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# Impact of Board Composition, Leadership and Ownership Structure on Firm Performance: Evidence from KSE 100-Index

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**Abstract:** Pakistan is an under developed market where corporate governance practices have been introduced to establish and maintain a good quality corporate culture in the organization. Firm performance measures with two proxy variables which is return on asset and market to book value meanwhile with two different techniques. Managerial ownership and leverage has negative significant with return on asset under OLS technique and random effect result shows that managerial ownership and leverage negative significant with market to book value.

**Key words:** Board · CEO Duality · Ownership · Firm performance

## INTRODUCTION

Corporate governance normally refers to the rules and regulations including both internal and external which are designed to mitigate the conflicts of interests among the shareholders and management. According to the Ehikioya "Corporate governance is concerned with the processes and structure through which members interested in the overall well-being of the firm take measure to protect the interest of the stakeholders." [1]. Corporate governance got very much attention all over the world from the last few years. It is due to financial recession and eruption of US scandals to protect the stakeholder's interests. Corporate governance is a hot issue in Asia due to the poor firm performance.

A number of studies have been conducted on the issue of poor corporate governance. According to Claessens, Djankov and Lang better corporate governance is helpful for searching more finance for the firm, running the organization on profit track and also to show better performance of the organization [2]. Elsayed argued about the new corporate model for making more effective corporate governance system [3]. Today mostly structures of the corporate follow the split-up the management from ownership which is based on traditional theory.

Corporate governance structure includes: firm's ownership structure, board composition and board leadership structure. Firm's ownership structure includes holding the share of the corporation. It can be one person and can also be more than one. Board composition consists of board size and board independence. Board of directors is responsible for the fairness of the firm's management. Board independence means the ratio of outside independent directors in firm's board and how much they have authority to make critical decision [4].

While for running the company a board of directors is a team with responsibilities of leading, controlling and directing the management of the company, with the primary objective to act as in the best interests of the firms' owners. Board of Directors is appointed for the evaluation of the firm performance in the best favors of shareholder's interest protection. So it is concluded that accurate performance of the duties of the Board of Directors will ensure the increase in the value of the firm as well as shareholders wealth.

**Corporate Governance in Pakistan:** Pakistani organizations in the past followed the corporate ordinance until 1983 which was very close to English corporate entities. After company act 1984, Pakistani entities follow this company act as rule for establishing and running the companies. The first draft about

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corporate governance was promulgated in 1998 by the Institute of Charted Accountants of Pakistan (ICAP). Security and Exchange Commission of Pakistan (SECP) is authorized to develop policies and guidelines for the companies that are listed on stock exchanges, In early 2002, the security exchange commission of Pakistan (SECP) introduced the codes and guidelines about corporate governance practices in Pakistan and this code covers the companies act 1984 as well as banking company ordinance 1962.The corporate governance model was promulgated after studying some international corporate governance models like Cadbury committee report, King's report from South Africa and Hampbell committee report from the united kingdom.

The corporate governance code is applied to all listed companies in Pakistan. The main objective is the enhancement of corporate governance and operational efficiency. There is Also established a system whereby company is controlled and regulated by its directors and it should be in compliance with the practices that are best in the favor of stakeholder at a wide range. It is restructuring the composition of board of directors to enable its presence of possible minority shareholders. The code focuses on the broadness and transparency in the dealings of corporate and the process of making decisions. Directors also required taking off the responsibilities which are fiduciary and in the greater interest of the stakeholders in a timely and transparent manner [5].

The new 2012 declared code of the corporate governance laid down the criteria for the directors listed companies with respect to eligibility criteria and qualification. One of the basic internal governance mechanisms of directors is developing the policies and strategies at corporate level, performance of management and its monitoring, hiring and firing of the executive staff and also ensures the accountability of the organization to its shareholders. The process of communication and disclosure are also overseen by the board [6].

The objective of this study is to measure the impact of leadership board composition and ownership on KSE-100 index non-financial firms of the economy in the highly dynamic environment of Pakistan. Scheme of the study: The first section about the introduction of corporate governance second section on brief literature review of previous studies third section on methodology and framework fourth section describe about result and final section on conclusion and policy implications [7-30].

