

Corporate Governance and Firm Performance a Case Study of Pakistan Oil and Gas Companies Listed in Karachi Stock Exchange

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Abstract

In this study the relationship between four Corporate Governance Mechanisms (board size, chief executive status, annual general meeting and audit committee) and two Firm Performance Measures (return on equity, ROE, and profit margin, PM), of Karachi Stock Exchange listed oil gas firms is examined for the period 2004 - 2010. The t-test and Multiple Regression analysis are applied to examine the significance dependency of the above mentioned variables. By using the panel methodology and OLS as a method of estimation, the results provide an evidence of a significant effect and positive relationship between ROE and board size as well as annual general meeting. But ROE has negative relationship with audit committee and CEO status and both have significant effect on it. The results further expose a positive relationship between PM, board size and annual general meeting and they have no significant effect. The study, however, could not provide a significant effect between PM and audit committee. The CEO status and audit committee have a negative relationship with PM but CEO status has a significant effect. The implication of this is that the board size should be limited to a sizeable limit and that the post of the chief executive should be occupied by different persons.

Index terms— Corporate Governance, Corporate Governance Mechanisms, Firm Performance Measures.

1 INTRODUCTION

Corporate governance is the set of processes, customs, policies, laws, and institutions affecting the way company is directed, administered or controlled. Corporate governance also includes the relationships among the many stakeholders involved and the goals for which the corporation is governed. In contemporary business corporations, the main external stakeholder groups are shareholders, debt holders, trade creditors, suppliers, customers and communities affected by the corporations activities. Internal stakeholders are the board of directors, executives, and other employees.

The term "corporate governance" came into popular use in the 1980's to broadly describe the general principles by which the business and management of companies were directed and controlled. Although its usage is now common, and the objectives to be achieved thereby generally understood, there is no universally accepted definition of "corporate governance". Although the utility of definitions is invariably exaggerated, definitions do have the advantage of providing a general framework for discussion and debate. For this purpose, and in view of the comparative infancy of the subject in Pakistan, a limited discussion of the definition of corporate governance is provided below.

A basic definition of corporate governance, which has been widely recognized, was given in a report by the committee under the chairmanship of 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.

"Corporate governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the directors include 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 Board's actions are subjected to laws, regulations and the shareholders in general meeting."

The Cadbury Committee report defines it as "the system by which companies are directed and controlled". A corporate governance system is comprised of a wide range of practices and institutions, from accounting standards and laws concerning financial disclosure, to executive compensation, to size and composition of corporate boards. A corporate governance system defines who owns the firm, and dictates the rules by which economic returns are August distributed among shareholders, employees, managers, and other stakeholders. As such, a country's corporate governance regime has deep implications for firm 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. Sound corporate governance practices help companies to improve their performance and attract investment while enabling them to realize their corporate objectives, protect shareholder rights, meet legal requirements, and demonstrate to a wider public how they are conducting their business. These practices have become critical to worldwide efforts to stabilize and strengthen global capital markets and protect investors. Good corporate governance contributes to sustainable economic development by enhancing the performance of companies and increasing their access to outside capital. In emerging markets good corporate governance serves a number of public policy objectives. The privatization of PTCL was also a big corporate scandal. An ex-Senior Vice President has claimed the privatization as Pakistan's Biggest Financial fraud. PTCL former official further commented that the deal was closed on 2.6 billion dollars including U-fone & Paktel, however only U-fone had enterprise value of more than 6 billion dollars which does not include assets of U-fone. Moreover, pricing decisions were made through old records instead of determining current market value, which means, it was like Buy One Get 2 Free offer. It has been reported further that in September 2006, when Etisalat had refused to honor the deal, they were offered a secret price discount of 394 million dollars along with commitment to lay off 20,000 employees and to bear the 50% cost of layout. Supreme Court of Pakistan has already given decision against the privatization of PSO and Pakistan Steel and if PTCL's privatization gets challenged on true facts, it will bring horrifying results.

