

The Effect of Board Characteristics as Corporate Governance Attribute on Firm Performance in Pakistan

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ABSTRACT

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Purpose: Most of the prior studies followed board characteristics as corporate governance attribute, the study to follow on the basis of literature support to use board characteristics as one of the corporate governance attributes. The objective of this research study is to investigate the effect of the board of director's characteristics on firm performance of the Pakistani oil and gas firms listed on Pakistan Stock Exchange (PSX).

Methodology/Design: Data was collected from the annual reports of oil and gas firms listed on (PSX). The study applies pooled OLS regression on all oil and gas firms listed on PSX for the period from 2008-2015. Return on assets (ROA) is used as a proxy for measuring firm performance which is the dependent variable. Whereas the independent variables used in the study are board size, board independence, CEO duality, board activity.

Findings: The board size and board independence are found significant factors of firm's performance in Pakistan. Whereas, CEO duality and board activity are insignificant in determining the performance of firms in Pakistani oil and gas firms.

Implications: The outcomes and findings of the present study are significant for, regulators, legislators and investors, in order to determine which governance mechanism is important in improving firm performance in Pakistan.

Key Words: Return on assets, board size, CEO duality, board activity.

1. Introduction

The Corporate governance is a phenomenon in which corporations are controlled and managed. The concept of corporate governance got rise in 1990's due to occurrence of huge bankruptcies and corporate scandals globally such as Enron, Xerox, WorldCom, Parmalat, Royal Ahold, Flowtex are few examples of high profile cases and scandals (Ronen & Yaari, 2008). These corporate collapse had decreased investors' confidence and trust in financial statements (Fodio et al., 2013) due to which it will be difficult for the companies to generate capital equity

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from investors and stock markets (Agrawal & Chadha, 2005). The criticism on the above said corporate scandals indicates the lapse in appropriate supervision on management by the audit committee and the board of directors (Al-Matariet al., 2012). In Pakistan, corporate scandals are still there such as Taj company scandal, Mehran bank scandal, national bank scandal, Pakistan Telecommunication Companies Limited (PTCL) privatizations are few cases. These corporate collapses push the Security and Exchange Commission of Pakistan (SECP) regulatory authority to develop a set of codes in order to increase governance practices, investor protection and reducing the trust deficits among the owner, agent and business community.

Consequently, for long time survival of firms, the significance of corporate governance attributes has been highlighted by these large world corporate frauds and scandals (Mokhtar et al., 2009). So the first codes were issued in March 2002 and are revised and re-released in 2012. Although the corporate governance codes in Pakistan are revised and re-released, but still the corporate governance environment in Pakistan is not mature enough and most of the businesses are controlled and managed by family members. In addition, in Pakistani companies the number of independent directors is insufficient, CEO is in duality and ownership is concentrated and is in the hands of a few large stockholders, mostly controlled by the family (Shabbir, 2012; Tahiret al., 2012). Hence the conflict of interest is between large and small shareholders (Shleifer & Vishny, 1997). The reason for all these conflicts are due to the separation of ownership and control in public companies which is called as agency problem (Jensen & Meckling, 1976).

Fama and Jensen (1983) suggested that firms need various monitoring and control mechanisms in the form of corporate governance attributes in order to overcome agency problems and increasing firm value. One of the control mechanism is board characteristics, as most of the prior studies followed board characteristics as a corporate governance mechanism, the study to follow on the basis of literature support (Brennan, 2006). The reason for choosing this attribute is that the main decision-makers in the business are the board of directors because they have the authority to revert all decisions that are made by the topmanagement (Fama & Jensen, 1983; Hermalin & Weisbach, 2003). Agency theory prophesies that boards will enrich the honor of a firm financial reports by observing the management. Evidence from previous studies suggested that various board characteristics such as board size, the composition of independent directors, the CEO duality and board activity may power the effectiveness of their monitoring role (Blacket al., 2006; Johlet al., 2015; Yermack, 1996). Moreover, the previous researches have shown that board characteristics are positively related with a firm performance in various economies however alternative crick of this research shown that there is no any association between board characteristics and firm performance. To bring together the contradictions and indecisive findings from the prior researches, this current research examined the association between board characteristics and firm performance for the oil and gas firms listed on Pakistan stock exchange (PSX).

