Naeem Tabassum · Satwinder Singh

Corporate Governance and Organisational Performance

The Impact of Board Structure

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Corporate Governance and Organisational Performance

"In today's complex and fast-moving business world, corporate governance practices are crucial for navigating change and managing new risks. Research continue to show the positive impact that governance mechanisms can have on business competitiveness. This thought-provoking book offers valuable insights on the link between governance and organizational performance, while it highlights best practices that can easily be implemented by Boards."

—H.E. Hamad Buamim, *President & CEO, Dubai Chamber of Commerce & Industry, Dubai, United Arab Emirates*

"This methodologically sophisticated and controversial study disputes the correlation between good corporate governance and financial performance in a pioneering study of Pakistan. Tick-box compliance cultures turn out to have little value compared to long-term strategies to create value."

—Geoffrey Jones, *Isidor Straus Professor, Harvard Business School, Boston, USA*

"Corporate Governance and Organizational Performance - The impact of Board Structure is a timely piece of research conducted with an extensive and in-depth analysis of data base of listed companies in Pakistan. The research is also of critical contemporary relevance to fellow emerging economies around the world that share similar political, economic, social, technological, and legal set-ups with Pakistan. Several of these economies are vying to be a major player in their respective regions. Lesson this research imparts is that companies that diligently apply the principles of corporate governance in all fairness and transparency have the potential to outperform rivals. The study highlights how a Board is structured and conducts, influences the market value of companies. This in turn inspires investors' lending and investing decisions. Policy recommendations of the study are that a corporate sector comprising of companies that implement the code of conduct of good governance, both, in letter and spirit could be the future of Pakistan vis-à-vis emerging economies."

—Rizwan Sayed, *Tax Director—PWC London, former Sr. VP Faisal Islamic Bank, Bahrain*

"We know that good corporate governance is fundamental to organizational success, yet why is this the case? Moreover, articulating what makes the difference and why is less clear, until now. This book seeks to distil the wealth of wise commentary about why good corporate governance matters into a tangible evidence base. I will be using some of the ideas from this book in my own work as a Board evaluator, independent NED (non-executive director), and keen observer of all things corporate governance."

—Lucy McClements, *Independent NED, Consultant, and former UK regulator, London, United Kingdom*

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With deepest love and respect for family members past and present
certaines dettes sont difficiles à rembourser

Foreword

Corporate Governance is rightly regarded as one of the key issues of our time. Business is a dominant force in the economic performance and political life of all major nations. Corporate Governance can be studied from different perspectives. There is a wealth of literature on business ethics, much of which is concerned with Corporate Social Responsibility (CSR). However, a great deal of this literature is concerned with 'preaching' rather than teaching or research. The delivery of CSR programmes depends on the system of Corporate Governance. Corporate Governance has to deliver on both financial performance and on social responsibility. This book focuses on financial performance; however, many of its findings also have implications for the delivery of social responsibility. Strong financial performance can provide a springboard for investing in CSR programmes. The converse also applies: strong CSR can enhance company reputation and brand value and thereby improve financial performance.

This book focuses on the structure of the Board. It examines the division of powers between the chair of the Board and the Chief Executive Officer (CEO), and how strictly this division is maintained. It considers the diversity of Board members (gender and nationality of directors), access to external information and opinion through non-executive directors, and access to expertise through sub-committees. It shows that the size, structure and composition of the Board are all crucial to the way in which the firm is managed. On the other hand, however, it also sounds a warning: the structure of the Board must be adapted to the business

environment of the firm. A Board structure that works well in one context may not work so well in another. Managers and policymakers need to identify the contingent factors determining the type of Board that is most appropriate in each set of business circumstances. 'One size fit all' does not apply to the composition of a Board.

The information provided in this study is invaluable. The research methodology sets a new standard for other researchers in the field. A wide range of readers will benefit from studying this book. It addresses important issues of general concern and does with an exceptional degree of intellectual rigour.

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Preface

The work on which this monograph is based was first conducted as doctoral work and won the Brunel University Vice Chancellor's first prize in 2018 for its originality and quality; however, this did not come around easily. Several years ago, when Naeem—a professional accountant, as a freshly minted MBA, also from Brunel—came around and started to discuss the topic, I was apprehensive, and warned of the difficulties and pitfalls in this type of work. I am an economist by training, but also have an honours First Degree in accountancy. My contention was that, if we were to say anything meaningful, it would have to be based on solid factual analysis, which can only be conducted if detailed time series data on key accounting and Board structure variables could be collected. After deliberations, we agreed to take on the project and also decided to back-up the findings with the help of a field survey, which was supposed to yield qualitative insights to supplement the quantitative results. Sadly, owing to time and financial constraints, we had to drop the latter and focus on the data side of things only. The survey questionnaire we had drafted came to be donated to another researcher working on the same topic in Pakistan.