2 b) Crescent Bank Fraud

The entire board of directors and CEO Anjum Salaam of Crescent Standard investment bank were legally stopped from running their offices on evidences of suspected fraud and irregular accounting. External Auditors had predicted a missing amount of over Rs.6 Billion, apart from illegal maintenance of parallel accounts, concealment of bank assets, un-authorized massive funding of group companies, unlawful investments in real estate and stock market, etc. the SECP took legal action against the companies officers, although much of the actions taken were criticized as insufficient. c) ENGRO Group of Companies SECP was at the receiving end of immense criticism once it had allowed Fertilizer giant ENGRO to establish its subsidiary ENGRO Foods. Critics believed that the company was associated with the urea business and were tremendously concerned about the extent to which hygiene requirements for the industry would be met by ENGRO foods. However SECP counter argument was based on the fact that ENGRO has had a rich history of sound corporate governance which satisfied SECP that ENGRO will be responsible in regards to hygiene issues associated with ENGRO foods. Time proved that Engro's corporate governance was in good practice and has led to the success of ENGRO foods with products such as Olpers Milk.

3 d) Taj Company

The Taj Company 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. What was far more disappointing was the religious affiliation the company had attached with its name. Even 15 years after their fraudulent practices have been stopped; the company still owes heavy liabilities to over 25000 people.

4 e) Mehran Bank

The National Accountability Bureau (NAB) has recovered Rs1.6 billion in the famous Mehran Bank scandal case by selling Benami property of defunct banks chief Younus Habib in Islamabad. The amount is stated to be the country's biggest-ever single cash recovery in a willful loan default case. In addition, the Younus Habib Group will also pay Rs420 million. According to the NAB, Younus Habib, former chief operating officer of the defunct bank, had offered to settle his liability through the sale of his Benami property and accordingly entered into a settlement agreement of Rs1.6 billion with the National Bank of Pakistan. The Mehran Bank had been doing badly since its very beginning in January 1992, and banking experts attributed this poor performance to Younus Habib's penchant for 'extra-curricular banking activities

The main focus on this study is to examine the relationship between corporate governance and firm performance of listed Karachi Stock Exchange (KSE) oil and gas firms. In the firm level corporate governance characteristic we have considered Board Size, CEO status, Annual General Meeting and Audit Committee.

5 And we have used indicators Return on Equity and Profit

Margin for Firm Performance.

The plan of the study is as follows. Section 2 briefly reviews the corporate governance policy framework of Pakistan. The review of empirical findings of previous research is presented in Section 3. The methodology of this study is provided in Section 4. Section 5 explores the relationship between corporate governance and performance and provides a description of the data. Section 6 presents the results for the relationship between corporate governance and firm performance and last section concludes.

6 III.

7 LITERATURE REVIEW a) Corporate Governance in Pakistan

The SEC, since it took over the responsibilities and powers of the Corporate Law Authority in 1999, has been acutely alive to the changes taking place in the international business environment, which directly: and indirectly impact local businesses. As part of its multidimensional strategy to enable Pakistan's corporate sector meet the challenges raised by the changing global business scenario and to build capacity, the SEC has focused, in part, on encouraging businesses to adopt good corporate governance practices. This is expected to provide transparency and accountability in the corporate sector and to safeguard the interests of stakeholders, including protection of minority shareholders' rights and strict audit compliance.

During the past few years, the financial and corporate world has witnessed significant changes. Following the Asian financial crisis, recent accounting scandals have brought to light the importance of an effective institutional framework that would help corporate management increase shareholder value while protecting the interests of other stakeholders.

In The Code is a compilation of "best practices", designed to provide a framework by which companies listed on Pakistan's stock exchanges are to be directed and controlled with the objective of safeguarding the interests of stakeholders and promoting market confidence; in other words to enhance the performance and ensure conformance of companies. In doing this, the Code draws upon the experience of other countries in structuring corporate governance models, in particular the experience of those countries with a common law tradition similar to Pakistan.

Corporate entities in Pakistan are primarily regulated by the SEC under the Companies Ordinance, 1997, and the various rules and regulations made there under. In addition, special companies may also be regulated under special laws and by other regulators, in addition to the SEC. In this way, listed companies are also regulated by the stock exchange at which they are listed; banking companies are also regulated by the State Bank of Pakistan; companies engaged in the generation, transmission or distribution of electric power are also regulated by the National Electric Power Regulatory Authority; companies engaged in providing telecommunication services are also regulated by the Pakistan Telecommunication Authority; and oil and gas companies are also regulated by the Oil and Gas Regulatory Authority.