**Literature Review:** The structure of Corporate Governance like board size, board composition, ownership structure and CEO duality is having a lot influence on the firm performance. Different evidences from the literature suggested that there may be a positive relation between structure of the Corporate Governance and Performance of the firm [29], having no relationship [8] or May having a negative relationship.

The board leadership structure is becoming a hotter topic due to the usage of confusing terms; such as dual and unitary structure, duality and non-duality and combining or opening the CEO and chairperson of the board [34]. The issue of duality and unitary is discussed in Cadbury committee report (1992) and separation of two posts is recommended [1]. Malaysian code on corporate governance explains that CEO duality leads high risk of ineffective leadership structure. Explanation of separation of these two posts is that board independence is compromised due to duality because CEO may appoint his favorite directors to serve his own interests [31-35].

Steven T.petra argued when there is duality structure then possible conflicts of interests occur [31]. CEO is self-evaluating position. If firm has adopted dual leadership structure, CEO may serve his own interests on the expense of shareholders and their interests may be compromised. Daily and Dalton found that in failed firms duality is more frequent. Practically, empirical result regarding about CEO duality and firm performance change country to country as well as industry to industry [14]. Various previous studies did not support the joined role of CEO and chairman Daily and Dalton, Chen *et al*. andrew *et al*, Steven T.petra, while others recommend that merging these two roles is preferable for firm performance Donaldson and Davis, Brickley *et al*. anderson and Anthony [14, 10, 3, 31, 17, 7]. Some previous studies identified that there is no relationship between firm performance of the corporation and leadership structure used in the corporation's Abdullah, Baliga *et al*., Daily and Dalton, Tin Yan [1, 4, 15 and 34].

It is assumed that performance is also affected by the number of board of directors. The members of the board are hired to investigate and manage the different aspects of activities of the firm. There is no agreement found that whether a small board or a large board will perform better. Yermack found that firm can perform better with the small number of board of directors [35]. Lam and Lee argued that firm performance is negatively

affected by large board of directors as it slow down the pace of decisions making process [27]. Ehikioya found positive relationship between board size and accounting base ratio which measure the firm performance but positive not significant relation with market to book value ratio [19]. Different aspects like weak communication and expenses for monitoring them are also some strong reasons behind the support of the small board of directors Lipton and Lorsch and Jensen, [25].

Another school of thought tends to believe that large board of directors having ability to move mangers towards low cost of debt and move them towards increase in value of firm, [3]. Studies by Wen *et al*. and Abor suggested about the positive relation between board size and leverage [33, 2]. They also mentioned that higher board size having more monitoring that will tend to move them towards higher leverage and greater the firm value.

According to the agency framework of Fama and Jensen board members have to resolve the agency problem between shareholders and managers by giving compensation plans to managers and by replacing those managers who are not actively participating in maximization of shareholders' value [21]. The main element from agency view of board is that outside board member will not violate the best interest of the shareholder with other directors because they will have incentives to build that reputation as an expert. So, it is important to have an independent board in the best interests of shareholders.

The framework of agency theory is most widely used by the investigators of the economics and finance to understand the relationship between value of firm and characteristics of the board. The outside directors are hired to protect the firm from the threats that can be environmental and also use the resources to get the advantage from them. Outside directors having impact on the firm performance but results are mixed. According to Wen *et al* there is a negative relationship between performance and number of board of directors from outside [33]. Bhagat and Black found that there is no relationship between Tobin's Q and outside directors [6]. According to another study the proportion of outside directors have a significant positive relation with firm performance [19, 7]. Higher number of outside directors found in those firms which tend to move towards low leverage and high market value of the equity [19].

Different studies try to examine the relationship of the performance with institutional and managerial ownership but found mixed results. Elsaye and Chen, Lin and Yi study result showed that institutional and managerial ownership had positive relationship but not significant with firm performance [20, 11]. Shareholders and management interest are aligned when management ownership increase because the owners tendency decrease to consume company resources, [26, 23]. Previous studies identified that there is no relationship between insider ownership and firm performance [11]. Some U.S data base studies found that firm performance low when management ownership rise and firm performance high with low management ownership, [24, 28].

## MATERIALS AND METHODS

**Theoretical Frame Work:** This research work aims to test the impact of board composition, leadership structure and ownership structure on firm performance.

