# IMPACT OF CORPORATE GOVERNANCE ON THE PERFORMANCE OF FINANCIAL SERVICES SECTOR: A CASE STUDY OF PAKISTAN ECONOMY


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# Pakistan Institute of Development Economics

## CERTIFICATE

This is to certify that this thesis entitled: **"Impact of corporate governance on the performance of financial services sector: A case study of Pakistan Economy"** submitted by Mr. Rao Muhammad Asad is accepted in its present form by the Department of Business Studies, Pakistan Institute of Development Economics (PIDE), Islamabad as satisfying the requirements for partial fulfillment of the degree of **Master of Science in Management Sciences**.

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# DECLARATION

I, Rao Muhammad Asad, Registration No. PIDE2016FMSMS16, student of MS Management Sciences, session 2016-2018, hereby declare that the material printed in this thesis entitled "Impact of Corporate Governance on the Performance of Financial Services Sector: A Case study of Pakistan Economy" is my own work and has not been printed, published and submitted as research work, thesis or publication in any form in any University, Research institution etc. within and outside of Pakistan.

**Dated**: **Julay 01, 2019** **Rao Muhammad Asad**

## DEDICATION

*This thesis is dedicated to my beloved parents and wife who have been supporting me all the way since the beginning of study, and who believe in the richness of learning.*

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| | |
|---|---|
| **ROA:** | Return on Assets |
| **ROE:** | Return on Equity |
| **EPS:** | Earnings per Shares |
| **BS:** | Board Size |
| **NM:** | Number of Meetings |
| **ACS:** | Audit Committee Size |
| **FS:** | Firm Size |
| **SECP:** | Security and Exchange Commission of Pakistan |
| **SBP:** | State Bank of Pakistan |
| **PSX:** | Pakistan Stock Exchange |

# ABSTRACT

Corporate governance is always considered as an important factor for the performance of any business entity. The present study aims to figure out the impact of governance on performance by using the multiple indicators of corporate governance. The sector used in this study is the financial services sector of Pakistan. Data has been collected from the Securities and Exchange Commission of Pakistan, State Bank of Pakistan and Pakistan Stock Exchange. A panel data analysis of the financial services sector has been done over the period of 2006 to 2017. The estimation techniques are fixed effect and random effect model. The performance indicators used in the study are Return on Assets, Return on Equity and Earning per share whereas corporate governance indicators are Board Size, Number of Meetings, Audit Committee Size and Firm Size obtained from firm's balance sheet. The findings of our study have shown that board size has a negative but significant impact with return on assets. Whereas the number of meetings, audit committee size and firm size has a positive but insignificant impact on return on assets. Further, in estimating performance through return on equity, it has been found that the number of meetings and firm size has a significant relationship with return on equity. At the end, in estimating performance through earning per share, our results have shown that firm size has a positive and significant impact on earnings per share. The results of our study are important in redefining the strategies for ideal boardroom size in the country and also academically important.

# CHAPTER 01

# INTRODUCTION

Financial services sector is the largest sector in Pakistan and plays significance role in its economy. Primarily, it helps to improve the economic conditions that lead to more capital projects. Over the past few decades, the financial services sector faces many challenges such as technological advancement, globalization and merger and acquisition. Such challenges affect the performance of financial services sector. Along with these challenges corporate governance practices also affect the performance of financial services sector. However, there is a conflict of opinion on it; some theorists support corporate governance in this respect and consider it to be the main issue affecting the performance of institutions in Pakistan whereas others support otherwise. Overall, the long-term performance of an organization depends upon the improvement of corporate governance because it is among critical factors providing strength in this regard.

Corporate governance is the system of rules, practices and processes by which a firm is directed and controlled. In the broad sense, it describes institution laws, policies, customs and processes directing the corporations in the manner they act, administer and control their business operational activities. It focuses on achieving organizational goals and managing the relationship among the stakeholders including the shareholders and board members. In this respect, it primarily focuses on removing the principle-agent problem in the organizations with the purpose of holding the individuals accountable for their actions. In the narrower sense, corporate governance is a standard establishing the competitive investment environment required for gaining a strong position by competitive companies in efficient financial markets.

## 1.1 Background of the Study

An important insight from the growing body of literature concerning the connection of board size and corporate governance in the western context is that corporate governance is influenced by control mechanisms such as takeover threats, executive compensation and board's monitoring. Also, the insight is that the corporations' financial performance is immediately affected if corporate governance becomes less effective. For this reason, the role of board directors with its mix of legal power independence and expertise in corporate governance cannot be overlooked. It remains a potentially powerful mechanism of corporate governance primarily due to its final responsibility, being at the apex of central control for the functioning of organizations.

Moreover, corporate governance assumes much prominence in instances resulting in lower domestic and foreign investments. Such investment is of critical importance for an economy's growth. However, according to Bhasin, (2013) financial frauds occur and damage a firm's image along with providing financial loss. It hampers the economic growth of the nation. Financial scandals such as Satyam, WorldCom and Enron highlight the fact that corporate governance remains of considerable practical importance in financial sectors. The investment decisions are made based on accurate and true financial information. However, corporations resort of manipulation of financial data commonly known as window dressing. It does not depict the true financial picture of the firm. Hence, an independent audit committee becomes a prerequisite to ensure investors' trust (Leung *et al.,* 2014). According to Nuryanah and Islam, (2011) it ensures potency of internal control structure as well. Thus, company's performance is directly related to the role of audit committee, which in turn relates to corporate governance.

The number of board meetings is an important assessment criterion of the effectiveness and functionality of corporate boards. Few studies, in this respect, have pointed towards a number of important issues. For instance, managerial talent, company culture, and other firm-level heterogeneities jointly and dynamically determine corporate performance and board meetings primarily because the issues and opportunities faced by companies tend to vary (Ntim *et al*., 2012 and Guest, 2009). Moreover, legal and institutional practices and company-specific corporate governance vary and these variations shape the connection of board meetings with corporate governance (Karamanou and Vafeas, 2005).

It elaborates the relationship of the firm in its outside and within the environment. For this reason, modern firms focus on increasing their size for getting a competitive edge over their competitors. Large size enables organizations to increase their market share and reduce production cost (Adburahman *et al*., 2003).

The significance of corporate governance has increased, over the past few years both in the academia and the services sector. According to Qureshi and Mehmood, (2018) company management who has dispersed ownership, has to face a different type of scandals. The reason behind these scandals is the lack of supervision and accountability. When that kind of phenomenon exists then we consider corporate governance practices to reduce that kind of scandals and thus, enhance the firm's financial performance (Qureshi and Mehmood, 2018). Corporate governance mechanism provides facilitation to enhance the performance of a firm as well as enhance efficiency ownership structure.

According to Chen and Najjar, (2012) in comparison to the joint stock companies, private copartner companies remain more efficient because private copartner increases companies efficiency from their skills and capabilities.

As a developing economy, there is difficult to attract capital investment into the country because strong corporate governance practices are essential to attract investors to invest in the economy. The economy with strong corporate governance and remarkable stock market presentation has considered that foreign investment comes into the economy. Ong *et al*., (2017) believe strong corporate governance practices provide strength to the company to realize its strategies and objectives as well as provide strength to meet their legal requirements. Dar *et al.*, (2011) believe that strong corporate governance practices in an emerging market provide strength to property rights, develop capital markets, reduce capital costs and provide strength to the economy during financial distress. Strong corporate governance practices provide assurance to an investor for their investment returns (Shleifer and Vishny, 1996). From the investors' perspective, firm financial performance along with its corporate governance practices are considered to be the key areas before making an investment decision.

The confidence of investors and financial lenders is based on strong corporate governance practices. As a result, businesses in Pakistan are in need to develop strategies as per the code of corporate governance to remain competitive in the market. For sustainable growth and the company's performance, Pakistan must hold strong corporate governance practices.

According to Jensen and Mecklings, (1976) agency theory, there should be a positive relationship between corporate governance and firm performance. They stated that high corporate governance practices lead to better and improved firm operating performance and stock market returns. This return may be in the form of dividends and increase market value. A firm with a higher profit ratio has higher positive cash flows and more profit to distribute, these states attract potential investors to increase the share price and hence the market value of the firm. Therefore, in the current study corporate governance variables used to investigate the effect of these corporate governance variables on firm performance.

## 1.2 Significance of the Study

This study will help in policymaking regarding the financial services sector and also provide help for the enhancement of corporate governance laws and rules that will describe the direct and indirect relationship of the performance of financial institutions and good corporate governance practices. This research would also be useful for local and foreign investors to invest in the financial services sector.

## 1.3 Objectives of the Study

As point out earlier, the area of testing the numbers of board meetings, board size, audit committee size, and firm size on returns on assets, returns on equity, and earnings per share is in infancy especially in developing economies like Pakistan.

