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The Impact of Corporate Governance on Financial Performance: Empirical Investigation from Banking Sector

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Abstract

In recent years, "corporate governance" has become increasingly critical for businesses of all sizes. Better corporate governance practices, which guarantee that businesses are run in an open, accountable, and ethical manner, can be attributed to improved financial performance. While good corporate governance practices can improve financial performance and increase returns, poor practices can cause financial scandals and erode shareholder value. The significance of sound corporate governance practices has recently come to be understood in Pakistan. The primary goal of corporate governance is to protect shareholders and other business partners from harm. Agrawal and Cooper (2017) note that preventing fraud, scandals, misrepresentation, and other corporate wrongdoing necessitates effective corporate administrative measures. Contrarily, poor corporate governance fosters a culture of dishonesty and misrepresentation, which can be extremely harmful to the company and its stakeholders. According to recent research, investors favour investing in businesses that uphold strict corporate governance standards. Strong governance directly leads to better financial outcomes and greater shareholder wealth. The scope of this research was limited to commercial banks trading on the Pakistan Stock Exchange (PSX). The findings of this research will help fill in the gaps in our understanding of how poor corporate governance affects the financial health of Pakistan's banking industry. While corporate governance is essential for ensuring that businesses are transparent and accountable, little is known about the link between corporate governance practices and financial performance in the Pakistani context. Three financial performance indicators were used, i.e. Return on Assets (ROA) and Return on Equity (ROE). Four independent variables were used in the research, i.e. CEO duality, the ratio of females to Directors, in-

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stitutional ownership, and the size of the BOD. Secondary data used in this research was obtained from annual reports of the companies published on their official websites from 2010 to 2022. The analysis examines the effects of variables like the proportion of male to female directors, institutional ownership, board size, and CEO duality on ROE. No statistically significant relationship was found between ROE and CEO duality, the percentage of women on the board, or the total number of board members. However, institutional ownership and ROE have a favourable and statistically significant relationship. This suggests insider ownership is associated with higher profitability than shareholders' equity. The effects of institutional ownership on measures such as return on assets (ROA), board size, gender parity on boards, and CEO duality are examined. There is no evidence that any of the independent variables significantly affected ROA.

Keywords: ***Corporate Governance, Financial Performance, Banking Sector***

JEL Classification: G21, G23

INTRODUCTION

Background of the Study:

In recent years, "corporate governance" has become increasingly critical for businesses of all sizes. Better corporate governance practises, which guarantee that businesses are run in an open, accountable, and ethical, can be attributed to improved financial performance. While good corporate governance practices can improve financial performance and increase returns, poor practices can cause financial scandals and erode shareholder value. The significance of sound corporate governance practises has recently come to be understood in Pakistan. The importance of sound corporate governance has been recognised by academics and professionals worldwide (Aguilera & Cuervo-Cazurra, 2016).

The primary goal of corporate governance is to protect shareholders and other business partners from harm. Agrawal and Cooper (2017) note that preventing fraud, scandals, misrepresentation, and other corporate wrongdoing necessitates effective corporate administrative measures. Financial experts, banks, clients, and shareholders gain from the company's enhanced reputation (Awolowo et al., 2018).

Contrarily, poor corporate governance fosters a culture of dishonesty and misrepresentation, which can be extremely harmful to the company and its stakeholders. According to recent research, investors favour investing in businesses that uphold strict corporate governance standards. Strong governance directly leads to better financial outcomes and greater shareholder wealth. The Securities and Exchange Commission of Pakistan (SECP) has issued corporate governance guidelines to promote and enforce good governance practices among Pakistan's publicly traded companies.

Scope of the Study:

The scope of this research was limited to commercial banks trading on the Pakistan Stock Exchange (PSX).

Objective:

Companies trading on the PSX are not the only ones who can benefit from this research's conclusions; investors and capital market regulators can, too. This study reveals the links between sound corporate governance and higher profits, which can help businesses become more competitive. The study results can help regulators create regulations that promote good corporate governance procedures and protect investors' interests.

Statement of Problem:

The findings of this research will help fill in the gaps in our understanding of how poor corporate governance affects the financial health of Pakistan's banking industry. While corporate governance is essential for ensuring that businesses are transparent and accountable, little is known about the link between corporate governance practises and financial performance in the Pakistani context. Companies may struggle to implement effective corporate governance procedures that boost financial performance due to a lack of expertise.

Research Question:

Is there a correlation between corporate governance and the financial performance of Pakistan Stock Exchange-listed commercial banks?

