DOES CORPORATE GOVERNANCE AFFECTS RISK: A CASE OF LISTED FIRMS ON PAKISTAN STOCK EXCHANGE

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Abstract

Sound governance system can inculcate investors' confidence. Good corporate governance practices craft the iconic position of corporations by making performance strong and reducing risk. The fundamental purpose of this study is to evaluate the influencing role of corporate governance on solvency risk of cement manufacturing corporations listed on the Pakistan Stock Exchange (PSX). For achievement of study goal, 20 cement sectors firms listed on the Pakistan Stock Exchange was employed from the period 2005 to 2014. Hypotheses were tested deploying regression analysis and results were tested via Best Linear Un-biased Estimator properties of regression. Corporate governance is calculated through board independence, board size, Chairperson and Chief Executive Officer (CCEO) Duality and audit committee, whereas solvency risk is measured through times interest earned. The findings reveal that board independence, board size and audit committee negatively affect solvency risk while CCEO duality has positive effect on solvency risk. This study is imperative for cement sector firms in understanding the significant corporate governance practices and impact on solvency risk in under developing country like Pakistan.

Keywords: Corporate Governance, Solvency Risk, Pakistan Stock Exchange.

1. Introduction

One of the major fields of business is corporate governance, which boost investors' confidence by permitting protection of stakeholders' interest. Investors have identified the importance of corporate governance system at national and international level (Owen, 2003). Equal consideration has got by corporate governance in developed and underdeveloping economies (Mallin, 2004; Reed, 2002; Solomon & Solomon, 2004). Due to financial scandals in underdeveloped counties, corporate governance has given much consideration (Baydoun, Maguire, Ryan & Willett, 2013). Many developing countries have given concentration as many of these countries lack appropriate corporate governance practices (Ekanayake, Perera & Perera, 2010). Pakistan is an underdeveloped country and the Securities and Exchange Commission of Pakistan (SECP) is focusing on proper implementation of corporate governance mechanism after issuing in 2002, as it plays a significant role in economic development. SECP has made corporate governance obligatory for all potential listed firms on Pakistan Stock Exchange in order to instill confidence of investors, ensure transparency, accountability and safeguard the interest of all stakeholders in particular of minority. Corporate governance system varies as countries are different. USA, UK and rest of English speaking countries follow Anglo Saxon system of corporate governance and Germany, France and Spain use European Continental system of corporate governance. Pakistan corporate governance system is based on Anglo Saxon system. In Anglo Saxon system of corporate governance, one independent board of directors monitors and controlled the entire functions of management for increasing shareholders value. A very few people possess the legal authority over management team and minority investors own very low protection, who look to the support of independent director (Hasan, 2009).

The corporations try to magnetize investors across the world by offering comparative good return. The goal of corporation and other stakeholders: lenders, business associates, employees and government, are achieved by applying good corporate governance system. Good governed companies will produce on time return to all stakeholders including shareholders. Poor governed corporations cannot attain profit and hence cannot meet operating needs and other financial requisites and become insolvent. Corporate governance is the mechanism used for sound performance (Ghabayen, 2012). According to John, Litov & Yeung (2005) application of corporate governance system diminishes risk and managers invest in riskier but advantageous projects. Solvency risk can be mitigating by preferring source of equity finance rather than debt finance (Brennan, 1995).

2. Literature Review

Corporate governance plays a substantial role all over the world due to emergence of markets, liberation of trade, financial crises and scandals, development of technology and mobility of capital. Corporate bodies are required to be governed as per the codes of corporate governance mechanism of own country. The system of corporate governance varies from country to country and applied globally having different hallmarks (Hasan, 2009). Outsider system of corporate governance (Unitary System) is followed in United State and English speaking countries, whereas, Insider Model (Dual System) of corporate governance is applied in European countries (Germany) (Nestor Thompson, 2000). Both the systems of corporate governance have developed from different regulatory, political and institutional environments (Babic, 2003). Outsiders Model of corporate governance inclined towards corporate managers' reward and control, while Insider Model of corporate governance relies upon controlling the behavior of managers and owners (Hashim, 2013; Shleifer & Vishny, 1997). There is insider system of corporate governance in Pakistan and Germany. However, uni-boarded system exist in Pakistan, whereas, companies have supervisory and management board. For the very first time, the system of corporate governance was introduced in USA in 1970 while the Securities and Exchange Commission of Pakistan firstly notified the codes of corporate governance in 2002 and still in updating process.