Firm performance can be measure with different way but this takes two proxy ratios to measure the firm performance. This study measure the firm performance accounting base and market base for this purpose we use ROA (return on asset) and MTBV (Market to book value). This study measure (ROA) as the percentage of firm's net income to the total asset of the firm during the given period of time. Return on asset was used as an accounting measurement of the firm performance [20]. MTVB is measure by the market value of the equity divided by book value of the equity.

CEO duality mean when one person performs two functions simultaneously- he is the chief executive officer as well as the chairman. CEO duality is used as a dummy variable for board leadership structure [1]. We take the value 1 if the chairman and CEO post serve by one person and take 0 values if both the two posts are held by two different persons.

A firm board size measured by number of the directors serve the organization is called board size. There are different opinions about the monitoring characteristics of size of board of directors. Argued that a large board was a team with responsibilities of leading, controlling and directing the management of the company. According to Yermack, large size boards were less effective monitoring tool [35].

Independence of the board is the second proxy variable of composition of the board. This study indicates that independence of board is a ratio of non-executive independent directors to on-board all directors [27]. The existence of non-executive independent directors on board gives you expectations to improve independent, transparent, prudent decision

making and objectives. Firm performance measure by accounting based ratio will be positively correlated with board independence.

Insider ownership is measured as percentage shares held by inside shareholders to the total number of shares outstanding. It is argued that insider ownership plays a strong role in reducing agency cost by aligning the interests of management and shareholders [23, 25].

Institutional ownership is measured as percentage shares held by institutional shareholders to the total number of shares outstanding. One of the views in existing literature argues that higher percentage holdings of institutional owners exert more influence on corporation decisions.

It is a valid argument that corporate power and corporate performance is being impact by the institutional investor's.Total number of shares owned by institutional investors divided by Total number of shares, through this proxy institutional investment can be measured. For the purpose of alignment of the interests of shareholders and managers the managerial ownership is an important part for this alignment Jensen and Meckling and it ultimately assures its impact on Performance [25]. Managerial shareholding is measured by the number of shares hold by the management divided by the total number of shares.

On the base of literature finding we take some firm specific control variables that have a significant impact on firm performance. These variables are firm size and firm leverage. Firm size is measured as log of total assets [1]. According to Lam and Lee big firms enjoyed a number of benefits by accruing the economies of the scale and they had better resources than other large firm size also needed to perform better raise capital as well as to protect the shareholders interest [27]. Debt to equity ratio is used as a proxy to measure leverage of a firm, which is calculated as dividing total short term and long term debt by total shareholder's equity. According to the Hutchinson and Gul to protect the owner interest the debt holders monitor the capital structure actively.

$$ROA_{it} = \beta_1 + \beta_2 CEOD_{it} + \beta_3 BSIZE_{it} + \beta_4 BIND_{it} + \beta_5 INOS_{it} + \beta_6 MGOS_{it} + \beta_7 DE_{it} + \beta_8 FSIZE_{it} + \mu_{it}$$

$$MTBV_{it} = \beta_1 + \beta_2 CEOD_{it} + \beta_3 BSIZE_{it} + \beta_4 BIND_{it} + \beta_5 IOS_{it} + \beta_6 MOS_{it} + \beta_7 DE_{it} + \beta_8 FSIZE_{it} + \mu_{it}$$

To measure the impact of corporate governance on firm performance used penal data regression. The equation run two times with same independent and control variables but different dependent variables such as ROA and MTVB. Independent variables are CEO duality, board size (BSIZE), board independence (BIND), management ownership (MOS) and institutional ownership (IOS). This study includes two control variables which affect the firm performance, Firm size (FSIZE) and Leverage (DE).

**Data and Sampling:** The sample size use in this particular research is (Karachi Stock Exchange) KSE-100 index companies. The time span form2008 to 2012 used in this study. The investment and financial firms are excluded from the sample companies because their financial structure, policies and financial reporting standards are different from rest of the non-financial companies. We take non-financial firms from KSE-100 index. For the purpose of data collection, annual reports of the sample companies are considered as a major source. These annual reports have been gathered from the official website of each sample company. Moreover, the websites of KSE and Business Recorder have also been used to obtain some relevant information.