Therefore, the study pursues two main objectives:

1. To investigate the relationship between corporate governance and performance of financial services sector of Pakistan.

## 1.4 Structure of the Study

The rest of the study is organized as follows: Chapter 2 will present the extensive literature survey to check the evidence that if board size, numbers of board meetings, audit committee size, and firm size have significant shape on firm performance which has been elaborated through returns on assets, returns on equity, and earnings per shares. Chapter 3 encompasses the methodology for testing the firm performance and the required variables to test the objectives. Chapter 4 will present the empirical findings and findings of the study. Chapter 5 will conclude the study.

# CHAPTER 02

# LITERATURE REVIEW

The importance of good governance has been established via empirical evidence. Over the last two decades, a primary portion of the literature on finance has been focused on corporate governance primarily for the reason that it is fundamental to the economies with extensive business background. Moreover, corporate governance facilitates success of entrepreneurship because it reduces the principle-agent problem. Jenson and Meckling, (1976) explained that firms face the problem of agency due to the separation of ownership from control. It leads to issues in controlling the assets of corporations in the best interest of the stakeholders of the companies (Berle and Means, 1932).

## 2.1 What exactly is Corporate Governance?

Corporate governance is the system of rules for directing and controlling a company. It balances the interests of the corporation with that of its stakeholders such as government, financiers, suppliers, customers, management, shareholders, and the community. It provides the framework for a corporate to carry out its business processes and achieving goals, therefore, it nearly addresses all spheres of management.

Furthermore, rights and responsibilities are distributed among different contestants like a board, management, shareholders and other stakeholders. It is being done through corporate governance structure. These rights and responsibilities help in the decision-making process for different organizational operational activities. Organizational objectives are set through corporate governance and also decide that how those objectives are accomplishing. Furthermore, corporate governance mechanism is much essential for an organization to increase their performance.

Today, organizations that follow proper corporate governance practices are more profitable and valuable. Those organizations also ensure their sustainability and pay extra dividend to shareholders (Yasser, 2011). It is necessary for an organization to monitor their operational efficiency to maximize their performance and it can occur by conducting regular meetings of the board of directors (Haider *et al.*, 2015). It has also been found that the modification of corporate governance positively influences banking sector of Pakistan and enhances their efficiencies and effectiveness (Haider *et al.*, 2015).

However, it was not how the philosophers and theorists first painted the canvas of corporate governance. In 1995, Margaret Blair explained that corporate governance is a whole set of institutional, cultural, and legal arrangements that are used to determine the role of the public corporations, the scope and execution of control on them by various factors, and the allocation of returns and risk arising as a result of their business activities (Blair, 1995). Margaret Blair, via this definition, limited the scope of the term to the public corporations only. He did not only exclude the private companies from it but also ignored the importance of balancing the interests of the shareholders with that of the corporation.

Robert Monks and Nell Minow have filled this gap in the 1995 version of their current book on the topic under discussion as they overviewed the guidelines and codes of practices of corporate governance. The authors discussed it in the context of the relationship among various participants in a corporation such as employees, shareholders, management, chief executive officer, etc. (Monks and Minow, 1995). They elaborated the fact that this relationship is used to determine the direction and performance of corporations. Thus, corporate governance, in its narrowest sense, provides a formal system to hold the shareholders accountable to the senior management. Currently, it is known to be the shareholder model (Carrillo, 2007). It is related to the expansion of democratic ideas from the philosophical standpoint, but it failed to support the practical perspective.

Companies were focused on maximizing the short-term revenue for the shareholders, yet they failed to provide the sustainable development of the corporations' activities. The reason behind this failure lies in the system abuses that emerge due to preferring short-term revenues for the shareholders on the long-term objectives of the business. It raised a question mark on the practicality of the shareholder model of corporate governance that resulted in several dramatic financial scandals through history. This scenario led towards the stakeholder model of corporate governance (Shao, 2009).

In its widest sense, corporate governance works under the stakeholder model. It describes and directs the formal and informal relationships within a corporation. In this context, it focuses on the firm's long-term performance as well as shareholder value (Heath and Norman, 2004). It works around the stakeholder relations and business ethics shaping the firm's success and reputation in the long run. Therefore, the alleged differences between the shareholder model and stakeholder model of corporate governance do not become ripe in the philosophical discussion where it is only a question of emphasis. However, in the real-world scenario, corporate governance is much more than focusing on the keeping the shareholders and stakeholders happy.

Based on the discussion above, it can be concluded that corporate governance is a set of rules and guidelines that describe and direct the roles and responsibilities of various, probably all, participants within a corporation. It covers all spheres of the administration and other business activities as it aims at maintaining a balance between the interests of the participants and the corporation. From the philosophical standpoint, corporate governance can focus on maximizing the short-term revenue for the shareholders. However, from the practical perspective, it must always prefer the long-term objectives of the business rather than focusing on the short financial goals.

## 2.2 What A Financial Institution Should Look Like?

Banks along with financial institutions are examined more than any other set of firms in the past few years (Shaheen and Nishat, 2005). Nearly every aspect of finance and banking has been studied through loads of papers and policies have been enacted, discussed, and proposed especially after the financial crisis in 2008 (Angelides *et al.*, 2011). It reminds us of the importance of the banking sector and the financial system. It turns the debate towards the question of how a good financial institution looks like. Banks are strange beasts. They are private sector firms much like railroads or electrical utilities. Their healthy function is in the public interest. However, there is surprisingly little consensus for such a ubiquitous entity on how an ideal bank should look like (McGlaughlin and Mehran, 1995). Similarly, lesser attention has been paid to paint a picture to describe the shape of a healthy financial institution.

The historical version of the banking system underscores the need of smooth functioning of financial markets because it revolves around individual depositors and their incarnation in the paper markets both repo and commercial. From the viewpoint of a social planner, the banks and financial institutions must attempt to balance potentially conflicting desires. They must play their critical role in the financial intermediation. In the real economy, severe and prolonged distress will result from any sudden shock that would prevent the banking system from playing this role (Paudel *et al*., 2013). However, financial institutions recover from these shocks much faster than the non-financial firms and households, both of that are characterized by longer time horizons of human and physical capital investments and illiquid nature of assets.

The need of safety and soundness of banks is contracted by the financial system's improvement and innovation. A large portion of past literature covers the link between finance and growth around the globe (King and Levine, 1993; Rajan and Zingales, 1998). According to Levine, (1997) a strong financial institution must provide five services from the financial perspective, i.e., (I) providing a system of payment for the movement of goods and services, (II) disciplining and supervising borrowers, (III) identifying viable investments, (IV) managing uncertainty and risk, and (V) promoting investment by aggregating society's savings.

From the point of view of a society, the financial institutions must continuously work on improving these functions over time. It is practically not possible due to the chances of destabilizing of the innovations. For instance, the emergence of credit cards has increased the ability of a financial institution to quantify the creditworthiness of the potential borrowers along with its screening ability. However, it has also increased the risk in the form of nonbanking competitors. This situation has made bank unstable over time as their profit margin has declined because the nonbanking creditors offer loans as well. Therefore, measuring financial performance of a bank is easier said than done.

Some studies have provided and used several proxies such as stock price for quantifying and measuring the financial performance of the banks. However, there is no direct research in this regard. Moreover, several interesting questions remain unanswered in this context such as how can real prices introduce the securitization process in the system or how individual financial institutions deal with systematic or idiosyncratic risk. Apart from this discussion, the financial institutions work within a framework of social mores, taxes, and laws. It means that they face the added dimensions of supervisory actions and specific regulations. Thus, external governors such as legislators, regulators, and participants and internal governors including risk officers and board of directors influence the functionality of a financial institution.

Board of directors is usually formed to provide an independent oversight of management's decision-making. It is involved in key decisions about internal control, organization, risk appetite, and strategy. Market participants, on the other hand, create the interaction of the banks within the competitive markets. Information and disclosure play a key role in this regard. Regulators can either mitigate the risk of market failure through regulatory disclosure and the resultant production of mandated information or they could motivate the management by increasing the level of adequate information through the compensation schemes. Both of these actions, at large, are governed by the principles of corporate governance.

## 2.3 Corporate Governance in Financial Institutions

From the theoretical survey, it can be examined that corporate governance has primarily been focused on the non-financial firms. In this respect, it works from the potential investors' implicit viewpoint. The existence of the modern corporation with decentralized ownership is the starting motivation for this discussion. With all the moral hazards embedded in the modern limited liability corporation's structure and operations, a viewer of this financial structure would wonder why any investor would ever invest in a publicly traded firm. The second question comes as the doubt on the ability of the sector to returns money of the investors (Shleifer and Vishny, 1997).