In this research study, firm performance will be determined through board characteristics as one of the corporate governance attributes. In Pakistan, corporate governance is at its preliminary stage, although the codes of corporate governance in Pakistan are revised and rereleased in 2012. Therefore, proper application of corporate governance and its practice is not streamlined in Pakistan yet. Hence, the current research study will establish an empirical association of board characteristics with firm performance in Pakistan. Board characteristics is one of the important element of firm's performance. This current research study is going to be conducted in the oil and gas sector of Pakistan. The results obtained from this particular study will help any other sector to obtain competitive edge by incorporating appropriate corporate governance practices in the firms, also help to increasing the performance of the company. Moreover, the results will provide important information to policy makers in order to take proper measures to confirm the actual implementation of corporate governance practices in Pakistan. The research objectives of the study are; (1). To determine the effect of board size on firm performance in Pakistan. (2). To find out the impact of board independence on firm performance in Pakistan. (3). To evaluate the effect of CEO duality on firm performance in Pakistan and finally (4). To investigate the impact of board activity on firm performance in Pakistan. Generally, the significant contributions of this study are twofold, namely theoretical development (knowledge) and policy implication. In relation to theoretical development, this study fills the gap in the literature by capturing the impact of various board characteristics on firm performance in oil and gas sector in Pakistan. In relation to policy implication, the findings of the current study can be fruitful for external auditors, regulators and legislators in their attempts to enhance the quality of monitoring mechanisms. There are also implications for users of financial statements and investors, especially for those who have keen interest on investing in oil and gas sector in Pakistan.

2. Literature Review

2.1 Board Characteristics and Firm Performance

Board characteristics are the most significant attribute of corporate governance due to its relevance for planning and decision-making for organizations (Lam & Lee, 2012). The boards of directors mitigate the grievances and improve the relations between stakeholders and firms in order to improve the level of financial growth (Fama & Jensen, 1983). Thus, the effectiveness of the board calculated through a number of parameters like independence, size, CEO duality, and activity.

2.1.1 Board Size and Firm Performance

Board size refers to the total number of board members on the board (Gulzar & Wang, 2011; Iraya et al., 2015; Masood & Shah, 2014; Uwuigbeet al., 2014). According to Lipton and Lorsch (1992), the best board size should make up of eight (8) or nine (9) directors, and greater

numbers will decrease the effectiveness due to problems regarding the process and coordination (Jensen, 1993). Board size seems to be different from one country to the other country, In case of Pakistan the revision of codes of corporate governance in the year 2012 does not specify the exact number of board members, the average number of members in the board are 6-7 in most of the firms in Pakistan. According to Johl et al. (2015), the appropriate size of the board should be determined how effectively the board is able to operate as a team.

The previous research studies provided mixed results on the association between board size and firm performance. Sandaet al. (2010), Chan and Li (2008), De Andres et al. (2005), and Mokhtar et al. (2009) revealed that large number of members on the boards are related with weaker firm performance. Likewise, Yermack (1996) used Tobin's Q ratio as a proxy for determining the value of firm performance, the result shows that there is a negative relationship between board size and firm performance. The previous studies which were conducted to analyze the association between board size and firm performance revealed negative results (Eisenberg et al., 1998; Mak & Kusnadi, 2005; Ujunwa, 2012), the result shows that larger board is ineffective in improving the financial performance of the companies.

On the contrary, the other views also claimed that small board size shows more competency to monitor the CEO's behaviors in addition to making appropriate decisions for the firm and increase firm performance. The Meta-analysis technique has been used by Dalton et al. (2003), revealing that larger the board size, greater the firm performance irrespective of the nature of the business and which measure was used to determine financial performance. However, De Andres and Vallelado (2008) favors for larger board to evaluate for creating more value for firm. This finding. was also .supported by some other prior studies by Shukeriet al. (2012), Brennan (2006), Daily and Dalton (1993) and Johlet al. (2015). There are some other similar researchers who found that there is no significant association between board size and firm performance (Bhagat & Black, 2002; Connelly & Limpaphayom, 2006). On the basis of the above-mentioned facts and empirical evidence, the study proposed the following hypothesis for empirical testing:
H₁: There is a negative association between board size and firm performance.