## RESULTS

This study investigates the impact of the board composition, leadership structure and ownership structure on firm performance. Panel data used in this study and as we know that heteroscedasticity is one of the major problems in panel data so we do check the existence of the heteroscedasticity by applying the white test. White test result reveals that heteroscedasticity presence in the data. This study used two techniques OLS and random effect model to examine the relationship between corporate governance variables and firm performance.

**Variance Inflation Factor Test Result:** Variance Inflation Factor (VIF) test is conceded to detect multicollinearity among independent variables. Multicollinearity means when independent variables (x) have an exact or almost exact linear relationship among them. If the value of the

Table 4.1:

| C | 3.311 | 25.781 | NA |
|---|---|---|---|
| CEOD | 1.057 | 1.441 | 1.189 |
| BSIZE | 0.034 | 2.45 | 1.258 |
| INO | 0.041 | 1.04 | 1.01 |
| MGO | 6.900 | 1.52 | 1.17 |
| DE | 0.035 | 1.935 | 1.069 |
| FSIZE | 0.000 | 1.804 | 1.21 |

Table 4.2:

| | CEOD | BSIZE | BIN | INO | MGO | LEV | FSIZE | MTBV | ROA |
|---|---|---|---|---|---|---|---|---|---|
| Mean | 0.186 | 9.191 | 0.555 | 0.297 | 0.084 | 2.057 | 16.563 | 2.774 | 0.135 |
| Median | 0.000 | 8.000 | 0.580 | 0.098 | 0.000 | 1.300 | 16.796 | 1.200 | 0.106 |
| Maximum | 1.000 | 15.000 | 0.930 | 24.320 | 0.569 | 57.190 | 19.702 | 50.000 | 0.582 |
| Minimum | 0.000 | 7.000 | 0.090 | 0.000 | 0.000 | 0.080 | 12.853 | 0.070 | 0.900 |
| Std. Dev. | 0.390 | 2.311 | 0.243 | 1.718 | 0.152 | 4.262 | 1.428 | 4.954 | 0.175 |
| Observations | 215 | 215 | 215 | 215 | 215 | 215 | 215 | 215 | 215 |

Table 4.3: Panel Least Squares and Fixed effect Result

| | Least Squares | | Random Effect | |
|---|---|---|---|---|
| Variable | MTVB | ROA | MTVB | ROA |
| C | (2.65326) | (-0.99279) | (1.55406) | (1.16028) |
| | 0.00860 | 0.32200 | 0.12170 | 0.24730 |
| CEOD | (0.58542) | (-1.36205) | (1.57381) | (-1.03110) |
| | 0.55890 | 0.17470 | 0.11710 | 0.60670 |
| BSIZE | (-0.37183) | (0.21216) | (1.09644) | (0.66493) |
| | 0.71040 | 0.83220 | 0.27420 | 0.50680 |
| BID | (-1.80770)* | (0.59731) | (0.75353) | (0.48309) |
| | 0.07210 | 0.55100 | 0.45200 | 0.62950 |
| INO | (-0.64415) | (0.91299) | (1.19595) | (0.13353) |
| | 0.52020 | 0.36230 | 0.23310 | 0.89390 |
| MGO | (-1.97839)** | (-2.83516)*** | (-3.44412)*** | (-1.00222) |
| | 0.04920 | 0.00500 | 0.00070 | 0.31740 |
| LEV | (0.93342) | (-2.56692)** | (-2.82558)*** | (-2.97122)*** |
| | 0.35170 | 0.01100 | 0.00520 | 0.00330 |
| FSIZE | (-1.64440)* | (1.99843)** | (4.57249)*** | (1.73735)* |
| | 0.10160 | 0.04700 | 0.00020 | 0.08380 |
| R-squared | 0.30000 | 0.24000 | 0.21000 | 0.36000 |

*Note: *,** and *** indicate the significant coefficients at 10%, 5% and 1% respectively*

variable of VIF exceeds to 10, which will happen if $R^2_j$ exceeds 0.9, highly multicollinearity exist in the variable. The results show that there is no multicollinearity between the variables.