Corporate governance answers both of these questions by holding management responsible for a firm's value maximization. This notion has widely been discussed in the literature that directors have a duty for safeguarding the interests of the shareholders while working on the success of the company in the long run. It is the enlightened shareholder value that is associated with the company directors' pivotal loyalty duty of acting in the interests of the organization (Keay, 2010). The enlightened shareholder value approach holds the view that the objective of long-term profit maximization for the shareholders cannot be achieved without the help and involvement of the stakeholders.

Thereby, fostering a strong relationship between the stakeholders is a must for the organization. It further elaborates that the long-term financial well-being of an organization is subject to the indispensable element of trust. The goals of the management are parallel with that of the shareholders by incentivizing the market for corporate control and providing equity-based compensation. For non-financial firms, it encourages the ownership of large equity blocks that is marshaled with the interests of the shareholders. However, for the financial sector, it is less powerful especially in the presence of the current regulatory restrictions on ownership and control in the context of the United States (Shleifer and Vishny, 1986).

In the real-world scenario, the interests of the shareholders contradict with that of the public if the quality of financial intermediation is not directly improved by the profitable opportunities for financial institutions (Stiglitz *et al*., 2009). Value-maximization, despite mixed empirical results, is a strong conceptual tool addressing the issues of the poorly managed firms such as it roots out corruption by punishing incompetent or lazy management. The interests of the shareholders and the public will marshal only in the absence of market failures in a world of perfect information.

Therefore, banks must enhance the quality of financial intermediation through the pursuit of productive activities to achieve value maximization and increased profitability (Stiglitz *et al*., 2009).

The existence of imperfect information in the financial markets cannot be denied. The former is the situation where all the parties involved in a situation have different information whereas investors involve in a risky event, due to the latter, knowing the fact that the cost of the risk would be borne by some other party (Stiglitz, 1981 and Hölmstrom, 1979). In comparison to a social planner, creditors and shareholders of bank deem an increased level of risk-taking optimal. The government bailouts and deposit insurance create moral hazards that increase the risk. It translates into returns that go to the banks and to its investors. However, the society will bear the cost of failure in this case. Furthermore, the banks pursue a strategy due imperfectly calculated risks because of the existence of imperfect information (Nier and Baumann, 2006).

Therefore, market discipline and information are closely linked because the latter is both an input and outcome of the former. The regulators also mandate the use and release of specific information. It increases market discipline. However, thinking critically, the mandated disclosure does not change the incentives of the market actors. Therefore, the origin and original motivation for producing the information is more important than its overall level. Further research, in this regard, to understand both negative and positive feedback loops in regulating increased, mandated information is required as it motivates the actors to produce more information.

Apart from increasing production of information, regulations can also increase motivation of the banks and their management to paying attention to the market. There are various approaches within the literature regarding the subject of marshaling the incentives of the shareholders and management. One of them is using market measures through compensation schemes. It is considered within the context of incentives because there are opinions that the risk monitors and risk takers had been less motivated to reduce the firms' exposure to risk before the financial crisis due to inadequate information. Therefore, compensation can be, and must be, utilized for marshaling the behavior of the shareholders and management to encourage the executives to think about the soundness and safety of the firm. That's how a financial institution should look like, and work like.

## 2.4 Corporate Governance and Board Size

Despite the established importance of the connection between corporate governance and board size, there does not seem to be a consensus on its importance in the past literature. Some of the financial economists such as Fama, (1980), Fama and Jenson (1983) consider the role of board size in this respect. They also acknowledge role of outside and independent directors as providers of relevant complementary knowledge and monitors of management (Fama, 1980; Fama and Jenson, 1983). In this context, the inside directors, i.e., the top management is involved in providing valuable information about the operational activities of the enterprises whereas the outside directors contribute both objectivity and expertise in evaluation of managers' decisions. They, while doing so, protect shareholders' wealth.

Hart, (1983) and Demsetz, (1983) on the other hand of discussion, are of the opinion that size of board is superfluous for the reason that markets marshal the interests of the stakeholders and the managers by providing powerful incentives. However, they question the need of outside directors in a board. In this respect, they question that if outside directors add to the economic discipline implemented by the market for corporate control, the managerial labor market, and managers by product and factor markets, and the alternative internal governance controls including ownership structure, bonding, and auditing.

To a large extent, the prevalent board culture of an organization affects the performance of the company. Reduction in the numbers of CEOs, and hence the organizational performance, has been observed due to the emphasis on courtesy and politeness on the cost of frankness and truth, i.e., discouraging conflicts and rewarding consent. Moreover, past research in this area indicate that an increase in board size makes them less effective primarily because the process and coordination issues overweigh the potential advantages of having more people of diverse background (Jenson, 1993; Hackman, 1990; Steiner, 1972).

Moreover, directors do not criticize the decision making process of the top management, and thus, the norms of behavior remains dysfunctional in most of the boards (Lipton and Lorsch, 1992). It has also been reasoned that a board size of seven to eight members is ideal (Jenson, 1993). The Cadbury Committee (1992) has recommended an ideal board size to remain between eight and ten. Furthermore, in most of the companies, the position of the chairperson of the board is held by the CEOs as well primarily because the chairperson is involved in organizing board meetings and overseeing the process of recruiting, training, and firing CEOs (Beasley, 1996).

Similarly, Kathuria and Dash, (1999) has also found a significant but inverse relationship between firm performance, i.e., returns on assets and independence of board of directors. However, the relationship becomes insignificant if firm performance is taken in terms of returns on equity (Kathuria and Dash, 1999). Moreover, firm performance and duality on the board exhibit a significantly constructive correspondence (Kathuria and Dash, 1999). In a similar fashion, the study also found a constructive correspondence between board size and promoter shareholding (Kathuria and Dash, 1999). However, this shape is limited to some performance of firm performance.

$H_o$: Board size does not affect the performance of financial services sector

$H_1$: Board size does affect the performance of financial services sector

## 2.5 Corporate Governance and Audit Committee Size

The concept of audit committee dates back to 1983 when Fama and Jenson gave the agency theory and emphasized on the role and importance of independent board and committees for reducing agency cost. Committee's efficiency can be concluded on the grounds of indicators such as composition of audit committees and recurrence of audit committee meetings (Menon and Williams, 1994). Moreover, it has also been asserted in the past literature that the numbers of outside directors in audit committees is crucial for its success (Jemison and Oakley, 1983). Simultaneously, the Securities and Exchange Commission of the United States has strongly emphasized on not having an audit committee at all instead of having one with all inside directors.

Moreover, Cohen *et al.,* (2011) also reasoned that independent audit committees play a critically important role in the corporate governance of a firm. Thereby, firms having independent audit committees tend to have low risk of fraudulent activities in the operational activities and thus, the firm performance improve (Beasley, 1996). The past literature further elaborates on the fact that there exists a constructive correspondence between returns on equity and presence of an independent audit committee (Kathuria and Dash, 1999).

In a similar fashion, the past literature also indicates that Bukit and Iskandar (2009) found that independent audit committees tone-down the earnings management.

Moreover, some other studies such as Abbot *et al.* (2002) also indicate an inverse relationship between earnings management and independent audit committees. Furthermore, several other studies reported enhanced performance of firms and improved quality of financial reporting due to presence of independent audit committees (Yasser *et al.* 2011; Nuryanah and Islam, 2011; Bouaziz and Triki, 2012; Arslan *et al*, 2014).

Simultaneously, the numbers of audit committee meetings held in a year plays a critically important role in firm performance as well. According to Al-Mamun, (2014) regular meetings of audit committees can help reducing the agency costs for an organization, and thus, increase its financial performance. The same study has also provided empirical evidence in the context of the role of recurrence of audit committee meetings and reduction of information asymmetry because it provides timely and fair information to the investors (Al-Mamun, 2014). Another study also provided empirical evidence on the constructive correspondence between numbers of audit committee meetings in a year and market capitalization and Tobin's Q (Kathuria and Dash, 1999).

$H_o$: Audit committee size does not affect the performance of financial services sector

$H_1$: Audit committee size does affect the performance of financial services sector

## 2.6 Corporate Governance and Board meetings

Board meetings are an important assessment criterion of the effectiveness and functionality of the corporate board. The empirical evidence of this connection is found in the past literature on a large extent (Jensen, 1993; Lipton and Lorsch, 1992). More importantly, the continue academic (Vefeas, 1999; Jensen, 1993) and public

(Lipton and Lorsch, 1992) debate on this connection bears testimony on the view that corporate governance is affected, either positively or negatively, by the numbers of board meetings per year.