2.1.2 Board Independence and Firm Performance

Board independence means the percentage of independent non-executive directors in the total number of members in the board (Irayaet al., 2015). The independent directors play a major role in arbitrating the conflicts. between management and shareholders and enhancing the transparency and compliance of accounting reports (Kent et al., 2010). According to Jensen and Meckling (1976), transparency of boards to monitor and control the opportunistic behavior of management is more concerned with pressure of outsiders. The board consists of executive and non-executive directors who are either non-independent or dependent directors. The Pakistani revised codes on corporate governance 2012 recommended that it is mandatory to have at least one or one third independent directors of the total members on the board.

The greater number of non-executive directors on the board tend to be negatively related to the fraudulent financial statement because independent directors do not have any self-interests and they control managerial activities to protect the interests of investors (Williamson, 1988). The literature posits the inconsistency between the independence of board and performance of firms. Dehaene et al. (2001) and Rhoades et al. (2000) support the argument of selecting independent board as outsiders for transparent results and the protection of stakeholders' interests, which may result higher level of return on equity. Lam and Lee (2012) investigated that large number of independent directors on the board tend to lead increasing firm performance as compared to the board with more executive directors. Consistent with this argument, the prior studies which were conducted to analyze the association between board independence and firm performance revealed positive results (Connelly & Limpaphayom, 2006; Kamardin, 2009; Krivogorsky, 2006; Lefort & Urzúa, 2008; Ponnu, 2008). Few researchers such as Erickson et al. (2005), Coles et al. (2001), Agrawal and Knoeber (1996), Klein (2002) and Yermack (1996) found a negative relationship between board independence and firm performance. On the contrary, De Andres et al. (2005), Bhagat and Black (2002), Haniffa and Hudaib (2006) and Nahar Abdullah (2004) have failed to find a statistically significant association between board independence and firm performance. On the basis of the above-mentioned facts and empirical evidence, the study developed the following hypothesis.

H₂: There is a negative association between board independence and firm performance.

2.1.3 CEO Duality and Firm Performance

CEO duality means when a person carries both roles of the firm's CEO and chairman of the board (Apadore & Zainol, 2014; Kamran & Shah, 2014; Nugroho & Eko, 2012). The argument in favor of CEO duality explains that, when CEO duality occurs in a firm, it will provide a more flexible environment for management and may provide more effective monitoring (Cornett et al., 2008; Davidson et al., 2004; Jensen, 1993). Moreover, the impartiality and quality of board control is generally perceived to suffer if the CEO is also the board chairperson. In case of Pakistan CEO is in duality as most of the businesses are run by family members and all the posts are occupied by family members. Therefore the performance of the firm is affected.

According to Rahman and Haniffa (2005) the role of CEO's duality is viewed with the help of stewardship theory and agency theory. Agency theory suggested that it is necessary to keep the roles of CEO and board chair separate in order to ensure the supremacy of board over management (Hashim & Devi, 2008). While, the stewardship theory suggests that by keeping the role of CEO and board chair unite, the authority and decision making of chair/CEO get enhanced that help in creating better performance and higher value for the firms. Brennan (2006) declared the negative association between CEO duality and firm performance. Moreover, Heenetigala and Armstrong (2011) concluded that duality of CEO impact negative on the firm's performance, so single entity on two positions may be biased in decision making in the firms. Likewise, Lam and

Lee (2012) described that CEO duality has a significant but negative relationship with firm performance. The findings of this study is consistent with the agency theory which suggests that board duality promotes CEO entrenchment by reducing board monitoring effectiveness and impedes firm performance. Consistent with this argument, the prior studies which were conducted to analyze the relationship between CEO duality and firm performance revealed negative results (Coleset al., 2001; Feng et al., 2005; Judge et al., 2003; Sanda et al., 2010; Ujunwa, 2012).

