variation or change in the dependent variable (ROA) is due to the variations in the predictors (independent variables and control variables). Conversely, it has been meant that *94.1%* variation in ROA is due to other factors that have been not included in the present study. Durbin-Watson statistic is used for the purpose to measure the correlation among the successive residuals that often occurs in the time series data. The value of Durbin- Watson ranges from *0* to *4*. The value of Durbin-Watson *(1.995)* revealed that there is about no autocorrelation exist among the successive residuals. The value of F- statistic is *17.448* showing that p-value significance *(0.000)* at *1%* significance level. It is indicating that there are some independent variables in the model that have the ability to account for the change in ROA.

Table 1: Board Mechanism and ROA

Model	*β*	*t*	*Sig.*
(Constant)	.001	0.720	.472
FRMLVRG	-.202	-6.075	.000*
BODSZ	.067	1.977	.048*
BODCMP	-.040	-1.121	.262
BODLDR	-.106	-3.128	.002*
FRMSZ	.007	0.201	.841
R^2	*Adj-*R^2	*D-W*	*F*
.074	.069	1.995	17.44*

** significant at 1% level*

After testing for the overall regression model by Global test in previous Table 1, the Student's t- test has been conducted to test the individual regression coefficients to know who the significant independent variables are among the all independent variables in this study. Among the three independent variables such as Board size, Board composition, Board leadership status, and two control variables such as Firm leverage and Firm size, only three variables have found statistically significant. The slope coefficient *(γ = -0.202)* of firm leverage shows that relationship between the firm leverage and Return on assets is negative and also points that on average one percent increase in the firm leverage causes a decrease of *20.2%* in the Return on assets keeping other variables constant which is significant at *1%* level of significance. The value of slope coefficient *(γ = -0.106)* of Board leadership status indicates an inverse association between ROA and the Board leadership status and specifies that on average placing a person having both the positions of CEO and Chairman lessens the profits by the value of *10.6%* having other factors remain fixed that are significant at *0.01* level of significance. Likewise, the regression coefficient *(γ = 0.067)* of Board size depicts the positive relation between the ROA and Board size and explores that on average increasing a one director on board causes an increase in the profits earned by utilizing the assets by *6.7%* keeping other predictors remains fixed at *0.05* level of significance.

Tobin's Q is the forward-looking approach used to measure investors' confidence regarding the future market performance of the companies. The behaviors and perceptions of investors regarding the market happenings and business strategies are reflected in the Tobin's Q [28]. In model of the table 2, coefficient of correlation *(R = 0.239)* signals that predictors are to some extent associated with dependent variable (Tobin's Q). Therefore, *0.054* of adjusted R^2 is indicating that about *5.4%* happening of variation in the Tobin's Q (dependent variable) is caused by the variations in the control variables and independent variables. On the contrary, it has been intended that *95.6%* change in Tobin's Q is because of other factors that have been not included in this study. The value of Durbin-Watson *(1.615)* made known that there is nearly no autocorrelation is existing among the successive residuals. The value of F- statistic is *17.771* showing that p-value significance *(0.000)* at *1%* significance level. It is indicating that there are some independent variables in the model that have the ability to account for the change in Tobin's Q.

Table 2: Board Mechanism and Tobin's Q

Model	β	*T*	*Sig.*
(Constant)	.003	5.069	.485
FRMLVRG	.175	5.220	.000*
BODSZ	.126	3.780	.000*
BODCMP	.056	1.544	.123
BODLDR	-.091	-2.693	.007*
FRMSZ	.043	1.179	.239
R^2	*Adj-*R^2	*D-W*	*F*
.057	.054	1.615	17.71*

** significant at 1% level*

In Table 2, the slope coefficient *(λ = 0.175)* of firm leverage shows that relationship between the firm leverage and Tobin's Q is positive and also points that on average one percent increase in the firm leverage causes an increase of *17.5%* in Tobin's Q keeping other variables constant which is significant at *1%* level of significance. The value of slope coefficient *(λ = -.091)* of Board leadership status an inverse association between Tobin's Q and the Board leadership status and specifies that on average placing a person having both CEO and Chairman positions reduces the profits by the value of *9.1%* having other factors remain fixed that significant at *0.01* level of significance. Likewise, the regression coefficient *(λ = 0.126)* of Board size depicts the positive relation between the Tobin's Q and Board size and explores that on average increasing a one director on board causes an increase in the market value by *12.6%* keeping other predictors remains fixed at *0.01* level of significance.