Moreover, a number of board meetings are considered an important measure to measure the effectiveness and intensity of corporate monitoring and disciplining (Jensen, 1993). Primarily, one theoretical proposition on the linkage between numbers of board meetings and corporate performance measures the intensity of the activities of the board as well as the effectiveness or quality of its monitoring (Conger et al., 1998). However, mixed evidence on the role of board meetings recurrence on corporate performance exists. Thus, one side of the literature supports the viewpoint that increasing numbers of meetings among the members of board at professional level positively shapes the performance of the firms primarily because regular meetings allow the directors to confer, setting strategy, and appraising managerial performance (Vafeas, 1999; Mangena et al, 2012; Sonnenfeld, 2002; Lipton and Lorsch, 1992).

On the other hand of discussion, one part of the past literature explicitly explain that board meetings are not helpful to shareholders primarily for the reason that director spend limited time together which cannot be used to exchange meaningful ideas among the members (Vefaes, 1999b). Instead, this time is consumed by regular business reporting in the form of presentation that eventually eats up the time for the outsiders and independent directors would have to effectively monitoring business activities (Lipton and Lorsch, 1992). Therefore, increasing numbers of board meetings can negatively affect the performance of a firm.

$H_0$: Number of meetings does not affect the performance of financial services sector

$H_1$: Number of meetings does affect the performance of financial services sector

## 2.7 Corporate Governance and Firm Size

Empirical evidence on the relationship between corporate governance and firm size primarily exist in the context of financial performance of an organization. Babalola, (2013) reasoned that the larger the size of a firm, the more profits it will be able to earn because under such an arrangement, the organization can largely influence its stakeholders. For this reasons, the large firms often outperform the small firms. In this context, corporate finance remains an area of interest in particular. Shepherd, (1972) and Scherer, (1973) notably emphasized on the importance of scale economies in larger firms.

More importantly, the market concentration and conduct have been highlighted by the structure-conduct-performance paradigm for the purpose of explaining profitability. This relationship has been elaborated in the light of economies of scale model in the past literature (Kumar and Kaur, 2016; Kartikasari and Merianti, 2016; Dogan, 2013; Babalola, 2013; Oladele and Adebayo, 2013; Blease *et al.*, 2010). However, mixed results still prevail. Some of the theorists reported constructive correspondence whereas others presented negative connection between the two (Punnose, 2008; Athanasoglou *et al.*, 2008; Wu, 2006).

$H_0$: Firm Size does not affect the performance of financial services sector

$H_1$: Firm size does affect the performance of financial services sector

## 2.8 Corporate Governance in Financial Institutions of Pakistan

The financial institutions especially banks in Pakistan are facing increasing challenges over the time due to technological advances, deregulations, and globalization. The failure of one bank will not only affect its stakeholders and the community at large but will result in systemic shape on the stability of other banks. The private banks and Islamic financial institutions, in this regard, are more prone to excessive risk taking to the money of the depositors because their own stakes are relatively low and limited while they are driven by profit maximization (Haider *et al*., 2015). Thereby, corporate governance becomes an essential part of the banking system in the country.

The board members must have a clear understanding of their role and be qualified for this position within the bank. They must also play a leadership role in approving business plans, strategy and objectives of the banks. Moreover, the board members must conduct their as well as the bank's affairs in accordance with high ethical standards and with integrity. Although the banks in Pakistan practice the traditional method of leaving the day-to-day running of the bank in the hands of the management while enforcing clear lines of responsibility and accountability through the board members but the nonexecutive and independent directors must be given considerable importance and adequate representation in the matters of decision-making.

Pakistan has been clear in its focus relating to corporate governance in the financial institutions for a while now. The Code of Corporate Governance provided by the Securities and Exchange Corporation of Pakistan has been applied in the country. It has issued and enforced prudential regulations regarding the board members' responsibilities within the context. Furthermore, it has laid down fit and proper tests for key executives, members of the board, and chief executive officers. The country has prescribed minimum disclosure requirements for banks as well. Additionally, the family representation and percentage of the independent directors among the members of board has also been prescribed.

As per the report issued by Pakistan and Gulf economist on February 21st, 2015, the banking industry of Pakistan consists of 55 banks that include 5 public sector banks, 5 Islamic banks, 17 private banks, 6 foreign banks, 8 development financial institutions, 4 specialized banks and 10 micro finance banks. These banks need to perform for the promotion of economic and financial stability of the country. Tariq *et al*. (2014) concluded that banking sector can perform well if it adopts accurate corporate governance practices. They further concluded a positive shape of frequent board meetings on the performance of these financial institutions.

Similarly, Ahmed *et al*. (2014) and Malik *et al.* (2014) successfully described a constructive correspondence between board size and performance of the banks in Pakistan. Additionally, Kaur, (2014) stated that the banks must work on establishing different committees such as employee's grievance committee and audit committee because they make a positive shape on the performance of the banks in the shape of check and balances and proper system of internal control. Furthermore, Inam and Aqeel, (2014) demonstrated a constructive correspondence of returns on equity, bank interest rate and net income with corporate governance.

## 2.9 Performance of Financial Institutions in Pakistan: Empirical Evidence

Over the past few decades, the financial sector of Pakistan has faced phenomenon changes. Many financial reforms have played a significant role in developing the banking sector in the country as they transformed its financial strength. The governance structure of banking sector has changed due to mergers and acquisitions of both private and foreign banks, restructuring of state owned banks, privatization, and introduction of Islamic banking sector in the country. According to Rehman and Mangla, (2010) the banking sector was considered as the government sector due to the fact that almost ninety percent of the market share was owned by the State owned banks before these reforms.

In 1972, all banks were nationalized in the country except for a few foreign banks that were limited in the expansion of their operations due to the strict regulations such as they were used for sanctioning loans on political bases as well as lending to the preferred sector of economy. These reforms gave remarkable results in the beginning but could not sustain for a long period. The bad and high influence of the government authorities was soon realized by the State Bank and it introduced new reforms soon in early 1990s. These reforms were aimed at strengthening the financial institutions through open policies and regulations.

In 1990s, three foreign banks and ten new private banks were granted with the permission to start operating in the country as a part of these reforms. Furthermore, the restriction on opening new branches of the existing banks was lifted as well. Privatization of the state owned banks started simultaneously. The 50 percent shares of the Muslim Commercial Bank were sold to the public, 26 percent to the private sector whereas the remaining 24 percent was sold in 2001-02. Similarly, the privatization of Habib Bank Limited, United Bank Limited, and Allied Bank Limited took place over the time as well (Rehman and Mangla, 2010).

In 1997, the state owned banks in Pakistan faced downsizing and huge structural changes as the World Bank funded them for going through such reforms for the betterment of the country's economy (Mollah *et al*., 2012). All those branches of the state owned banks that had not been performing well over the past few years were closed down. Many employees voluntarily retired from their bank jobs under the golden shake hand scheme. It has been observed that the mergers and acquisitions of both private and foreign banks have largely influenced the banking sector of the country during this era as State Bank introduced encouraging policies in this regard. Resultantly, twelve banks were merged and acquired. Nine of them were owned by the private domestic banks. Additionally, Islamic banking was introduced at the same time (Rehman *et al.,* 2010). All of these reforms resulted in healthy returns and high growth rates that the banking sector of the country is enjoying right now. It has become more liberal. However, it still faces the issues of corruption, political influence, and unnecessary controls of the government.

## 2.10 Corporate Governance and Performance of Financial Institutions in Pakistan: Empirical Evidence

Corporate Governance has become critical for all entities and, therefore, the codes of Corporate Governance or legislations are being adopted increasingly by the organized sectors in the developed and developing countries (Khalid and Hanif, 2004). In Pakistan, several steps have been taken in this regard. Firstly, it has issued and enforced regulations defining the Responsibilities of the Board of Directors. It has also laid down a fit and proper test for key executives, board members, and Chief Executive Officers. Also, those failing to fulfill this criterion and passing the test in this regard are not allowed to hold the respective offices.

Despite the many efforts, the financial institutions especially the banking sector in Pakistan are facing several challenges. Most of them appear in the form of the consequential management of risks due to the adoption of Basle II Accord. It presents an unparalleled opportunity for banks. It provides the banks with high-performance and distinct competitive advantage in the international markets. It frees up the idle capital and readies it to be put to use. It brings the challenge of inducting and retaining highly skilled human resources within the financial institutions. It has become a priority for the chief executive officers, the educational institutions, the shareholders, and the regulators (Klapper, 2004).

The second challenge arises in the form of the need for the banking sector, in particular, to automate and reengineer its business processes (Narayan and Godden, 2000). The choices in this regard include using technological solutions and moving to multi-channel delivery modes and E-banking to provide satisfaction to the customers by reducing the transaction costs. Furthermore, the sector needs to identify, quantify, and mitigate credit, market and operational risks instead of only dealing with the credit risks. It indicates that the country is in dire need of embracing the modern systems such as Management Information Systems and Internal Rating Systems to essentially manage these risks.

