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Compliance and multidimensional firm performance: Evaluating the efficacy of rule-based code of corporate governance

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ABSTRACT

This study seeks to evaluate the efficacy of the Pakistani Code of Corporate Governance by finding out its impact on firm's performance and efficiency. This exploration is done in the context that Securities & Exchange Commission of Pakistan's choice of corporate governance regulations is heavily influenced by Anglo-Saxon approach, whereas de-facto realities of Pakistani corporate environment are quite in contrast.

Using a panel data of 119 firms for the period of 8 years i.e. 2003 to 2010, and using a multidimensional performance framework i.e. financial performance and technical efficiency, we find that the extent of compliance has increased since the issuance of code in 2002. After controlling for firm size, growth, dividend payout, age and leverage, we find significant positive impact of compliance on firm's performance (ROA, ROE and ROCE). We also find a weak positive relationship between compliance and technical efficiency. We suggest that compliance is not linearly related with financial performance and we find that high compliant firms are less profitable than average or low compliant firms. This implies that one-size-fit all approach along with mandatory compliance is a questionable approach for Pakistani firms.

This study is first in Pakistan in providing empirical evidence on efficacy of the rule-based Code of Corporate Governance and also adds to growing but underdeveloped literature on compliance and firm performance in emerging/developing economies. Further, this study offers insight to policy makers on the efficacy of current corporate governance regulations and offers a research framework for assessing the extent of compliance, effectiveness and economic impact of code of corporate governance.

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1. Introduction

The series of high profile corporate collapses (Claessens and Yurtoglu, 2012; Davies and Schlitzer, 2008; Lavelle, 2002) due to fraud and inadequate systems of check and balances brought the issue of governance in corporate form of the business in the spotlight. This worldwide attention made corporate governance reforms and regulations, a priority agenda for governments and market regulators around the globe. This emphasis is evident from the number of published reports around the world, during the last two decades, e.g. Cadbury Report (1992) and Higgs Report (2003) in the UK, Viénot Report (1995) in France, King-I (1994) and King-II (2002) in South Africa, Peters Report (1997) in the Netherlands, Cardon Report (1998) in Belgium and Preda Report (1999) in Italy.

As a result, as these reports have formed basis, governments around the globe have started addressing the problem of corporate governance by introducing and implementing governance codes for corporate form of business, using different implementation protocols i.e. rule based or principle based. The rise and wide acceptability of codes of good governance can be seen from the fact that there were 72 codes in 24 countries in 1999 (Aguilera and Cuervo-Cazurra, 2004) and in 2008 the website for European Corporate Governance Institute reported 189 codes in 63 countries (Zattoni and Cuomo, 2008). As per information on ECGI's website[1] (as of February 2013), there are 92 countries and many international organizations (e.g. World Bank, OECD) that have issued one or more codes of good governance.

Following the international demand for governance reforms in the capital markets, Pakistan has introduced a number of reforms, which include introducing new legislation to strengthen the equity market liberalization process and development and implementation of corporate governance codes. In March 2002, Securities and Exchange Commission of Pakistan (SECP) issued the code of corporate governance (SECP, 2002) for publicly listed companies. The requirements of the code are heavily influenced from the UK and US governance regulations. In contrast to widely applicable “comply or explain” approach, Pakistan followed the US rule based approach and made the requirements of the code as mandatory.

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[1] www.ecgi.org (as on 18th February 2013).

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The corporate governance structure in any country is determined by several factors; the de facto realities of the corporate environment in the country; the legal and regulatory framework that defines the rights and responsibilities of stakeholders involved; and each firm's articles of association. While developing the code of corporate governance Pakistan was also influenced by the international advocacy of Anglo-American model[2]. Pakistan presents an interesting case for studying the impact and efficacy of the code of corporate governance the de facto realities of the corporate environment are quite in contrast from the system of corporate governance adopted. The Pakistani capital market is characterized by concentrated ownership structure through cross shareholdings and pyramid ownership structure (Claessens et al., 2000; Thillainathan, 1999), family based business groups, debt (from banks) as a preferable form of financing instead of equity, an underdeveloped equity market and inactive market for corporate control, i.e. takeovers.

There exists a vast anecdotal and empirical evidence both in developing and developed world that good corporate governance can cause or lead to improved financial performance and benefit shareholders through access to more capital, reduction in cost of capital (Reddy et al., 2010), free cash flow be distributed among shareholders rather than being expropriated (Jensen, 1986; La Porta et al., 2002), reduction of control rights of managers and the probability that managers make investment decisions that can enhance shareholder value (Shleifer and Vishny, 1997). It is argued that poor quality regulations can increase compliance costs for business and other groups, cause unnecessary complexity and associated uncertainty as to regulatory obligations and reduce the ability of government to achieve its objectives(OECD, 2008). Therefore a corporate governance system which is compatible with capital markets and corporate culture will, theoretically, facilitate the business and thus enables a firm to realize the previously noted benefits, in sum, improved financial performance and efficiency.