LITERATURE REVIEW

Review of Literature:

A business's bottom line can benefit from good corporate governance, which is why this topic has received so much attention in academic circles. Good corporate governance can benefit a company's bottom line by, among other things, decreasing agency costs, expanding financing opportunities, and increasing investor confidence (Bokpin & Isshaq, 2009). Good corporate governance practices like board diversity and independence have also improved financial performance (Ujunawa et al., 2012). Corporate governance has been shown to impact companies' bottom lines across different nations and contexts, and this has been the subject of numerous prior studies.

Cement sector: The importance of good corporate governance to the prosperity of cement companies in Pakistan is the subject of this research. The analysis focuses on board size, the presence of a dual-role CEO, and the prevalence of family control. In addition to earnings per share and the current ratio, analysts also looked at return on equity, equity debt, return on assets, and return on equity. Researchers have discovered a connection between a good Corp. Government and thriving companies (Rehman et al., 2013).

Research shows that a giant board is associated with higher returns on assets (ROA), suggesting that a more hands-on deck leads to better business results. However, a negative

correlation between ROA and CEO status indicates that companies with dual CEOs typically perform worse. However, we found no correlation between ROA and board makeup, suggesting that the board's composition has little bearing on cement companies' bottom lines (Shahzad et al., 2015).

An analysis of current literature concerning the connection between good corporate governance and profitable enterprises. A content analysis strategy has been used to investigate the recurrent themes identified in the aforementioned research (Rasheed & Nisar, 2018).

Automobile sector: A study determined the relationships between foreign representatives' domestic activities and automobile companies' success. A robust regression model was used to analyse annual data for 12 years and account for any outliers. It was discovered that the presence of foreign board members significantly influenced the companies' outlandish financial success. Audit committees and a sizable board were indicators of a transparent governance structure. In contrast, independent directors' and institutional investors' involvement was found to be inversely related to firm performance (PeiZhi & Ramzan, 2020).

In India, researchers have examined the relationship between corporate governance practices and the financial success of publicly traded Indian companies. Information for Indian automakers listed in the NSE 500 was gathered between 2014 and 2018. Results unmistakably show Corp.'s direct influence. On how well-run businesses are financially (Mathur et al., 2020).

Another study looked into how corporate governance affects a company's productivity. Information was gathered from the fertiliser and automotive industries between 2006 and 2016. The results (Ahmed et al., 2018) show that larger boards are associated with higher profits in the automotive industry, while smaller audit committees are associated with lower profits.

Pharmaceutical sector: To test the hypothesis that good corporate governance would result in better financial outcomes, researchers looked at the Pakistani pharmaceutical market. Multiple regression models were used to examine the potential effect of corporate governance on profits. According to studies conducted by Ibrahim, Rehman, and Raoof (2010), corporate governance has a major impact on return on equity (ROE) but almost no impact on return on assets (ROA).

Another study looked at the correlation between corporate governance and the prosperity of Pakistan's pharmaceutical sector. The research used ROA and ROE as performance indicators to examine the board's size, composition, education, experience, and the CEO's dual role. This research shows that the size, composition, experience, and education of a company's board significantly affect that board's ability to steer the company towards financial success. An inverse correlation was also found between the chief executive officer's dualities and the firm's returns on sales and assets (Iqbal, 2016).

Electronic sector: A recent study examined how corporate governance practises inside and outside the company impacted banks' financial results. Researchers in India looked at how corporate governance influenced the bottom lines of companies selling consumer electronics through the Internet. Market capitalisation was used to choose a sample of seven Indian consumer electronics companies and analyse their corporate governance practises. Audit committee meeting frequency, member independence, and board diversity were studied as

corporate governance mechanisms. Other metrics used to evaluate a company's performance include return on assets and return on capital employed. In addition, the company's size can stand in for the control variable. The study establishes a link between corporate governance factors and financial efficiency indicators like return on assets and investment. Mandal and Al-ahdal (2018) found that only audit committee independence was significantly correlated with performance when accounting metrics were used.

Commercial banks: Independent board members, high concentration of ownership, freedom from political pressure on the board, and robust legal protection were all found to improve the financial performance of banks in the Middle East and North Africa study. The number of women on boards, a moderately sized board, performance-based compensation, and anti-takeover mechanisms all contributed to better corporate governance. However, none of these elements significantly impacted bank performance (El-Chaarani et al., 2022). Good governance practises, as shown by research conducted on a panel dataset of 173 MFIs in 18 Asian countries between 2007 and 2011, can improve MFIs' financial performance and ensure their long-term viability. In contrast, the study discovered that MFIs with more robust governance practises typically have higher levels of profitability and sustainability (Iqbal et al., 2019).