Another challenge that the scenario of corporate governance and performance of financial institutions in the country currently face is the fog that is created by the best guesses. Although commercial clients and consumers benefit from more accurately assessed and timely information as it leads to increased customer loyalty and satisfaction in a highly competitive market, the fog must be cleared out. It is created by the best guesses. Reliable data and objective historical track record must replace it as both of them form bases of the future decisions (Mehmood and Sethi, 2009). The stronger sets of transaction trails and historic data must also be accessed by the regulators for detailed examination and policy decisions.

Additionally, market discipline must be strengthened. Mandated information, as discussed earlier, can play a critical role in this regard. Some other relevant mechanisms include raising funds through capital markets, listing on the Stock

Exchanges, and credit ratings. They can be used for fortifying market discipline. Moreover, lower capital requirement for lending and good internal controls must also be implemented in the financial institutions of the country because they are essential for improving overall governance emphasis and capital assessment processes in the corporations (Kouser *et al*., 2012).

However, the biggest challenge to corporate governance in Pakistan is the existence of bureaucracy layers. Because of it, the system is very top heavy. It means that many layers of management along with a long list of presidents and vice presidents are required for the system to pass information through. Thus, reception of accurate, important data is not easy for the lower levels of the companies. Therefore, there are many chances for the managers to distort the message to sound better. Resultantly, the unwieldy businesses start to respond slowly to change due to the long chain of command (Ameer, 2013). Thereby, flat business structures with few layers of command are the demand of the time.

Furthermore, corporate governance in the institutions of Pakistan faces a different type of struggle internally. A board of executives can propagate standards throughout the business and make good decisions on company policies. But what if the managers decide not to listen to and follow the board? There are often a few troublemakers within a business structure. Rebellious managers are involved in subverting or ignoring the decisions of the boards are many levels of the business. Therefore, methods to enforce standards and discipline managers are the need of the hour.

Additionally, there prevails a negative connotation about corporate governance in Pakistan, mostly because of the questionable practices of board members and key executives. The problem arises because of the attention that is given to the companies that commit some kind of fraud that results in bagging of questionably large bonuses by many executives even in a contracting economy (Dunstan *et al*., 2011). This situation has caused an atmosphere of distrust among investors and consumers. The best solution to fight this situation for the corporations is to show increased transparency in their mission and work.

### 2.11 Research Gap

Primarily, the connection between board size and corporate governance of financial sectors has empirically been tested in the western context (Pfeffer, 1972; Kosnik, 1987). Pakistan, in particular, lacks an empirical study in this context. Moreover, while significant studies have studied the connection of corporate governance with the financial performance of a company in Pakistan, only a few have considered the role of an independent audit committee in this relationship. In a similar fashion, a heavy concentration of existing studies on the connection between board meetings recurrence and corporate governance exists in the matured economies of North America and Europe only (Vefeas, 1999a, and Yermack, 1996). Simultaneously, mixed evidence on the role of board meetings recurrence on corporate performance exists (Vefeas, 1999a; Mangena *et al*, 2012; Sonnenfeld, 2002; Lipton and Lorsch, 1992; Vefaes, 1999b).

In the context of Pakistan, some of the studies have empirically investigated the link of corporate governance to firm performance with conclusive results (Rehman and Mangla, 2010; Yasser, 2011; Haider et al., 2015; Arif and Syed, 2015; Gohar and Batool, 2015; Bhutta and Mustafa, 2018). But the present study investigates the influence of corporate governance on financial services sector performance. In the present study, the financial services sector is divided into commercial banks, insurance companies, and leasing companies. Also, the present study will include more potential variables that affect the firm performance, i.e., returns on assets, earnings per share, and returns on equity. The present study is including the latest dataset before and after the financial crises of 2008. Importantly, the selection of financial services sector companies based upon the annual turnover. The previous studies did not account the firm size and no of meetings in the investigation of impact of corporate governance on the financial performance of the services sectors. Present study used firm size as a control variable,

# CHAPTER 03

# DATA AND METHODOLOGY

## 3.1 Theoretical Background

A few studies empirical tested the relationship of corporate governance and firm performance (Haider *et al*., 2015; Rehman and Mangla, 2010; Arif and Syed, 2015). Nadeem *et al.*, (2015) and Arif and Syed, (2015) used panel data to examine the relationship between corporate governance and firm performance. They used performance measures as dependent variable and corporate governance as independent variable.

## 3.2 Data Sources

For accurate information, annual reports of public listed companies used. So, we collected financial reports from the Securities and Exchange Commission of Pakistan (SECP), Pakistan Stock Exchange (PSX) and State bank of Pakistan (SBP) website.

## 3.3 Sample Period

This study based on secondary data. Data used for the period of 2006 to 2017. The study covers a period of 12 years this means firms that were delisted or newly listed during the study period would be excluded. The availability of the annual statement of firms is the main source of information. In this study, commercial banks, insurance companies, and leasing companies are included.

## 3.4 Econometric Models

Corporate governance indicators are regressed to examine the performance of financial services sector. Returns on assets, returns on equity and earning per shares used as financial performance measures. Study used 3 corporate governance variables and one control variables. Corporate governance variables are Board size, numbers of meetings and audit committee size whereas control variable is firm size.

Model-1 $ROA_{i,t} = \propto_1 + \beta_1 BS_{i,t} + \beta_2 NM_{i,t} + \beta_3 ACS_{i,t} + \beta_4 FS_{i,t} + \in_{i,t}$

Model-2 $ROE_{i,t} = \propto_2 + \beta_1 BS_{i,t} + \beta_2 NM_{i,t} + \beta_3 ACS_{i,t} + \beta_4 FS_{i,t} + \in_{i,t}$

Model-3 $EPS_{i,t} = \propto_3 + \beta_1 BS_{i,t} + \beta_2 NM_{i,t} + \beta_3 ACS_{i,t} + \beta_4 FS_{i,t} + \in_{i,t}$

## 3.5 Econometric Methodology Map

For this particular study that studies the relationship between corporate governance defined by firm performance in the terms of returns on assets, returns on equity and earnings per share and the respective board size, numbers of board meetings, audit committee size, annual general meeting and firm size. The econometric methodology map comprises of two steps. *Firstly*, the dependent variables will be regressed over the independent variables. *Then*, diagnostic testing will be conducted.

### 3.5.1 Regression Analysis

For the statistical procedure, regression analysis is used for estimating the straight line linear relationship relating two or more variables. Overall, it summarizes the amount of change in one variable associated with a change in another variable(s). For a panel, dataset fixed effect model and Random effect model are the best options. They are discussed in detail as under:

### 3.5.2 Fixed Effect Model

Panel data has issue of heterogeneity that is the result of using cross sectional data over time period. So due to the cross section units there is heterogeneity problem in panel data (Gujrati, 2003). The fixed effect model is best estimation technique that deals the heterogeneity. In fixed effect model the cross sectional differences can be measured over a long period. Other model cannot measure the differences and results can be biased. So in our study the proposed estimation technique would be fixed effect model.

### 3.5.3 Random Effect Model

Along with fixed effect model the proposed model was random effect model while considering the contradiction against use of fixed effect model by using large sample size. Random effect model used to captures the ignorance of large sample size and this ignorance should be expressed through error term (Kementa, 1986). Most of the time the error of cross sectional units is ignored that is related to the standard error of equation.

### 3.5.4 Hausman Testing

Hausman developed test in 1978. This test is used for the sensitivity analysis of both fixed effect and random effect models. For the selection of best results, Hausman test used.

## 3.6 Description of Variables

For this particular study, financial performance of firms in the financial services sector of Pakistan has been taken as the dependent variables. For the purpose of simplification, it has been sub-divided into returns on assets, returns on equity, and earnings per share. All of these three dependent variables will be regressed on the independent variables, i.e., board size, board meetings recurrence, audit committee size, and firm size.

### 3.6.1 Dependent Variables

Firm performance is the only dependent variable in this study. However, for the purpose of simplification, it has been divided into further three variables, i.e., returns on assets, returns on equity, and earnings per share. They are discussed in detail in the following subsections.

**Returns on Assets**

Returns on assets measure a firm’s ability to generate profit against total assets. The returns on assets, sometimes abbreviated as ROA, are a company's net income divided by its total assets. The formula is presented as under:

$$\text{Returns on Assets}=\frac{NI}{TA}*100$$

Where;

NI = Net Income

TA = Total Assets

The returns on assets formula looks at the ability of a company to utilize its assets to gain a net profit. Increase in the value of return on assets is a good indicator for the Industry that shows rise in income of Industry against assets. Net income in the numerator of the returns on assets formula can be found on a company's income statement. Net income is the amount earned by a company after subtracting out the expenses incurred, including depreciation and taxes. Earlier Nadeem *et al*. (2015); Arif and Syed, (2015); Rehman and Mangla, (2010); Yasser, (2011); Gohar and Batool, (2015) has used the variables in their studies and found that it measure the performance of the firm.