Therefore in this context, the main purpose of this study is to find out the effectiveness and efficacy of the current code of corporate governance by using finance approach to corporate governance i.e. by finding out the relationship between compliance with firm's efficiency and financial performance. This is accomplished by constructing a compliance index to measure the extent of compliance with the code of corporate governance and comparing it with multi-dimensional firm performance measures. The firm performance is measured through financial performance measures (using accounting ratios) and efficiency measures (using DEA).

1.1. Significance and justification of the study

Neither Securities and Exchange Commission of Pakistan (SECP) nor any other study in Pakistan has attempted to evaluate the effectiveness of the code of corporate governance or addressed compliance performance relationship. Therefore there is a dire need for evaluating the economic impact and effectiveness of the code. The evaluation methodology in the field of law is quite different and as in general “Codes” are less like laws and more like guidelines/best practices. Also they are equally applicable to all listed firms and every firm is required to comply with it within its unique firm setting, therefore it makes sense to evaluate outcomes of firm's core activities while complying with the code, to use as indicator of the impact and effectiveness of the code. Therefore in line with economics and social sciences research we are using outcomes (financial & operational performance) to measure the effectiveness of the process i.e. the code of corporate governance. Also this is the first study which offers evidence on the economic consequences of complying with the code of corporate governance for Pakistani listed firms.

Further, the extant research in Pakistan has suffered from three main limitations. First, mostly the use of only large firms e.g. KSE-100, second shorter study periods, and third use of market or market based hybrid measures e.g. Tobin's Q. The problem with using market based measures is that our stock markets are inefficient, very volatile and there is clear evidence of insider trading and price manipulation by colluding stock broker (Hameed and Ashraf, 2006; Iqbal, 2012; Khawja and Mian, 2005; Mirza and Afzal, 2009; Tariq and Butt, 2008). This problem is common with stock markets of emerging economies (Mei et al., 2004; Siddiqi, 2007). Results and findings based on such measures can be misleading and questionable.

This study is first to attempt to overcome these shortcomings by analyzing a large sample of 119 firms for Pakistan (large, medium and small sized firms with wider presence) over a longer period of time, 2003 to 2010, i.e. 8 years and employing multi-dimensional performance measures to assess the impact on both firm's financial and operational performance. Further this study contributes towards a smaller branch of literature that combines productivity literature with corporate governance literature.

2. Literature review

Ariff and Ratnatunga (2008) assert that the concept of corporate governance can be looked upon from four viewpoints i.e. economic, legal, societal (social) and applied finance. This study is attempting to assess the efficacy of SECP's code of corporate governance by employing applied finance viewpoint towards corporate governance.

The theoretical foundations for corporate governance research can be found in Agency theory (Alchian and Demsetz, 1972; Jensen and Meckling, 1976), which pointed out the conflict of interest between management and owners due to separation of ownership and control. To minimize this divergence between interest of mangers and shareholder and to reduce the agency cost, agency theory suggests the installation of internal and external control mechanism. This is what recently known as corporate governance (Haniffa and Hudaib, 2006). Shleifer and Vishny (1997) affirmed that the main purpose of the corporate governance is to provide a sense of security to capital providers. The two other theories that have been used separately or with agency theories are; information asymmetry and managerial signaling theory (Kapopoulos and Lazaretou, 2007; Rhee and Lee, 2008) and convergence theory (Clarke, 2004a,b).

Mega corporate failures, globalization and increased awareness of investors are the triggers of worldwide popularity and diffusion of good governance codes (Iturriaga, 2009; Mallin, 2007). The extant of research on codes can be divided in to three main categories.

First category includes those studies that have examined the extent of compliance with codes of corporate governance within a single country or across multiple countries (e.g. Akkermans et al., 2007; Alves and Mendes, 2004; Berglöf and Pajuste, 2005; Chizema, 2008; Hooghiemstra and van Ees, 2011; Seidl et al., 2012; Talaulicar and Werder, 2008; Werder et al., 2005). Some of these studies have attempted to identify reasons for non-compliance. Second set of studies are those that have examined the effect of compliance with codes of corporate governance on corporate behavior like CEO turnover, earnings management and board structure (e.g. Chen et al., 2011; Dahya et al., 2002; Dedman, 2003). And finally the third category includes those studies that have investigated the relationship of compliance with the codes of corporate governance and financial performance of firms. Here we will take a brief account of these third types of studies.

There is evolving but still premature (Talaulicar and Werder, 2008; Teh, 2009) literature aiming at exploring the relationship between compliance and performance. Reddy et al. (2010) investigated the empirical question regarding code compliance and financial performance for New Zealand. They carefully concluded that there is evidence that the recommendation of code has positive influence on firm performance. The presence of remuneration committee as recommended by the code is also positively related to the firm performance. Goncharov et al. (2006) reported for Germany that firms with higher degree of compliance are priced at premium in contrast to the firms with low degree of compliance.

[2] Soederberg (2003) noted that “despite the claim that the international standard of corporate governance embodies ‘universal principles’, the definition advanced in the ROSCs intentionally draws on the Anglo-American variant”.

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