The results regarding the direct relationship of board size and performance of the firms are according to expectations as observed in the previous studies with ROA [29,11,13,30] and with Tobin's Q [11,30,31]. The two important theories, agency and resource dependency, support the view that financial performance of the corporations might be made better by boards consisting of large number of directors [32]. Initially, boards having large number of directors provide more opportunities for securing key resources due to their associations with more diverse experience, business contacts and skills that smaller boards lack [33]. Likewise, uncertainties are reduced by the larger boards through providing larger access to the external environment to which they are associated [34]. Pfeffer and Salancik [35] suggested that board should be larger if the need for effectual external contacts and links increases. Thus, all these cause the enhancement in the performance of the firm.

The demand for having large number of directors on board has rationale behind that it produces positive results for the corporations as the evidences have been observed in the research of board interlocks [36]. For instance, Effectual capital acquisition has association with board interlocks [37]. Yawson [32] mentioned that the ability of the managers is increased for making decisions related to business by seeking business advice from the knowledge base platform enhanced by larger boards. John and Senbet [38] pointed that board size also has direct relation with the overseeing capacity of the board. The rationale is that large of directors come with diverse skills that will help in enhanced monitoring and inspection of decisions made by managers and that also assists in balancing the authority of CEO in case of his dominance [19]. Anderson *et al.* [39] made another argument that low cost of debt is enjoyed by those firms where there has an existence of large number of directors because it is believed by the creditors that larger boards in those firms are more effectual monitors. For availing the prospective profitable opportunities, the accessibility of low cost debt facilitates the firms which cause more increase in the profits.

In the findings, the relationship of Board composition with both ROA and Tobin's Q is found out to be insignificant and negative. Agarwal and Knoeber [40] found negative relationships while Sunday [42] found insignificant relationships in their studies. Though, the proponents of stewardship theory contend that dominance of non-executive directors may have negative influence on performance of the firm [45]. It has been asserted that non-executive directors often unable to comprehend the intricacies of company and have less business knowledge [46]. The part–time outside directors present on the other companies' board makes worse this problem [47]. Consequently, there remains not much time required to monitor and advise the board.

Lack of real independence, excessive monitoring and suppressing strategic actions are the included in the arguments given against non-executive directors dominated on board [34,24]. It might be for the reason of asymmetry of information or that outside directors have limited information and they have to hinge on the information provided by the inside directors for the purpose of making decisions based on information [48]. In order to have better transparency, the introducing of the notion of outsiders on the board might benefited but might not lead towards the creation of value addition economically for the firm because of the ignorance of the fact of variance in the idea of the introduction of independent directors may have benefits for greater transparency, but the non-consideration of the underlying institutional and cultural differences in an emerging economy may not result in economic value addition to the firm [49].

The Inverse association found in this study between the Board Leadership Status representing CEO duality and the Firm performance supports for the agency theory. The results matched with the negative association of Board leadership status with the profitability of the firm [14, 20, 26, 28, 30, 41] whereas the relationship of Board leadership Status with the market performance (Tobin's Q) revealed in this study also has evidences in the past researches conducted showing that the confidence of investors is shaken when Board leadership status is Duality of CEO which results in decrease of firm performance [20, 50]. As said by Jensen [51] that monitoring of the process of CEO's appointment, dismissal, evaluation and remunerating and also managing or running of board meetings is the responsibility of the Chairman. Jensen [51] makes argument that the effectiveness of the board in overseeing the CEO is compromised, thereby thus augments agency problem, due to the dual role of CEO. Consequently, presenters of agency theory contend that board independency would be increased by making available effectual checks and balances on the behavior of the manager through splitting the roles of Chairman and CEO [33].

5. CONCLUSION

The emergence of corporate governance in Pakistan is a decade ago. This study intends to explore that whether the board mechanism have any impact on the performance of the corporation or not. Sample period is comprised of seven years covering from 2005 to 2011. The total 127 companies consisting of 882 total observations have been included in the study as the sample size. The results revealed that board size have significant and positive impact on Return on assets whereas board leadership status is showing significant but negative effect on Return on assets. On the other side, only board size and board leadership status affecting Tobin's Q significantly and positively.

The important implication for academicians and researchers is that they could build model or expand knowledge by including the other board mechanism. The regulators and officials could make policies to ensure and expand standards by increasing the board size up to eight directors and dual leadership status should be eradicated since all these provide the base for augmenting the performance of the firm. This study has been limited to panel data analysis; three factors of board mechanism and sample of 127 firms so it is recommended to include other factors of board mechanism such as Participation rate of outside directors, Board diversity, Number of board committees, financial expertise on board, Directors' qualification on board, Age of CEO, Tenure of CEO, Age of directors and tenure of directors and year-wise analysis, sector-wise analysis or pooled data analysis could be done in addition to extend the sample for the best representation of population.

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