**Returns on Equity**

A return on equity is used to measure firm profitability. It measures a firm profitability by revealing how much profit a company generates with the money shareholders have invested. The formula is presented as under:

$$\text{Returns on Equity}=\frac{NI}{TE}*100$$

Where;

NI = Net Income

TE = Total Equity

This is useful for comparing profitability among different firms of the same industry. Higher value of this is good for Industry as it shows that Industry is utilizing shareholder's invested money in good way and it attracts more shareholders to invest in the equity. The important thing about this is to consider the accurate measure of profit-making capacity of organizations. Nadeem *et al*. (2015); Arif and Syed, (2015); Rehman and Mangla, (2010) has used the variables in their studies and found that it measure the performance of the firm.

**Earnings per Share**

Earnings per share are defined as the net profits divided by the numbers of outstanding shares in a company. The formula is presented as under:

$$\text{Earnings per Share} = \frac{NP}{NOS}*100$$

Where;

NP = Net Profit

NOS = Numbers of Outstanding Shares

Investors take their investment decisions primarily based on the earnings per share ratio. Empirical past literature has provided ample evidence in this regard.

Saeidi, (2007) indicated that market ratios including the earnings per share ratio are used for long-term planning and investment decisions.

### 3.6.3 Independent Variables

Five independent variables have been deduced from the past literature in the light of their importance and significance in the context of corporate governance and firm performance. The list includes board size, numbers of board meetings, audit committee size, annual general meeting and firm size. They are discussed in detail as under:

**Board Size**

Board of directors is a governing body of an organization. Its members normally elected by shareholders of the firm at annual general meeting to look after the shareholders interest and to govern the organization. Board of directors is an ultimate decision-making authority and set the organization policies, objectives and overall direction of the organization. Board size indicates that how many directors are included in the board to run the organization operations. Nadeem *et al*. (2015) and Dar *et al*. (2011) has used the variables in their studies and found that it measure the performance of the firm.

**Numbers of Board Meetings**

Formal board of directors meeting held after a definite interval to consider organization policies issues and primary issues. Boards of directors meeting held under the supervision of chairman of the organization and it must meet the quorum requirements. According to companies' ordinance board of directors should meet at least once in quarter or four times in a year Nadeem *et al*. (2015) and Dar *et al*. (2011) has used the variables in their studies and found that it measure the performance of the firm.

### Audit committee size

Audit committee is one of the main Operating committee of firm board of directors to look after the financial reporting of the firm. An audit committee is selected number of members of firm board of directors whose responsibilities include helping auditors remain independent of management. Nadeem *et* al. (2015) and Niazi *et al*. (2011) has used the variable in their study and found that it measure the performance of an organization.

### Firm Size

Take natural log of total assets of a firm. Earlier Yasser, (2011); Gohar and Batool, (2015) and Matos *et al*., (2012) have used the variable in their studies and found that it measure the performance of the firm.

# CHAPTER 04

# RESULTS AND DISCUSSION

This study aimed at examining the performance of financial services sector of Pakistan and investigating the relationship between corporate governance and performance of financial services sector of the country. In this respect, under the light of past literature, this particular study adopted firm performance as the dependent variable that depended on firm size, board size, board meetings recurrence and audit committee size. The data was extracted from the official records of State Bank of Pakistan, Security and Exchange Commission of Pakistan and Pakistan Stock Exchange website. The obtained data was run through Fixed Effect Model and Random Effect Model for the purpose of statistical testing. This chapter will explain and interpret the obtained results for this particular study.

## 4.1 Descriptive Analysis

Descriptive statistics are described in given Table (4.1) to get the information of all variables.

**Table 4.1: Descriptive Analysis**

| | Mean | Std.dev | MIN | MAX |
|---|---|---|---|---|
| **Return on Assets** | 2.53 | 10.63 | -62 | 100 |
| **Return on Equity** | 12.42 | 69.75 | -339 | 1050 |
| **Earnings per Share** | 6.99 | 22.91 | -47 | 367 |
| **Board Size** | 8 | 1.43 | 6 | 13 |
| **Number of Meetings** | 6 | 1.98 | 4 | 17 |
| **Audit Committee Size** | 4 | 0.76 | 3 | 7 |
| **Firm Size** | 24.14 | 2.49 | 18.04 | 28.62 |

The summary statistics of all variables performed over the period 2006 to 2017 on the sample of 30 financial firms of Pakistan listed at Pakistan Stock Exchange. Results show the mean value of ROA is 2.53. It means that firm earning against its total is 2.53. ROA measures the firm ability to generate profit against total assets. Return on assets takes in to account, both “efficiency concept” and “earning prospective. Higher value of ROA is favorable for firm because it shows that firm is efficiently utilizing its assets to generate income. While the low value of ROA is not favorable for firm because it shows that firm is not efficiently use their assets to generate income. The standard deviation of ROA is 10.63 it shows that data set is spread form the mean value of ROA. Higher value of standard deviation shows that risk on return on assets is high whereas the low value of standard deviation shows that risk on return on assets in low. So, low standard deviation is favorable for firm because it’s near the mean value of the dataset and firm has low risk on their investment. The minimum and maximum values of ROA are -62 and 100 respectively. The minimum value of ROA goes down to -61.56 and maximum value goes to 100.

The mean value of ROE is 12.42 it shows that return on equity is 12.42 against its total shareholder equity. Higher value of ROE is suitable for firm because it indicates that firm utilizes its equity efficiently to generate income and it attracts shareholders to invest in the equity. While the low value of ROE is not favorable for firm because it shows that firm is not utilizes its equity properly to earn income. Similarly, if we see the statistics of standard deviation the value of ROE is 69.75 it shows the large spread between the dataset. The standard deviation of ROE is for away from the mean value of ROE. Higher value of standard deviation is not favorable for the firm because it shows the high risk on firm investment while the low value of standard deviation is suitable for firm because it shows the low risk on their investment. If we analyze the statistics of minimum and maximum the values are -339 and 1050 it shows that minimum value of ROE goes to -339 whereas the maximum value goes to 1050.

The mean value of EPS is 7 is shows that firm earning per share is 7 against the outstanding shares of the firm. Higher earnings per share are always better than lower because this means that the firm is more profitable and has more profit to distribute to its shareholders. Higher earning shows the better performance of the firm while the low earning shows bad performance of the firm. So, that's why higher value of EPS is favorable for the firm. If we see the statistics of standard deviation the value is 22.91. This value is for away from the mean value of EPS its shows the large spread between the dataset. Higher value of standard deviation in not favorable for firm because its shows the high risk on earning per share while the low value is suitable for firm because it shows low risk on earning per share and it also shows that firm take less risk against their earnings. If we analyze the statistics of minimum and maximum the values are -47 and 367 respectively. It Indicate that the minimum value of earning per share is -47 because in that study net profit was used instead of earning available to shareholders and net profit may be in negative. The maximum value of earning per share of the firm is 367.

The mean value of BS is 8 and it shows the average number of board of directors in firm. Minimum three boards of director and maximum fifteen boards of director can appointed for the supervision of the firm in case of public limited companies. Here, 8 is the average number of directors appointed for the supervision of the firm. If we analyze the statistics of standard deviation the value of standard deviation is 1.43. It shows that the value of standard deviation lies near to the mean value of BS and there is a minor spread between the dataset. Lower value of standard deviation is consider better because lower value represent the ideal size of board of directors and that ideal size of board favorable for the firm. If we see the statistics of minimum and maximum of BS the values are 6 and 13 respectively. It shows that the minimum number of board of directors in the dataset is 6 while the maximum number of board of directors is 13.

The mean value of NM is 6 it indicates that Board of directors should meet at least 6 times in a year. According to the companies act board should meet at least four times in a year. In other words we can say that board should meet at least once in a quarter. In present study board of directors should meet at least 6 time a year to oversight the activities and affairs of its firm. If we see the statistics of standard deviation the value of standard deviation is 1.98 and this value is near to the mean value of NM. Lower values of standard deviation is better than higher values of standard deviation, Because, low value represent low risk for the firm and provide valuable information about the dataset. In present study the value of standard deviation is not spread from the mean value of NM. It means that 6 meetings of board are favorable for the firm. If we analyze the statistics of minimum and maximum the values are 4 and 17 respectively. It shows that the minimum board meetings in a year are 4 while the maximum board meetings in a year are 17.