In relation to the CEO duality, other similar studies found no significant association between CEO duality and firm performance, indicating that the duality is neither a motivation nor a constraint for managers to increase firm performance. These findings are consistent. with prior studies by Carapeto et al. (2005), Schmid and Zimmermann (2008) and Wan and Ong (2005). On the basis of above-mentioned facts and empirical evidence, the study proposed the following hypothesis for empirical testing:

H₃: There is a negative association between CEO duality and firm performance.

2.1.4 Board Activity and Firm Performance

Board activity provides an opportunity to discuss all of the important issues of the firm on a timely basis. The frequency of board meetings is considered to be an important way of improving the effectiveness of the board. Board activity has been defined as the number of meetings conducted by the board in a year (Gulzar & Wang, 2011). According to Ronen and Yaari (2008), board activity is a key element of board operations and it is the responsibility of the board of directors to attend board meetings. In Pakistan, the revision of codes of corporate governance in 2012 recommended to attend board meeting on regular basis in order to increase firm performance. Also, it is mandatory for the board to disclose the number of board meetings conducted in a year. There are contradictory suggestion found for frequency of board meetings conducted in a year. Lipton and Lorsch (1992), favor for having frequent meetings for better performance while Carcello et al. (2002) had reservation for frequent meeting due to fear of high cost but at the same time, they are found agreed with notion of frequent meeting due to chance of in depth audit for better performance. It was also found that companies with poor board attendance at meetings perform .significantly worse than boards which has good attendance during financial crisis. On the contrary, the other view claim that frequent attendance of board meeting is not always useful or effective in increasing firm performance (Vafeas, 1999). Also, there are pessimist point of view with respect to waste of time, increase in travelling and administrative cost that may lead to firm less productive (Evanset al., 2002). On the basis of above-mentioned facts and empirical evidence, the study proposed the following hypothesis for empirical testing:

H₄: There is a negative association between board activity and firm performance.

3 Research Methodology

3.1 Research Design

According to Bickman and Rog (2008), research designs serves as the architectural blueprint of a research project, linking design, data collection, and analysis activities to research questions. The study employs a quantitative research approach based on the extensive literature reviewed. In the quantitative research approach, data can be analyzed in terms of numerical values. According to Punch (1998), the quantitative methodology is the best approach in order to get a better understanding of a research problem through numerical tendency.

3.2 Population, Sampling and Data Collection

For analyzing the effect of board characteristics on firm performance, secondary data was collected from published annual reports of the oil and gas firms listed on PSX for the period of 2008-2015. The collection of data for analysis started from the year 2008 due to its availability on published sources that is Data stream (Thomson Reuters) and annual reports by oil and gas companies. However, some firms were established after 2008, some of firms in duration of this time where dropped from stock exchange and some have incomplete data; therefore the target population of this study only contains 16 oil and gas firms selected from oil and gas sector.

The reason for choosing oil and gas sector is that Pakistan is undergoing the worst shortage of oil, gas and electricity (Saleh, 2015). The main reason for this is inappropriate distribution of resources, unstable law and order situation, poor management and bad governance (Saleh, 2015). Since the oil and gas sector has a massive share in the country's economic growth this sector hold great significance. The present research study used panel data techniques. Moreover, census sampling technique is adopted for the collection of secondary data from oil and gas firms listed on PSX. The criteria for sampling are: (1). The firm remained listed on PSX during the selected period of time (Tabassum et al., 2013), (2). Only firms with complete required data are included (Latif & Abdullah, 2015) and (3). Firms with incomplete data are excluded (Shah *et al.*, 2009).

3.3 Dependent and Independent Variables

The dependent variable used in this study is Return on Assets (ROA) which is used as a proxy to measure firm's performance. The reason for choosing this variable is justified from some prior studies (Johl et al., 2015). Whereas, board activity, board size, CEO duality and board independence are the independent variables used in this study. Table 3.1 shows the list of selected dependent and independent variables along with their formulation.