**Descriptive Statistics:** Table 4.3 gives the detail of descriptive statistics of the independent variables used in our analysis. According to the descriptive statistics result the mean values of the CEO duality is 0.186 and standard deviation is00.390. Descriptive statistics result reveals that 0.186 firms had CEO duality in total sample size. The mean value of the board size in 9.19 and standard deviation is 2.311.The result reveals that the mean board of directors is 9 in our sample and the maximum board of directors is 15 in firms. The board independence mean is0.555 and maximum board independence in any firm in sample is 0.93.Institional ownership mean value is 0.297 and standard deviation is about 1.718. Result reveals that the 29 percent ownership has financial institutions. The mean value of the managerial ownership is 0.084 and standard deviation is 0.152.We take the natural log of the firm size value for the purpose of test the descriptive statistics and result reveal that mean value is 16.563 and standard deviation is about 1.428 in sample firms used in this study.

Table 4.4 shows the result impact of corporate governance variables on firm performance using OLS and random effect techniques. We have used Hausman test which is a specification test to find whether fixed effect or random effect is more appropriate for panel data. According to the Hausman test we have to apply the random effect model because our null hypothesis is not rejected. Previous studies results about CEO duality were inconclusive. This study result shows that CEO duality has positive but insignificant with market to book in both techniques least square and random effect. On the other hand CEO duality has negative but insignificant with ROA. We conclude that adopting CEO duality or non-duality depends upon on firm characteristics and certain circumstances. Brickley at el. suggest that there is no such board leadership structure which is optimal, firm performs can and cannot be better under CEO duality and non-duality [7]. Under both leadership structure firm tolerates cost and enjoy assistances. Under non-duality

the cost would be compensation distribute between two executive and inconsistence their decision making as well as information asymmetry cost associate. CEO has well knowledge about the firm opportunities growth and liable make firm strategies. Corporate change their leadership if non-duality cost greater than CEO duality firm adopt CEO duality and if CEO duality cost greater the non-duality then firm adopt non-duality.

Board size has insignificant impact on form performance in both techniques used in this study. Lam and Lee argued that firm performance is negatively affected by large board of directors as it slow down the pace of decisions making process[27]. According to the different aspects like weak communication and expenses for monitoring them are also some strong reasons behind the support of the small board of directors. Board independence has negative and significant with MTBV in least squares result but insignificant with random effect technique. Previous studies Klein and Yermack recommend that more non-executive directors effect negatively on the performance of the firm [35]. Non-executive directors role are not clearly define in Pakistan corporate governance, due to this non-executive, independent directors incapable play their role to bring organization into profit track as well as they cannot freely take independent decision.

Institutional ownership has positive but insignificant relationship with firm performance in both techniques. The result shows that institutional ownership has no influence on firm performance. Least square shows that managerial ownership has negative and significant relation with both proxies used to measure firm performance which is MTBV as well as ROA. According to the Hermalin and Weisback firm performance decrease when managerial ownership increases but few studies suggest that when managerial ownership increases it case the positive firm performance because due to the managerial ownership the interest aligns between managers and owners of the organization [24]. Our fixed effect result shows that managerial ownership has negatively related with MTBV. This study includes two control variables on the basis of past literature. Debt to equity has negative significant relationship with firm performance in both techniques. Firm size has positive and significant impact on firm performance measures used in this study.

## CONCLUSION

Pakistan is an under developed market where corporate governance practices have been introduced to establish and maintain a good quality corporate culture in the organization. Results show that 18 present firms in KSE 100-index have CEO duality. This study test result shows that CEO has insignificant impact on firm performance. Firms need to adopt leadership structure on the basis of firm characteristics. Board size has no significant impact on firm performance in this study sample firms used for analysis. Board independence has also no significant impact on proxy variables used to measure firm performance. Pakistan corporate governance manual does not define the clear role of the independent non-executive directors. This study sample firm has high ration independent non-executive they need to reduce the board independence. Institutional ownership has no impact on the firm performance. Institutions have interest on the firm's performance and they look after the firm decisions but here institution ownership has no impact on firm performance in both techniques which used to estimate the model. Managerial ownership has negative impact on firm performance both in accounting and market measures. Its means managerial and shareholder interest are not align when management ownership increase.

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