The mean value of ACS is 4 it indicates that the average number of members in audit committee is 4. The size of ACS varies upon the size of the firm because large firm requires large ACS while the small firm requires small ACS. In present study dataset the average ACS is 4 it means that four members of the ACS assist the board of directors to fulfill its corporate governance and overseeing responsibilities in relation to an entity financial reporting. If we see the statistics of standard deviation the value of standard deviation is 0.76 it indicates that there is minor spread between the dataset because the value of standard deviation is near to mean value of ACS. Lower value of standard deviation is favorable for the firm because it represents low risk and valuable information. If we analyze the statistics of minimum and maximum the values are 3 and 7 respectively. It indicates that minimum size of ACS is 3 while the maximum size of ACS is 7.

The mean value of FS indicates that large firms achieve from economies of scale and are stronger enough to of risk of default. Hence, large firms gain higher credit rating and lower default risk. Whereas, the small firms are not achieve from economies of scale and are not strong enough to protect the risk of default. If we analyze the statistics of standard deviation the value of standard deviation is 2.49. Lower value of standard deviation is better than the higher value of standard deviation because low value favorable for the firm and it indicates low risk of the firm. If we see the statistics of minimum and maximum the values are 18.04 and 28.62 respectively. It indicates that the minimum size of the firm is 18.04 whereas the maximum size of the firm is 28.62 in present study dataset.

### 4.2 Correlation Matrix

To check the existence of multi-collinearity in model shows correlations among independent variables which introduce a problem because the estimates of parameters becomes inefficient and shows large standard errors. The results then make the coefficient values and signs unreliable. In addition, multiple independent variables with high correlation add no additional information to the model

**Table 4.2: Correlation Matrix of Variables**

| | ROA | ROE | EPS | BS | NM | ACS | FS |
|---|---|---|---|---|---|---|---|
| **Return on Assets** | 1.000 | | | | | | |
| **Return on Equity** | 0.0617 | 1.000 | | | | | |
| **Earnings per Share** | 0.5272 | 0.1520 | 1.000 | | | | |
| **Board Size** | 0.0083 | 0.0780 | 0.0649 | 1.000 | | | |
| **Number of Meetings** | -0.0513 | -0.1382 | -0.0705 | 0.0349 | 1.000 | | |
| **Audit Committee Size** | 0.0875 | 0.0254 | 0.0706 | 0.1487 | -0.0069 | 1.000 | |
| **Firm Size** | 0.0102 | 0.0051 | 0.1288 | 0.3976 | 0.2411 | 0.2425 | 1.00 |

Thus, Correlation of each variable with itself gives the value of 1. The higher values indicate higher correlation the lower value specifies lower correlation. ROE, EPS, BS, ACS and FS are positive correlated with ROA whereas NM is negative correlated. EPS is positive correlated with ROA and ROE. BS is positive correlated with ROA, ROE and EPS. NM is negative correlated with ROA, ROE, EPS and positive correlated with BS. ACS is positive correlated with ROA, ROE, EPS, and BS. NM negatively correlated with ACS. FS has positively correlated with ROA, ROE, EPS, BS, NM and ACS.

## 4.3 Results of Regression Analysis

This section contains the results of three regression equations. This study aimed at examining the performance of financial services sector of Pakistan and investigating the relationship between corporate governance and performance of financial services sector of the country. In this respect, under the light of past literature, this particular study adopted firm performance as the dependent variable that depended upon board size, audit committee size, and number of meetings and firm size. For that purpose we take three performance measures to measure the performance of financial services sector.

Measures the performance of the firm through ROA, ROE, and EPS and measures the corporate governance through board size, number of meetings, audit committee size and firm size. Here firm size used as a control variable.

### 4.3.1 Results of Corporate Governance variables on Return on Assets using Fixed Effect Model Analysis

The first regression equation for this particular study exhibits the relationship between returns on assets and board size, numbers of meetings, audit committee size, and firm size.

**Table 4.3: Results of Corporate Governance variables on Return on Assets using Fixed Effect Model Analysis**

| Variables | Coefficients |
|---|---|
| **(Constant)** | -20.86 |
| | (0.31) |
| | -1.61 |
| **Board Size** | (0.01) |
| | 0.20 |
| **Number of meetings** | (0.58) |
| | 0.09 |
| **Audit Committee Size** | (0.92) |
| | 1.47 |
| **Firm Size** | (0.08) |
| **Prob F = 0.0561** | |

P-value of F statistic is significant it means that our model is very good and nicely fitted and all coefficients are not equal to zero. The regression result showed that the relationship between ROA and board size is significance with a p-value of 0.015. The coefficient of board size is negative and significant at a 5% significance level as its p-value is less than 0.05. This result is consistent with (Cheng 2008). According to Cheng (2008), bigger boards mean lower profitability because larger boards are more conservative a less risk-taking, providing an effective corporate governance mechanism. In contrast to theories predicting that lesser boards are more effective, a study conducted by Mohamad (2009) confirmed that having a larger board does not undermine their performance. This result is consistent with the study of (Haider et al., 2015; Arif and Syed, 2015; Cheng, 2008). It means that a change of -1.61 in the board size will introduce a corresponding change of 1 in returns on assets. Moreover, the board size is a key determinant for the governance of any firm. It plays an integral role in the decision making of any firm.

Number of meetings showed insignificant impact with a p-value of 0.58 at 5% significant level. This result is consistent with (Haider et al., 2015). Numbers of meetings are considered for decision making by the board of directors. In the financial services sector of Pakistan, firms follow the family own business strategy and that is why they do not focus on the number of meetings. Most companies organize a fewer number of meetings due to some costs associated with these meetings. Those companies organize the number of meetings in a year those who want to get out of some serious financial crisis.

The audit committee is considered to be independent while making any recommendations. In our study, we are analyzing the audit committee size. The regression analysis for the relationship between audit committee size and ROA is insignificant with a p-value of 0.92 at a 5% significant level. Haider et al., (2015); Qureshi and Mehmood, (2018) stated that the audit committee size has a negative and insignificant relationship with financial performance because it totally depends upon the independence of the committee, not the size. So we can say on the basis of our results that the audit committee size does not influence the performance of the company. The audit committee mostly refers to the recommendations for the improvement in financial reporting. The legislation made for the companies to disclose their financial information for shareholders and tax purposes.

The regression result showed that firm size has insignificance relationship with ROA with a p-value of 0.08 at a 5% significant level. In most of the developed economies the firm size shows the positive and significant relationship on ROA as in the study of Sheikh et al., (2017). In our study, the insignificant results depict that the financial sector apparently does not rely upon the firm size because it operates on liquid securities, liquid assets, and loans. The study of Ong et al., (2015) and Khan et al., (2014) explained that due to excessive use of liquid assets the return on assets is not affected by the firm size. For this reason, the firm size is insignificant. Firm size denotes the value of the overall assets of the firm. It is considered as the most important variable which is used for the evaluation of firm performance.

### 4.3.2 Results of Corporate Governance variables on Return on Equity using Random Effect Model Analysis

The second regression equation for this particular study exhibits the relationship between returns on equity and the board size, number of meetings, audit committee size, and firm size.

**Table 4.4: Results of Corporate Governance variables on Return on Equity using Random Effect Model Analysis**

| Variables | Coefficient |
|---|---|
| **(Constant)** | -51.91 |
| | (0.004) |
| **Board Size** | 0.10 |
| | (0.92) |
| **Number of Meetings** | -2.35 |
| | (0.001) |
| **Audit Committee Size** | 0.52 |
| | (0.77) |
| **Firm Size** | 3.02 |
| | (0.000) |
| **Prob F = 0.0001** | |

P-value of F statistic is significant it means that our model is very good and nicely fitted and all coefficients are not equal to zero. The regression result showed that the board size has an insignificant relationship with ROE and its p-value is 0.92 at a 5% significance level. Those Results were consistent with the study of (Arif and Syed, 2015; Ali and Kamal, 2016). Furthermore, he justified that the services sector focuses on better service providing and board size make decisions for the betterment of services. The ROE basically depends on the total equity of the companies and how efficiently firms utilize their equity. For this reason, the regression analysis shows an insignificant impact of board size on the ROE.

The regression analysis showed significant impact of number of meetings on return on equity by value of 0.001 at 5% significance level. This result is consistent with (Haider et al., 2015). The coefficient value of the number of meetings is -2.35. The number of meetings has a significant impact because in the financial services sector the number of meetings is considered as the most important factor because it positively leads to better problem solutions. The study of Haider *et al.* (2015) analyzed the impact of the number of meetings on the performance of the services sector. Their study shows the significant results on the performance.