Table 1: Definition of Variables

VARIABLES	Formulation
Dependent Variables	
Return on Assets (ROA)	Measured as a percentage of net profit after taxes to total assets of the firm
Independent Variables	
Board Size ((BS)	Total number of members on the board
Board Independence (BI)	Number of independent directors
CEO Duality (CEODL)	CEO duality is represented by a dummy variable with the assigning value 1 if the role of CEO and chairman are combined and 0 otherwise
Board Activity (BA)	Number of board meetings conducted in the year

4 Results and Data Analysis

The quantitative data analysis would be adopted by using pooled OLS regression. The data has been analyzed using the STATA software. Equation 1 provides the association between board characteristics and firm performance by using a regression model.

$$ROA_{it} = \beta_0 + \beta_1 BDS_{it} + \beta_2 BDIND_{it} + \beta_3 CEODL_{it} + \beta_4 BDA_{it} + \varepsilon_{it} \quad (1)$$

4.1 Descriptive Statistics

Descriptive statistics are brief descriptive coefficients that summarize a given data set, which can be either a representation of the entire population or a sample of it. Descriptive statistics are broken down into measures of central tendency and measures of dispersion. The measure of central tendency include the mean, median, and mode, while measures of dispersion include the standard deviation, minimum and maximum. To obtain an overview of the nature of data set, descriptive statistics analysis were employed for dependent and independent variables.

The descriptive statistics are shown in Table 2, which depicts the mean, minimum, maximum, and standard deviation of all the variables which have been taken under study. Return on Assets (ROA) varies from -0.268 to 0.513, with a mean value of 0.110 and standard deviation of 0.123 respectively. Board size of a firm (BDS) varies from 6.000 to 15.000 with a mean value of 9.234 and standard deviation of 2.601 respectively. The mean value of board independence (BDIND) is 1.781, ranging from 0.000 to 9.000 with a standard deviation of 2.350. CEO duality (CEODL) varies from 0.000 to 1.000, with a mean value of 0.750 and standard deviation of 0.434 respectively. The mean value of board activity (BDA) is 5.625, ranging from 4.000 to 16.000 with a standard deviation of 2.224.

Table 2: Descriptive Statistics

STATS	Mean	Min	Max	Std. Dev.	Observations
ROA	0.110	-0.268	0.513	0.123	192.000
BDS	9.234	6.000	15.000	2.601	192.000
BDIND	1.781	0.000	9.000	2.350	192.000
CEODL	0.750	0.000	1.000	0.434	192.000
BDA	5.625	4.000	16.000	2.224	192.000

ROA = Return on Assets, BDS = Board Size, BDIND = Board Independence, CEODL = CEO Duality, BDA = Board Activity

4.2 Correlation Analysis

To examine the strength and direction of relationship between board characteristics and firm performance, analysis of correlation matrix was estimated. The findings of the correlation matrix are presented in Table 3. The table shows that the correlation coefficients of board independence with board size is 43.49% at the level of 1% significance. Likewise, board activity is significant at 1% level with board size at 21.98% of correlation. Similarly, the correlation coefficients of return on assets with board size is -16.86% at the level of 10% significance. The correlation coefficients of board activity with board independence 17.85 at the level of 10% significance. Less the value is good for the firm indicating that there is no multicollinearity issues in the given data. , A number of previous studies such as Hairet al. (2006); Gujarati and Porter (2009) suggest 0.8 at the beginning at which multicollinearity concerns may harm the regression analysis.

Table 3: Correlation Matrix

	BDS	BDIND	CEODUL	BDA	ROA
BDS	1				
BDIND	0.4349***	1			
CEODL	0.0012	-0.018	1		
BDA	0.2198***	0.1785*	-0.0108	1	
ROA	-0.1686*	0.1035	0.0068	0.0208	1

The p-values shown in parentheses i.e. ***, **, and * denotes significance at 1%, 5% and 10% levels, respectively. ROA = Return on Assets, BDS = Board Size, BDIND = Board Independence, CEODL = CEO Duality, BDA = Board Activity.

4.3 Variance Inflation Factor (VIF) and Tolerance Test

Table 4 presents the findings relevant to VIF and tolerance value for the sample of oil and gas firms listed on PSX. The condition of VIF and tolerance is that, if the value of VIF is more than 10 and the value of tolerance is less than 0.10 for any variable, it means the variable has some problem, which further needs to be addressed. The result of this test shows that the variance inflation factor (VIF) value was less than 10 and the tolerance value of variables was more than 0.10. Thus, this indicates that there is no evidence for the multicollinearity problem between predictor variables.