The Securities and Exchange Commission of Pakistan (SECP) has established rules for corporate governance that publicly traded companies in Pakistan must adhere to. The SECP regulations require a non-executive board of directors, an audit committee, and periodic financial reporting. It is, however, essential to investigate whether or not following these guidelines improves business results.

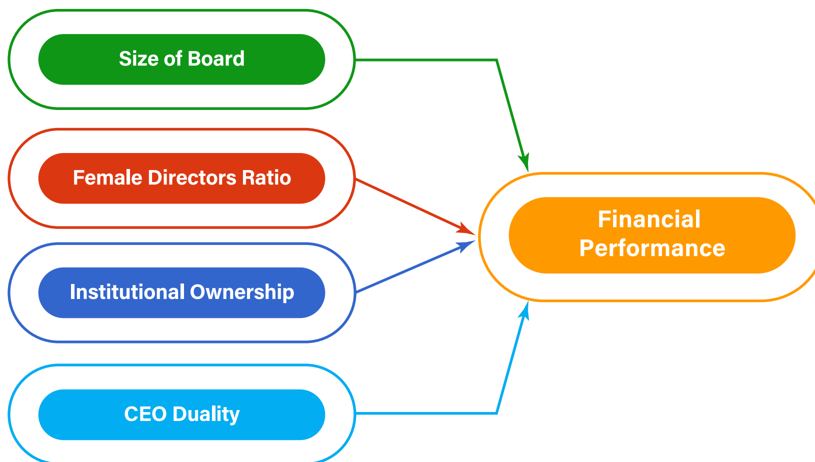
Conceptual Framework:

The agency theory, which postulates that managers and shareholders often conflict with one another owing to the differences in their different objectives, serves as the theoretical foundation for this study. Corporate governance is the mechanism to guarantee that the interests of shareholders and management align with one another and that conflicts of interest are kept to a minimum. Increases in financial success that may be ascribed to corporate solid governance include profitability, returns on assets and equity. These are only some of the metrics of success that can be linked to effective corporate governance.

The conceptual framework also considers how the makeup of a company's ownership, audit committee, and board of directors all affect the company's corporate governance practises and financial performance. The structure and make-up of the board are very important factors to consider in order to guarantee efficient management supervision, and it is the audit committee's responsibility to guarantee that financial statements are accurate and comprehensive. However, a corporation's ownership structure affects the organisation's governance because of the influence and power that shareholders have over the company's decision-making process.

Therefore, the conceptual framework for this research involves the independent variable of corporate governance practises. This variable is assessed by parameters such as board size, institutional ownership, and the fraction of shareholders that are institutions.ag This research is theoretically based on the agency theory, which postulates that managers and shareholders commonly have interests that directly oppose one another. Good corporate governance aims

to eliminate or reduce the likelihood of conflicts of interest and foster an atmosphere where the interests of shareholders and management align with one another. A rise in profitability, return on assets, and return on equity are three metrics that may be used to assess the correlation between good corporate governance and financial performance. The conceptual framework also considers how the composition of the board of directors, the audit committee, and the ownership group all affect the organisation's corporate governance practises and financial performance. The organisation and make-up of the board are critical to the success of management supervision, and it is the audit committee's responsibility to examine the company's financial statements to ensure that they are accurate and comprehensive. However, the power and control that shareholders have over a business's management is influenced by the ownership structure of the organisation. This affects the governance of the company. Corporate governance practices are employed as an independent variable in this study's conceptual framework because they are measurable and can be evaluated using board size, institutional ownership, the number of women on the board, and CEO duality. This is because these practices have been shown to affect firm performance positively. The company's profitability, as measured by ROA and ROE, is the factor that will determine the study's outcome. The percentage of female directors on the board and the presence of a dual-role CEO. The financial performance of the firm, as evaluated by return on assets and return on equity, is the factor that serves as the dependent variable in this analysis.



Hypotheses:

The following hypotheses are viable based on the conceptual framework:

H1: There is no relation between BOD size and financial performance.

H2: There is no relation between Institutional ownership and financial performance.

H3: There is no relation between the ratio of females on the board and financial performance.

H4: There is no relation between CEO duality and financial performance.

RESEARCH METHODOLOGY

Data:

Panel data, consisting of thirteen banks listed on the Pakistan Stock Exchange for thirteen years, starting from 2010 to 2022, has been utilised for analysis.