Traditionally the system of corporate governance is concerned with shareholders (principals) and managers (agents) conflict. Jensen and Meckling, (1976) describe in Agency Theory that the conflict arises when principal assign the corporate operation to agents. The principals expect agents for successfully operation of firm in the best interest of firm, however, the interest of agent might deviate from the principal interest. Solvency risk effect corporate stakeholders. Stakeholders interest collide often times. A few hold greater control in corporate decisions. A system is required which can preserve the interest of each stakeholder from exploitation form individual stakeholder's decision. Butt, (2012) describe that corporate governance is the system employed in companies for getting the interest of each stakeholder. The mechanism applied in order to direct and control is known as corporate governance (Australian Standard, 2003). Accentuate accountability and controlling in corporate governance mechanism. The central purpose of corporate governance system is directing and controlling for brining precision in firms which impact performance of corporation. Separation of firm's ownership and control is the fundamental reason of the agency conflict, which cries for effective implication of corporate governance mechanism. Audit committee is one of the effective controlling measures of corporations (Abbott, Park & Parker, 2000; Hashim & Hameed, 2012). Sound amount of return is assumed by corporate investors, which is fulfilled due to good corporate governance, while poor governed corporations will bear risk. Risk is the difference between actual return and expected return. Saito, (2008) defined risk as deviation of return on assets from the from standard deviation. Roggi, Garvey and Damodaran, (2012) linked risk to the expectation of human beings. Risk is classified as controllable (unsystematic) risk and uncontrollable (systematic) risk. Uncontrollable risk is market risk which affects the entire economy not an individual firm and firms are affected due to external factors: high inflation, interest and recession. Uncontrollable risk cannot be controlled but can be mitigated via diversification. Controllable risk is the business risk and which is affected due to corporate inside factors (Aggarwal & Samwick, 1999). Corporate governance effect corporate risk (Prasetyo, 2011). Good corporate governance system can minimize corporate business risk. Sound corporate governance system improves efficiency of managers, reduce risk, boost stakeholders' worth and get competitive advantage. Corporate governance has negative impact on corporate risk (Hashim, 2014; Hashim, Khattak & Kee, 2017; Mayers & Smith, 2010; Rafi, Kazmi & Hashim, 2014; Rogers, 2002; Sharpe & Stadnik, 2007).

The basic objective of this study is to analyze the effect of corporate governance on solvency risk of cement manufacturing corporations on Pakistan Stock Exchange and recommend indicators for improving practices of corporate governance and mitigate solvency risk.

2.1 Hypotheses

For achievement of study aim, underneath hypotheses are formulated.

H_1: Board independence has negative impact on solvency risk.
H_2: Solvency risk is negatively affected by board size.
H_3: Audit committee negatively effects solvency risk.
H_4: CCEO duality and solvency risk have negative relationship.

2.2 Model

The model is build on the basis of existed literature (Agyei & Owusu, 2014; Azeem, Hassan & Kouser, 2013). Diverse facets of corporate governance and solvency risk have been utilized from these researcher by adding new proxies and calculation.