The fact that work had started to attract attention on its own perhaps would not have been enough to coax us to publish it as a research

monograph.[1] Our search showed that, to date, no work of this nature has been shared in a monograph form with researchers, practitioners and institutional agencies of Pakistan—an emerging economy that shares most of its economic and social attributes with fellow emerging economies. The statistical analysis has yielded meaningful insights into the link between Corporate Governance and performance (see Chapter 4). Researchers seeking to pursue future work of this nature will find the methodology adopted helpful. The framework applied in this work is also sufficiently robust to be operationalized for future empirical works. Managers will find plenty of useful advice to enhance performance. Practitioners working in the field of advising firms would find the results useful in their toolbox of consulting ideas and sermons. Much of the existing research has been conducted in the Anglo-American context, where firms have diffused ownership, capital markets are efficient, and shareholder rights are strongly protected by various laws. In contrast, institutional settings and the economic environment differ significantly in emerging economies, and, as such, the findings of studies conducted in developed countries are not generalizable. There is significant potential for this research to benefit, notably those bearing similarities to Pakistan in terms of their culture, political, social and economic structures.

We would have liked to see more robust links between CG and financial performance of firms than those that finally came around. The only way to explain this conundrum is to borrow from Sir Mervyn King:

> Good Corporate Governance is about 'intellectual honesty' and not just sticking to rules and regulations, capital flowed towards companies that practiced this type of good governance.
>
> —Mervyn King (Chairman: King Report)

Furthermore, as a piece of advice for corporate sector of Pakistan vis-à-vis emerging economies:

> It is clear that good Corporate Governance makes good sense. The name of the game for a company in the 21st Century will be conform while it performs.
>
> —Mervyn King (Chairman: King Report)

[1]A paper partially based on this work in *British Journal of Management*, is also now gradually gaining momentum (cf. Singh S, Tabassum N, Darwish T, Batsakis G (2017), 'Corporate Governance and Tobin's Q as a Measure of Organizational Performance' *British Journal of Management*. ISSN 1045-3172. DOI: 10.1111/1467-8551.12237.

And finally:

> Global market forces will sort out those companies that do not have sound Corporate Governance.
>
> —Mervyn King S.C. (Chairman: King Report)

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University of Dubai, UAE Satwinder Singh

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I am grateful to all my family members, especially my wife Sehar and lovely daughters, Iman and Sara, for their love, support and patience. I am indebted to my daughter Sara for her 'editorial skills' (she changed one word but is threatening to sue me if I do not give her any credit for it).

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Our publishing contacts at Palgrave Macmillan, Jessica Harrison and Arun Kumar Anbalagan, and Keerthana Muruganandham—thanks to you for being so understanding and helpful.

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Abbreviations

ACCA	Association of Chartered Certified Accountants
ADB	Asian Development Bank
AMLA	Anti-Money Laundering Act
ASX	Australian Securities Exchange
CDC	Central Depository Company
CDS	Central Depository System
CEO	Chief Executive Officer
CIPE	Centre for International Private Enterprise
CSR	Corporate Social Responsibility
FDI	Foreign Direct Investment
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GMM	General Method of Moments
ICAP	Institute of Chartered Accountants of Pakistan
IFC	International Financial Corporation
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
IPR	Intellectual Property Rights
IV	Instrumental Variables
KSE	Karachi Stock Exchange
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
PESTLE	Political, Economic, Social, Technological, Legal and Environmental
PICG	Pakistan Institute of Corporate Governance
RDT	Resource Dependence Theory
ROA	Return on Assets

ROE	Return on Equity
ROSC	Review of Observance of Standards & Codes
SBP	State Bank of Pakistan
SCT	Social Contract Theory
SECP	Securities and Exchange Commission of Pakistan
SOE	State-Owned Enterprise
TQ	Tobin's Q
TRIPS	Trade Related Aspects of Intellectual Property Rights
UN	United Nations
VIF	Variance Inflation Factor
WB	World Bank
WTO	World Trade Organisation

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CHAPTER 1

Corporate Governance

This objective of this chapter is to introduce the concept of Corporate Governance and define the concept in its narrow and broader outlook. The chapter also explain the importance of CG and the rationale behind this work. The discussion is organized under the following headings.