Table 4: VIF and Tolerance Test

Variable	VIF	1/VIF
BDS	1.270	0.7898
BDIND	1.240	0.8032
CEODUL	1.000	0.9994
BDA	1.060	0.9431

BDS = Board Size, BDIND = Board Independence, CEODUL = CEO Duality, BDA = Board Activity

4.4 Pooled OLS Regression Analysis

Pooled OLS model is also known as a constant coefficient model, is generally used for estimating unknown parameters in a linear regression model. It helps to reduce the errors between the estimated points on the line and the actual observed points (Hill *et al.*, 2008). It is assumed that the intercept and coefficient are homogenous for all firms. In general, ordinary least square regression model ignores the individual and time effects. Table 5 shows the result of pooled OLS regression of oil and gas sector listed in PSX.

Table 5: Pooled OLS Regression of Board Characteristics with Firm Performance

Dependent Variable	Independent Variables	Coefficients	P-value
Firm Performance (ROA)	BDS	-0.0127***	0.001
	BDIND	0.0111***	0.007
	CEODUL	0.0032	0.871
	BDA	0.0023	0.562
	Cons	0.1933	0.000
	R Square	0.068	
	F-Statistics	3.450	
	Prob (F- Stat)	0.000	

The p-values shown in parentheses i.e. ***, **, and * denotes significance at 1%, 5% and 10% levels, respectively.

According to Table 5, the F statistics was highly significant ($F = 3.450$, $p\text{-value} < 0.000$), indicating that board characteristics could be considered to be influencing firm performance. The R square value is 0.068 which indicates that the variables in the model explained only 6.8% of the variation in firm performance. According to Gujarati and Porter (2009), the objective in regression analysis is not to obtain a high value for R square but rather to obtain dependable estimates of the true population regression coefficients and draw statistical inferences about them. The researcher should be more concerned about the logical or theoretical relevance of the explanatory variables to the dependent variable and their statistical significance; if the R square is low it does not mean the model is necessarily poor (Gujarati & Porter, 2009).

According to Table 5, the finding of the regression model indicates that board size - 0.0127 ($p = 0.001$) is negatively significant to the firm performance. The result showed that firms with more board size will cause a decrease in firm performance thus supporting H_{1a} . The findings are supported by some prior studies (De Andres & Vallelado, 2008; Sanda et al., 2010). The Table also shows that board independence 0.0111 ($p = 0.007$) is positively significant to the firm performance. The results revealed that an increase in board independence will cause an increase in firm performance thus supporting H_{2a} . The results are supported by some previous studies (Connelly & Limpaphayom, 2006; Lefort & Urzúa, 2008; Ponnu, 2008). Whereas CEO duality and board activity have no significant relationship with firm performance. These findings are consistent with some previous studies (Carapeto et al., 2005; Schmid & Zimmermann, 2008).

5 Conclusion and Future Recommendations

In the overall sample of oil and gas firms listed on PSX, board size remained significantly negatively and board independence is significantly positively correlated with a firm performance by using OLS regression. The findings show that small board and more independent directors on the board is effective in increasing firm performance (Kamardin, 2009; Krivogorsky, 2006; Lefort & Urzúa, 2008; Sanda et al., 2010). However, the findings found that CEO duality and board activity does not affect firm performance in the oil and gas sector in Pakistan. In Pakistan revision of Corporate Governance codes in 2012 in Pakistan improve governance mechanism in Pakistan specifically board composition and structure in order to create good dynamics of board composition discussion which will lead to better firm performance and create good value creation to shareholders.

This study relies on quantitative information published in the DataStream system and annual reports. Future research may need to adopt qualitative information and use appropriate research methodologies to provide enhanced evidence on the association between board characteristics and firm performance in various economies. Future research could consider if there are other board characteristics variables that could be used to investigate the said relationship. Future research may consider a longer time frame with the resulting impact between board characteristics and firm performance.

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