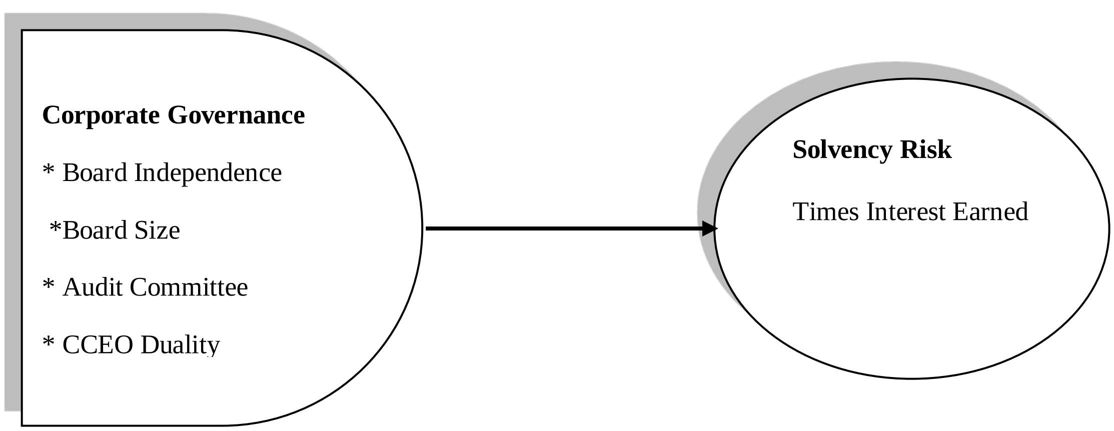

Figure 1: Model

3. Data

The Sample of 20 cement sector firms enlisted on the Pakistan Stock Exchange from 2005 to 2014 is selected. The data regarding corporate governance and solvency risk is analyzed deploying descriptive statistics, correlation analysis and regression analysis using Stata 13 for data analysis.

3.1 Descriptive Statistics of the Variables

Below table report descriptive statistics of corporate governance and solvency risk.

Table 1: Internal Consistency and Reliability (N=200)

Variables	Mean	Std. Dev	Min	Max
Board Independence	0.16	0.37	0.01	1.01
Board Size	1.78	0.08	1.88	4.01
CCEO Duality	0.17	0.38	0.01	1.01
Audit Committee	1.47	0.84	0.01	4.01
Times Interest Earned	1.49	0.39	0.97	1.49

3.2 Correlation Analysis

Solvency Risk and Corporate Governance. The results of solvency risk with corporate governance reveals that board independence, board size and audit committee has negative correlation with times interest earned, whereas, CCEO duality has positive correlation with times interest earned.

Table 2: Correlation Analysis: Times Interest Earned with Corporate Governance

	TIE	BI	BS	CCEOD	AC
Board Independence	-0.31				
Board Size	-0.09	-0.03			
CCEO Duality	0.04	0.02	0.21		
Audit Committee	-0.18	-0.07	-0.02	-0.12	1.00

Note. TIE= Times Interest Earned, BI= Board Independence, BS= Board Size, AC= Audit Committee and CCEOD= Chairperson and Chief Executive Officer Duality

4. Analysis and Discussions

Corporate governance and times interest earned. The impact of corporate governance with solvency risk is evaluated. The results are robust and adjusted R-square is 0.36. The results demonstrate that board independence, board size and audit committee are negatively affected by times interest earned, whereas CCEO duality has positive effect on times interest earned.

Table 3: Regression Analysis: Corporate Governance and Times Interest Earned

	Coef.	Std. Err.	t	P	[95% Conf. Interval]	
Board Independence	-14.12	0.38	4.16	0.00	07.42	20.80
Board Size	-0.13	0.53	2.09	0.02	-02.94	2.68

CCEO Duality	0.25	0.35	2.09	0.04	-05.40	5.90
Audit Committee	-3.73	0.82	1.50	0.04	0.08	7.36
	Number of observations	=	200			
	F Value	=	6.43			
	P Value	=	0.00			
	Adjusted R-squared	=	0.36			

5. Conclusion

This study discovered that most of the facets of corporate governance negatively affect solvency risk of cement manufacturing firms enlisted on Pakistan Stock Exchange. The result revealed that solvency risk is significantly affected by the corporate governance. There is several evidence of hypothesis used in this study that corporate governance negatively solvency risk. The analysis presents evidence that board independence, board size and audit committees negatively affect solvency risk whereas, CCEO duality positively affects solvency risk. Director independence, board size and accurately operation of audit committee minimize solvency risk of cement sector firms listed on Pakistan Stock Exchange. This study proves the previous research work done on effect and relationship between corporate governance and solvency risk (Anderson & Reeb, 2003; Cheng, Evans & Nagarajan, 2008; Wahla, Shah & Hussain, 2012).

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APPENDIX: DEFINITIONS

Corporate Governance Variables

Board Independence. Number of independent directors in the board.
Board Size. Number of all board members.
CCEO Duality. Chairperson and chief executive officer duality mean that whether one person is performing dual role or separate person
Audit Committee. Number of audit committee members of the company.

Solvency Risk

Times Interest Earned. Earnings before interest and taxes with interest expenses.
Earnings Before Interest and Taxes / Interest Expenses.