Variables:

Dependent Variables:

Two financial performance indicators were used, i.e. Return on Assets (ROA) and Return on Equity (ROE).

Independent Variables:

Four independent variables were used in the research, i.e. CEO duality, the ratio of female Directors, institutional ownership, and the size of the BOD.

Inclusion criteria:

Commercial banks registered on the Pakistan Stock Exchange were included.

Data Collection:

Secondary data used in this research was obtained from annual reports of the companies published on their official websites from 2010 to 2022.

Statistical Techniques:

This research uses the panel regression estimator via the E-views package. It is one of the dynamic panel estimation methods to test the effects of corporate governance on the proposed dependent variable.

RESULTS AND DISCUSSIONS

A descriptive analysis of the variables included in the study are given in Table 1.

Table 1: *Descriptive Analysis*

	CEO DUALITY	FEMALE RATIO	OWN	SOB	ROA	ROE
Mean	0.922619	0.038741	0.048151	8.630952	0.013288	0.149065
Median	1.000000	0.000000	0.001820	8.000000	0.010000	0.160000
Maximum	1.000000	0.500000	0.674100	14.00000	0.140000	0.900000
Minimum	0.000000	0.000000	0.000000	4.000000	-0.017600	-1.367000
Std. Dev.	0.267994	0.072698	0.116520	2.146044	0.018354	0.156625
Skewness	-3.163376	3.345659	3.774040	0.364580	4.912515	-4.884111
Kurtosis	11.00695	20.07423	18.34618	2.549787	31.47083	56.69992

Jarque-Bera	728.9730	2354.121	2047.351	5.140563	6349.836	20853.69
Probability	0.000000	0.000000	0.000000	0.076514	0.000000	0.000000
Sum	155.0000	6.508425	8.089431	1450.000	2.232360	25.04290
Sum Sq. Dev.	11.99405	0.882606	2.267350	769.1190	0.056255	4.096722
Observations	168	168	168	168	168	168

Descriptive analysis shows that most bank CEOs also serve on the board of directors, with a median duality ratio of 0.923. A value of zero indicates that the CEO of some banks was not a board member. The average female board ratio is 0.039, which shows few women on the board. The maximum value of 0.6741 suggests that directors hold sizable ownership stakes in some banks. The average value for ownership ratio is 0.048, indicating that institutional ownership is very small or negligible. There is a wide range in board size between 4 and 14, with an average of 8, suggesting that banks tend to have sizable boards. The average return on assets is 0.0133, a respectable return compared to total assets. The large gap between the minimum and maximum values indicates that some banks are making significant profits while only a few are losing money. With a mean value of 0.149, banks' average returns on shareholders' equity are respectable. ROE's minimum and maximum values range from -1.37 to 0.9 and show a similar significant difference to ROA, indicating that some banks are making high profits while others are making losses.

Table 2: *Results of Panel Analysis for ROE*

Dependent Variable: ROE				
Method: Panel Least Squares				
Date: 05/22/23 Time: 18:00				
Sample: 2010 2022				
Periods included: 13				
Cross-sections included: 13				
Total panel (unbalanced) observations: 168				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	0.090237	0.060511	1.491243	0.1378
CEO DUALITY	0.034889	0.048623	0.717536	0.4741
FEMALE RATIO	-0.228214	0.441503	-0.516902	0.6059
OWN	0.253961	0.103857	2.445290	0.0155
SOB	0.000650	0.007047	0.092244	0.9266
R-squared	0.051645	Mean dependent var	0.149065	
Adjusted R-squared	0.022374	S.D. dependent var	0.156625	
S.E. of regression	0.154863	Akaike info criterion	-0.857497	
Sum squared resid	3.885148	Schwarz criterion	-0.745927	
Log likelihood	78.02977	Hannan-Quinn criter.	-0.812217	
F-statistic	1.764408	Durbin-Watson stat	1.140986	
Prob (F-statistic)	0.123013			

A positive(+ve) correlation between CEO duality and ROE is indicated by the coefficient of 0.034889. Even though the coefficient is insignificant (p=0.4741), having a CEO who is also the chairman has no impact on ROE.

The FEMALE RATIO coefficient is -0.228214, indicating a negative(-ve) relationship

between ROE and the number of women on the board. However, the p-value of 0.6059 suggests that the female representation factor has no statistically significant effect on ROE.

There is a 0.253961 correlation between institutional ownership and return on equity. The coefficient shows an association between insider ownership and ROE with a p-value of 0.0155.