Audit committee size did not affect directly to ROE. We analyzed in our analysis that the audit committee size has insignificant with a p-value of 0.77 at a 5% significance level. This result is consistent with the study of (Dar at al., 2011 and Haider et al., 2015). The study of Dar et al., (2011) and Haider et al., (2015) analyzed the impact of governance on firm performance and they found that audit committee size has an insignificant relationship with ROE. Because, it totally depends upon the independence of the audit committee, not the size. It means that the size of the audit committee is not really mattered but the independence of the audit committee is matter because the audit committee improves the financial reporting of the firm. So we can say on the basis of our results that the audit committee size does not influence the performance of the company.

Firm size has a significant impact on ROE with a p-value of 0.000 at a 5% significance level. While the coefficient value of the firm size is 3.02. This result is consistent with the study of Sheikh et al., (2017). He justified that when the company owns more equity and then utilizes it to earn more. For that reason, the firm size positively affects firm performance. We can say that financial sector companies based on equity and this shows positive significant results on the performance of the companies.

### 4.3.3 Results of Corporate Governance Variables on Earning per Share using Random Effect Model Analysis

The third regression equation for this particular study exhibits the relationship between earnings per share and the board size, number of meetings, audit committee size and firm size.

**Table 4.5 Results of Corporate Governance variables on Earning per share using Random Effect Model Analysis**

| Variables | Coefficient |
|---|---|
| **(Constant)** | -26.84<br>(0.008) |
| **Board Size** | 0.52<br>(0.25) |
| **Number of Meetings** | -0.49<br>(0.06) |
| **Audit Committee Size** | -0.36<br>(0.60) |
| **Firm Size** | 1.33<br>(0.001) |
| **Prob F = 0.0039** | |

P-value of F statistic is significant it means that our model is very good and nicely fitted and all coefficients are not equal to zero. Regression results indicate that board size has insignificance impact on EPS with a p-value of 0.25 at a 5% significance level. Because board size is related to decision making and it does not affect the EPS directly. For this reason, the results of board size are insignificant with EPS.

The regression result showed that the number of meetings has an insignificant impact on EPS with a p-value of 0.063 at a 5% significance level. Because, EPS is not directly related to the number of meetings, it is related to the number of shareholders and the number of outstanding shares. Another reason, Pakistan financial services sector mostly family owned business and the board of directors lay upon the members of a family. Most companies organize a fewer number of meetings due to some costs associated with these meeting. The present study stated that the number of meetings can influence the overall performance of the company but it does not affect the EPS individually. The number of meetings of the board of directors plays an integral role in the performance of any firm. Mostly, those companies organize a number of meetings in a year those who want to get out of some serious financial crisis.

The regression analysis has shown the insignificant impact of audit committee size on EPS with a p-value of 0.60 at a 5% significance level. These results were consistent with (Haider et al., 2015). The study explained that the audit committee size does not directly affect the EPS because the audit committee's core purpose is to make sure the necessary disclosure of financial information. For this reason, the audit committee size is insignificant in our case.

The regression result shows the significant impact of firm size on EPS with a p-value of 0.001 at a 5% significance level. The coefficient of the firm size is 1.33. These results were consistent with (Sheikh et al., 2017 and Kyereboah., 2007). The justification they made is clear that when the firm has more equity and utilize it to earn more than firm size positively affects the firm performance. It shows how the public believes and invests in the company's capital. Furthermore, the financial sector provides financing services and owns less fixed assets.

# CHAPTER 05

# DISCUSSION AND CONCLUSION

This study examined the performance of financial services sector of Pakistan and investigated the relationship between corporate governance and performance of financial services sector of the country. Corporate governance is defined as the system of rules, practices and processes by that a company is directed and controlled. It provides the framework for a corporate to carry out its business processes and achieving goals. Therefore, it nearly addresses all spheres of management from performance measurement and corporate disclosure to action plans and internal controls. It hypothesized that board size, numbers of board meetings, audit committee size and firm size has significant shape on returns on assets, returns in equity and earnings per share in the context of financial services sector. To statistically test this hypothesis, the study employed Fixed Effect Model and Random Effect Model.

## 5.1 Discussion

In its widest sense, corporate governance works under the stakeholder model. Some of the financial economists have considered the role of board size in this respect (Fama, 1980; Fama and Jenson, 1983). Reduction in the numbers of CEOs and hence the organizational performance has been observed due to the emphasis on courtesy and politeness on the cost of frankness and truth, i.e., discouraging conflicts and rewarding consent. For this reason, board size has a constructive correspondence with returns on assets. The findings of this particular study in this regard are consistent with the findings of Hart, (1983); Demsetz, (1983); Fama, (1980); Fama and Jenson, (1983); Jenson, (1993); Hackman, (1990) and Steiner, (1972).

Although the board size has shown a significant relationship with the returns on assets for the selective companies of Pakistan, the causation is reverse in direction. It indicates that an increase in the board size decreases the returns on asset equivalent to the coefficient value, which in this case is -1.618. It means that an increase of board size by 1.6% will bring a decrease in the returns on asset for that particular company by the same percentage.

Moreover, an audit committee's efficiency can be concluded on the grounds of indicators such as composition of audit committees and recurrence of audit committee meetings (Menon and Williams, 1994). The past literature further elaborates on the fact that there exists a constructive correspondence between returns on equity and presence of an independent audit committee (Kathuria and Dash, 1999). However, the results indicate that audit committee size does not shape firm performance. Thus, the results are contrary to the findings of past literature.

Lastly, the results of this particular study indicate that board meetings recurrence and firm size shape the returns on equity in opposite directions. These results are consistent with the continue academic (Vefeas, 1999; Jensen, 1993) and public (Lipton and Lorsch, 1992) debate on this connection bears testimony on the viewpoint that corporate governance is affected, either positively or negatively by the numbers of board meetings per year.

## 5.2 Conclusion

In this study, the relationship between corporate governance and firm performance is investigated by using balanced panel data analysis for financial services Sector of Pakistan over the period of 2006 to 2017. The performance indicators are ROA, ROE and EPS whereas corporate governance indicators are BS, NM, ACS and FS calculated from firms' balance sheet.

The study is based on the performance of financial firms therefore the performance has been analyzed with various ways. First we regressed corporate variables against performance variables and result shows that BS has negative but significant impact with ROA whereas NM, ACS and FS has positive but insignificant impact on ROA. Bigger boards mean lower profitability because larger boards are more conservative and less risk taking whereas lesser boards are more effective. The board size is key determinant for the governance of any firm. It plays an integral role in the decision making of any firm.

Second, in estimating performance through ROE, the results lead to conclude that NM and FS have significance impact on ROE whereas BS and ACS have insignificance relationship with ROE. NM has negatively correlated with ROE whereas FS has positively correlated with ROE. Number of meetings has significance impact because in financial services sector the numbers of meetings are considered as the most important factor because it positively leads to better problem solutions. The firm size positively affects the firm performance because financial services companies based on equity and this shows positive significant results on the performance of the companies. Audit committee size has insignificant relationship with ROE. Because it totally depends upon the independence of audit committee not the size. It means that size of the audit committee is not really matter but independence of the audit committee is matter because audit committee improves the financial reporting of the firm.

Thirdly, in estimating performance through EPS, the result shows that FS has positive and significant relationship with EPS whereas BS, NM and ACS have insignificant impact on EPS. Corporate governance is internal regulatory mechanisms that operates inside the companies and is adopted firstly because it is an international practice provided by SECP. It is mandatory to satisfy this requirement and secondly because it is an internal control system of the firms and owners of these firms feel protected when these requirements are adopted. Moral hazard issues can be damaging not only to premium payer and shareholders but also to the owners of companies. Introduction to the mechanism of corporate governance to be adopted by financial companies was to lessen the moral hazard problems that ascended within companies. This is mainly implemented to mitigate the dangers of bankruptcy and insolvency. The focus on subject of corporate governance came into consideration internationally in 1980‘s and was implemented in Pakistan in 2002. Still there is a room for improvement in the mechanism for proper implementation of all the attributes of corporate governance in Pakistan. It is required that the financial statements of companies should be prepared by other accountancy firms, the financial statements are published and the shareholders are given minute details. Size of board does impact the performance, for instance the large size of board can be injurious to performance. The size of board has put into consideration and can be the factor that needs to be carefully administered because they are directly linked to performance.

## 5.3 Recommendations

The present study try to figure out other possible explanation of board size, number of board meeting, audit committee size and firm size but there also need rigorous analysis including the marketing strategies and staff efficiencies. Therefore, the study suggests some suitable steps to be taken by the financial institutions. These suggestions are explain respectively.

Pakistani Banking and insurance industry should be focus on lesser board because lesser board is more effective and profitable.

The code of corporate governance should be implemented and all the attributes should be incorporated by financial firms to avoid bankruptcy and insolvency of financial firm in Pakistan.

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