- *Introduction*
- *Concept of Corporate Governance*
- *Definition of Corporate Governance*
- *Importance of Corporate Governance*
- *Rationale for This Study*
- *Motivation for This Study.*

Introduction

We are living in an era of unprecedented globalisation that is transforming the face of the world economy. A gradual lifting of trade barriers, revolution in telecommunications, data processing and transportation facilities have accelerated the pace of global inter-dependence turning the world into an increasingly level playing field. Whereas there is no denying the positive impact of globalisation, its overall benefits remain unevenly distributed across developed and emerging economies. Inadequate development of Corporate Governance (CG) principles, particularly in emerging economies, is seemingly an important factor that contributes to this disparity. CG 'is the whole system of controls, both financial and

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otherwise, by which a company is directed and controlled' (Cadbury, 1992). It involves a set of rules and relationships between the internal and external stakeholders of a company, aimed at creating an environment in which the company can achieve its business objectives. CG is a widely accepted tool in keeping businesses under control and checks so as to prevent management from abusing their power and corporate resources for personal benefit.

Evidence suggests that the degree to which companies comply with good CG practices is an important factor in investors' decision in choice of companies. In 1996, McKinsey surveyed a large number of US investors, with the majority of respondents confirming they were willing to pay a higher price for shares in companies that were well-governed, responsive and proactive when it came to protecting the interests of shareholders. In June 2002, McKinsey conducted a similar survey in other parts of the world, including Asia, Europe and Latin America, with respondents registering the same opinion as their American counterparts in terms of being willing to pay premium for the shares and securities of well-governed and transparent companies. Investors—both individual and institutional—are therefore recognised as being more likely to risk their financial resources by making investments in companies with a good record of CG achievements (Bushee, Carter, & Gerakos, 2014), less information asymmetry and exploitation of the rights of minority shareholders (Choe, Kho, & Stulz, 2005).

Corporate Governance practices have the potential to become a powerful development tool for emerging economies seeking to achieve national objectives. The importance of CG, for the commercial success and ultimately (given the global hold of private enterprises) for the social welfare of the world cannot be overstated. In the next section, we further clarify the concept of CG.

Corporate Governance (CG)

The term 'governance' has its origin in Latin word gubernare, meaning 'to steer', and has commonly been applied in the context of the steering of a ship (Solomon, 2010). Corporate Governance,[1] as a term, is used as a proxy for authority and control in the context of

[1] Henceforth we may use 'governance' to mean 'Corporate Governance'.

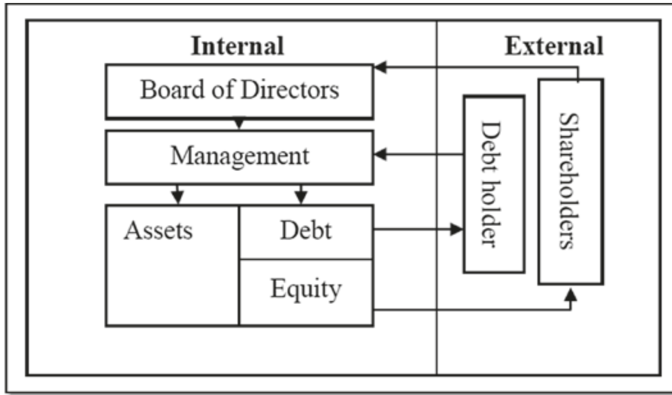

Fig. 1.1 A model of corporate governance (*Source* Corporate governance and the balance sheet model of the firm—adapted from Ross et al. [2005])

public companies (Luo, 2007). Figure 1.1 portrays the essence of CG in business environment; the left-hand side of the diagram depicts the elements of a company's internal CG whilst the right-hand side displays the external elements of CG on the company. The management of the company is shown as acting on behalf of the company's shareholders to decide where to direct the company's financial and other operating resources. The Board of Directors, as the most important component of internal mechanism of CG, has the responsibility of advising and monitoring management, hiring and firing, and senior management teams (Jensen, 1993). The model highlights the separation between providers and users of financial resources in a publicly traded firm, with this separation creating the need for suitable governance structures.

Defining Corporate Governance

The concept of CG, and the understanding of such, varies from firm to firm, country to country, and even from scholar to scholar. Different authors have defined the term CG in different ways and done so notably in line with their own understanding, experience and interest in the subject. Some authors have defined the term in its narrow sense, whereas others explain it in relation to its broader meanings (Abdullah & Page, 2009).

Despite the fact that CG has become a buzzword, its precise definition remains blurred (Gillan, 2006). A survey of literature revealed an absence of consensus as to what constitutes CG (Solomon, 2010). Following section presents some of the commonly cited definitions in their narrow and broad perspectives.