A small positive correlation between board size and return on equity is indicated by the coefficient of 0.000650. The coefficient indicates a positive relationship between ROE and board size, but the p-value of 0.9266 indicates that the relationship is not statistically significant.

Table 3: *Results of Panel Analysis for ROA*

Dependent Variable: ROA				
Method: Panel Least Squares				
Date: 05/22/23 Time: 17:57				
Sample: 2010 2022				
Periods included: 13				
Cross-sections included: 13				
Total panel (unbalanced) observations: 168				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	0.008881	0.006652	1.335074	0.1837
CEO DUALITY	0.009739	0.005730	1.699643	0.0911
FEMALE RATIO	-0.021288	0.019775	-1.076522	0.2833
OWN	0.008528	0.012290	0.693924	0.4887
SOB	-0.000482	0.000711	-0.678896	0.4982
R-squared	0.026546	Mean dependent var	0.013288	
Adjusted R-squared	0.002657	S.D. dependent var	0.018354	
S.E. of regression	0.018329	Akaike info criterion	-5.131326	
Sum squared resid	0.054762	Schwarz criterion	-5.038351	
Log likelihood	436.0314	Hannan-Quinn criter.	-5.093592	
F-statistic	1.111240	Durbin-Watson stat	0.754212	
Prob(F-statistic)	0.353086			

Having two CEOs is correlated with increased ROI (coefficient of 0.009739). The coefficient showing that CEO duality has no significant effect on ROA has a p-value of 0.0911, indicating as much. The coefficient of determination (R2) for the correlation between female representation in management and financial performance is -0.021288. The coefficient indicates that the female-to-male ratio does not affect the return on investment (ROI), but the p-value of 0.2833 indicates otherwise.

The correlation coefficient between institutional ownership and return on investment is 0.008528, suggesting a positive correlation. However, there is no correlation between ownership and ROA, as indicated by the coefficient's p-value of 0.4887. The correlation coefficient between board size and ROI is -0.000482, indicating a weak negative relationship. The effect of board size on return on investment (ROI) is not statistically significant, as shown by the corresponding coefficient's p-value of 0.4982.

Hypotheses Assessment Summary:

H1: There is no relation between the size of BOD and financial performance. ***Retained***

H2: There is no relation between Institutional ownership and financial performance. ***Rejected***

H3: There is no relation between the ratio of females on the board and financial performance. ***Retained***

H4: There is no relation between CEO duality and financial performance. ***Retained***

DISCUSSIONS:

Both Return on Equity (ROE) and Return on Assets (ROA) are considered in the regression analyses. Let us talk about the results of each table independently.

ROE as a Dependent Variable, Table 1

The analysis examines the effects of variables like the proportion of male to female directors, institutional ownership, board size, and CEO duality on ROE. No statistically significant relationship was found between ROE and having a co-CEO, the percentage of women on the board, or the total number of board members. However, institutional ownership and ROE have a favourable and statistically significant relationship. This suggests insider ownership is associated with higher profitability than shareholders' equity.

ROA as a Dependent Variable Table 2

The effects of institutional ownership on measures such as return on assets (ROA), board size, gender parity on boards, and CEO duality are examined. There is no evidence that any of the independent variables significantly affected ROA.

CONCLUSION, LIMITATIONS & RECOMMENDATIONS:

Conclusion:

The findings indicate that CEO duality, female ratio, and board size do not significantly affect ROE or ROA. These results suggest that corporate governance practices like CEO duality and board size, as well as gender diversity in top executive positions, may not have a significant impact on a company's ability to turn a profit. However, these results do not match those of earlier studies. This could be because PSX-listed banks rarely change the size or composition of their boards and because the representation of women on these boards is extremely low.

Limitations:

This research concentrated on the effects of only four corporate governance factors: chief executive officer (CEO) duality, the percentage of women on the board, institutional ownership, and board size. Other researchers may also use other significant factors. Besides the ROA and ROE used in this study, financial performance can be calculated in various ways. Another drawback of the study is that it only included banks registered with the PSX, which means that

other researchers could use any other sector with the same set of variables.

Recommendations:

Companies headquartered in Pakistan should understand the value of corporate governance. This research shows that some banks with negative ROA and ROE maintain the same board composition. Rather than hiring a qualified and experienced CEO, these banks are entirely reliant on the skill set that is present on the board. Banks should appoint at least three women to the board so that the effect of having women on the board can be measured on the bottom line. The female representation on boards is also very low.

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