So the parties involved in corporate Governance are? Board Of Directors ? Shareholders ? Audit Committee ? Chief Executive Officer & Management

The Role of BOD

The board of directors has the responsibility to ensure that corporate behavior conforms to best governance practices. This requires directors to exhibit certain behavioral norms, including: (a) informed and deliberative decision-making; (b) division of authority (c) effective monitoring of management; and (d) evenhanded performance of duties owed to the company and to 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

11 B) ANNUAL GENERAL MEETING

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 integrity of the financial statements of the company (2) The effectiveness of the internal control over financial reporting (3) The independent 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 (??) 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 the Securities and Exchange Ordinance, 1969, the Securities and Exchange Commission of Pakistan Act, 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.

8 The Role of CEO & Management

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.

IV.

9 CORPORATE GOVERNANCE MECHANISMS

For measuring corporate governance and Firm performance different variables are used by the researchers such as Board Size, Audit Committee, Annual General Meeting and the Status of CEO.

10 a) Board Size

It is expected that limiting board size is to improve firm performance because the benefits by larger board of directors increased monitoring are outweighed by the poorer communication and decisionmaking of larger groups [Lipton and Lorsch (1992); ??ensen (1993)]. ??rown and Caylor (2004) add to this literature by showing that firms with board sizes between 6 and 15 have higher returns on equity and higher net profit margins than do firms with other board sizes. When board size increases, agency problems in the boardroom increase simultaneously, therefore leading to more director free-riding problems and internal conflicts among directors. What's more, a large board is more likely to be controlled by the CEO rather than the board controlling management. Eisenberg et al. (1998) maintain that when board size increases, coordination and communication problems increase. This causes greater agency problems and costs.

11 b) Annual General Meeting

The Annual General Meeting (AGM) is the most important and most powerful body of our organization. The AGM is the ultimate decision maker. The AGM gives the organization direction in policy when dealing with the goals.

The AGM appears to have emerged as an accountability mechanism in early English local government and joint stock companies (Cordery, 2005) and, although prevalent in Western Society, there is a paucity of research on its effectiveness, if this is the primary rationale for the existence of perpetuation of AGMs. Extant research has considered shareholder activism in AGMs (e.g. ??arens, 2002; ??arinetto, 1998) and whether this activism is empirically successful ??Karpoff, Malatesta, & Walkling, 1996). From another aspect, Strätling (??003) investigated the United Kingdom Department of Trade and Industry 1999 proposals for AGM reform to which respondents reacted negatively. Typically an AGM includes: the members electing the controlling committee,

that committee presenting financial accounts and reflecting on the organization's successes. The controlling actors may report achievement against key performance indicators in both financial and nonfinancial terms (Pitchforth, 1994), thus fulfilling accountability demands. Roberts and Scapens suggested accountability "will be open to further negotiation and refinement in the actual course of interaction" (1985, p.450), and acknowledged that the place and manner in which the information is provided also impacts on accountability. As the AGM is an occasion for face-to-face accountability, members can question and challenge the controlling actors' reports, providing refinement and insight within the accountability process. Accordingly, this research assesses the potential for AGMs for effective scrutiny and the discharge of accountability, through a qualitative method employing observation and analysis of the process of accountability between members and actors at AGMs. The main function of the AGM is to receive and to react to reports on activities of the Board of Directors, the Executive, and the Auditor. This is where the democratic process of the Company is really shown. The membership has the opportunity to elect who they want to represent.

12 c) 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). The company would provide a critical oversight of the company's financial reporting and auditing processes (FCCG, 1999; Walker, 2004).

Indeed, the existence of an audit committee in a firm (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.

13 c) 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 for 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 the CEO performs a 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.

V.

14 METHODOLOGY a) Sample/ Research Design

The data used for this study is originated from Audited Financial Statements of the listed firms and Balance Sheet Analysis of joint stock companies listed on Karachi Stock Exchange (2004-2010). The firms used are selected by non-probability sampling technique. A total of 12 listed firms are used for analysis in which one firm's (Attock Petroleum) data is not available due to some limitations. Panel data methodology is taken on because it combines time series and cross sectional data. The method of analysis is that of multiple regressions and estimation is Ordinary Least Squares (OLS).

15 b) Model Specification

The economic model used in this study is given as: $Y = \alpha + \beta x + \epsilon$

Where, Y is the dependent variable. α is constant, β is the coefficient of the explanatory variable (corporate governance mechanisms), x is the explanatory variable and ϵ 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: $PERF = \alpha + \beta_1 (BSIZE) + \beta_2 (AGM) + \beta_3 (CEO) + \beta_4 (AUDCOM) + \epsilon$
 $ROE = \alpha + \beta_1 (BSIZE) + \beta_2 (AGM) + \beta_3 (CEO) + \beta_4 (AUDCOM) + \epsilon$

16 Variable Description

Tables A and B below show the variables and their descriptions as used in this study.