Narrow View of CG

In its narrowest sense, CG is defined as a system of relationships amongst the internal actors of a firm, namely its Board of Directors, management and shareholders. When defined in its narrow sense, the definition suggests that both the directors and management of the company are only accountable to its shareholders (Cadbury, 1992; La Porta, Lopez-de-Silanes, & Shleifer, 1999; Shleifer & Vishny, 1997). Sir Adrian Cadbury, in his famous and widely recognised report The Financial Aspects of Corporate Governance, defined CG as follows:

> Corporate Governance is the system by which companies are directed and controlled. Boards of directors are responsible for the governance of their companies. The shareholders' role in governance is to appoint the directors and the auditors and to satisfy themselves that an appropriate governance structure is in place. The responsibilities of the directors include setting the company's strategic aims, providing the leadership to put them into effect, supervising the management of the business and reporting to shareholders on their stewardship. The Board's actions are subject to laws, regulations and shareholders in general meeting. (Cadbury, 1992: 14)

Similarly, Shleifer and Vishny (1997) define CG as "*the ways in which suppliers of finance to corporations assure themselves of getting return on their investment*". CG has also been defined as "*a set of mechanisms through which outside investors (owners) protect themselves against expropriations by the insiders (managers)*". According to La Porta et al. (1999), CG may be inferred as "*a set of mechanisms through which outside investors (owners) protect themselves against expropriations by the insiders (managers)*".

The narrow view of CG is all about protecting the interest of those who have supplied financial resources to the company.

Broader View of CG

The wider view of CG suggests taking a look beyond the interests of investors and the company's internal responsibilities. This view of CG suggests that companies have a set of economic and social responsibilities as well, towards other stakeholders in the company, including, for example, employees, suppliers and the community. OECD has outlined this perspective as follows:

> Corporate Governance involves a set of relationships between a company's management, its Board, its shareholders and other stakeholders. Corporate Governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. (OECD, 2004: 11)

CG with a broader view has also been defined as:

> The system of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity. (Solomon, 2010: 6).

In an elaborate attempt CG has also been defined as:

> the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs ('corporate insiders') on one hand, and those who invest resources in corporations, on the other. Investors can include suppliers of equity finance (shareholders), suppliers of debt finance (creditors), suppliers of relatively firm-specific human capital (employees) and suppliers of other tangible and intangible assets that corporations may use to operate and grow. (Oman, 2001: 13)

Although there is no sole universal definition of CG, policymakers in different countries pursue the same objectives when seeking to grow public trust and the confidence of investors (ICAEW, 2005). It is clear from the definitions that good CG be founded on the principles of protection, accountability, transparency and disclosure. In its narrow outlook, at the organisational level, CG creates trust between the suppliers of finance and the company's management; in its wider sense, CG creates

overall confidence at the aggregate economy level. In both cases, the end goal is to protect shareholders whilst ensuring an efficient allocation of resources for benefits of wider communities (OECD, 2004). This dual objective makes CG more important and more difficult not only to understand but also to apply to a wider group of stakeholders.

In this book, we argue that CG mechanism is a combination of both internal and external factors put together to create an environment of trust, ethics and moral values to direct and control the activities of companies to create economic value for shareholders and to achieve a balance between public and private interests.

The Importance of CG

McKinsey in 1996 surveyed a large number of US investors, and subsequently found that investors were willing to pay a higher price for shares in companies that were well-governed, responsive and proactive in protecting the interest of shareholders. In a similar survey conducted in 2002 in other parts of the world, including Asia, Europe and Latin America, investors expressed similar sentiments, i.e. that they were willing to pay premium for the shares and securities of well-governed and transparent companies. This has also been confirmed in academic studies (see, for example, Chen, Chen, & Chung, 2006). It has generally been recognised that investors—individual and institutional—are more likely to risk their financial resources by making investments in companies with a good record of CG achievements (Bushee et al., 2014) and reduced information asymmetry and exploitation of the rights of minority shareholders (Choe et al., 2005). Good governance practices have the potential to become a powerful development tool, particularly in emerging economies seeking to achieve goals of industrialisation.

Stressing the importance of good CG for domestic and international economic activities, the OECD (2004) stated:

> If countries are to reap the full benefits of the global capital market, and if they are to attract long-term 'patient' capital, Corporate Governance arrangements must be credible and well understood across borders. Even if companies do not rely primarily on foreign sources of capital, adherence to good Corporate Governance practices will help improve the confidence of domestic investors, may reduce the cost of capital, and ultimately induce more stable sources of financing. (OECD, 2004: 13)