17 AC = Audit Committee

The composition of audit committee that is outside as a proportion of the total for firm i in time t .

18 AGM = Annual General Meeting

The total number of meetings in a year VI .

19 EMPIRICAL RESULTS AND DISCUSSION

20 Descriptive Statistics

Table ?? shows the descriptive statistics of all the variables used in this study.

21 Table C :

committee indicates that round about 3 auditors are essential for good performance of a firm. The AGM indicates that at least 5 meetings are required for the firms.

VII. By applying t -test, we conclude that our hypothesis that there is no significance difference of profit margin between public and private companies is true as the p -value is 0.00 so it is also highly significant. Same is the case with our hypothesis of that there is no significance difference of audit committee between public & private companies. But our hypothesis of that there is no significance difference of return on equity between public & private companies and there is no significance difference of board size between public & private companies as the p values are 0.15 and 0.23 respectively.

22 REGRESSION RESULTS AND DISCUSSION

23 VIII.

24 CONCLUSION

There is no doubt that a number of studies have been conducted so far and is still on going on the examination of the relationship between firm performance measures and corporate governance mechanisms, but the results of these studies are mixed. This study examines the relationship that exists between firm performances, by using indicators (ROE and PM) and four corporate governance mechanisms (board size, annual general meeting, chief executive status and audit committee). For data analysis we have used 11 oil and gas firms listed on the Karachi Stock Exchange for the period of 2004 -2010. Panel data methodology is employed; the method of analysis is multiple regression and the t -test. The study discloses the following results: a. There is a positive relationship between two Firm Performance Measures (ROE and PM) and Two Corporate Governance Mechanisms (Board size & AGM) but they have no significant effect b. There is a negative relationship between ROE, CEO status and audit committees but they have significant effect. c. There is a negative relationship between PM and CEO status and audit committee, but CEO status has a significant effect on PM. . . ^{1 2 3}

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Figure 1: Corporate 5 Global

		interest of the company and the shareholders. This can be better achieved through independent monitoring of management, transparency as to corporate performance, ownership and control, and participation in certain fundamental decisions by shareholders.	
		II.	SOME FAIL-URE IN PAK-ISTAN DUE TO
		LACK OF CORPORATE GOVERNANCE	
		a) PTCL	
		The positive effect of good corporate	
governance on different stakeholders ultimately is a strengthened economy, and hence good corporate governance is a tool for socio-economic development. After East Asian Economies collapsed in the late 20th century, the World Bank's President warned those countries, that for sustainable development, corporate governance has to be good. Economic health of a nation depends substantially on how sound and ethical businesses are.		Corporate governance	serves two
indispensable purposes.			
? It enhances the performance of corporations by establishing and maintaining a corporate culture that		motivates directors,	managers and
entrepreneurs to maximize the company's operational efficiency thereby ensuring returns on investment and long term productivity growth.			
? Moreover, it ensures the conformance of corporations to laws, rules and practices, which provide mechanisms to monitor directors' and managers'			
accountability that in turn safeguards the investor interest. It is fundamental that managers exercise		behavior through	corpora

Figure 3:

A

Variable	Description/ Measurement
ROE = Return on Equity	Profit after tax Total equity shares in issue
PM = Profit Margin	Profit after tax Turnover

Table B : Independent variable description

Variable	Description/ Measurement
BSize = Board size	Number of directors on the board. Value zero (0) for if the same person
CEO = Executive Status	Chiefcupies two or more posts among chairman, MD, GM and the Chief Executive and one (1) for otherwise.

Figure 4: Table A :

Corporate Governance and Firm Performance a Case Study of Pakistan Oil and Gas Companies Listed in

	PM Table G : t-test
Mean No. Hypothesis	15.25 t-statistic P-value 37.73
1	Median H o : There is no significance 3.70
	Mode difference of profit margin 2.60 between public & private
	Std. 22.59
	Devi- ation compa- nies.
2	Skewness H o : There is no significance 0.94 Kurtosis -0.59 difference of

Table D : Independent variables AC CEO AC CEO By applying regression test we conclude that Dependent

and it has no significant (sig.0.15) see in appendix
A.Similar result appear for annual general meeting. But
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

[Note: are same in different time periods and for individual Table D also shows that ROE is also positively
corelated 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). Also see in appendix B.]

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