THE CORPORATE GOVERNANCE PARADOX: A COMPARATIVE ANALYSIS OF MULTINATIONAL AND DOMESTIC MANUFACTURING FIRMS IN PAKISTAN

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Abstract

This paper examines the impact of firms' location on its corporate governance quality and profitability. There are two commonly held views on the quality of corporate governance and profitability of multinational corporations operating in the developing countries. Firstly, the quality of corporate governance practiced by multinational corporations is generally higher than that of domestic companies. The second view postulates that multinational corporations show better financial performance than domestic companies. The converse side of this coin is that domestic companies have lower profitability due to the poor quality of their corporate governance, but our research reveals an interesting departure from these pervasive inferences. Our results show a strong positive relationship between firms' location and financial performance, better quality of corporate governance for domestic firms and that the multinational corporations' superior financial performance is due to factors other than quality of their corporate governance not covered in the present research.

Keywords: Corporate Governance Index, Location, Corporation, Ratio Analysis

JEL Classification: G34

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Introduction

In the current corporate scenario two views are available related to the quality of corporate governance (CG) and financial performance of multinational firms (MNFs) working in developing countries. According to the first view, the quality of CG practices of MNFs is normally superior to that of domestic firms (DFs) whereas the second view assumes that MNFs are performance wise better than DFs. A fairly large number of research studies, as cited later in this paper, appear to support these two seemingly twin views. Combining these two views, it is concluded that the quality of CG is positively related to the financial performance of firms. This paper looks at the issue in a slightly different way by analyzing the location of firms' impact on its CG quality and eventually their financial performance. We have paid due regard to the size of firms being studied, taking it as a control variable.

Cadbury report on CG (1992) provides the most basic definition of CG describing CG as a system directing and controlling companies. One of the co-authors of this paper (Butt 2013) defined CG as "the mechanism used to control and direct the affairs of a corporate body in order to serve and protect the individual and collective interest of all its stakeholders".

CG practices vary with the location (ownership, control and operation) of firms as ordained by multinational enterprises (MNEs) theory (Dunning, 1988; Hymer 1960; Hennart & Park, 1994; Yu & Ito, 1988). DFs have some clear benefits over MNFs like awareness of the local market and low administrative costs whereas MNFs have the benefits of scale economies (Markusen, 1995). However, they are supposed to bear more cost to balance these benefits; as such they require extra capabilities to compete.

CG indicates the procedures, practices and arrangements that lead a company to be managed and enable a firm to run its matters to meet its objectives and achieve long-term sustainability. All the firm irrespective of size, location and legal status needs good CG practices and can benefit from these. In other words, firms whether small or large, domestic or multinational, public or private require good CG practices and good CG environment. Corporate sector of Pakistan comprise of firms having different sizes and locations. MNFs are supposed to abide by the rules and regulations of their respective host countries besides following the law of their parent country. This has a nominal bar on their objective to maximize profitability. Due to the heterogeneous expertise possessed by MNFs and their strong financial positions, these firms have a clear edge over DFs with respect to financial performance.

Justification for the Research

Past literature related to CG has usually focused on investigating the association linking CG practices with firms' financial performance; scientific research investigating the effect of CG on

firms' financial performance based on location is nominal. To cover the gap in existing research, this study provides a full picture of Pakistani firms by examining the impact of firms' location and CG practices on their financial performance with size as a control variable. The suggestions of the study are useful for usage by researchers, regulators and financial planners for making more informed investment decisions.

Theoretical Background

Many theories in the field of CG are initiated covering different areas. These studies include Alchian and Demsetz (1972), Hymer (1960), Jensen and Meckling (1976), Kapopoulos and Lazaretou (2007), Clarke (2004) and Rhee and Lee (2008). The theoretical base of the current study may be associated to multinational theory clarifying the perception of multinational enterprises, motivations after and ways applies by MNFs for foreign investment (Dunning, 1988; Hymer 1960; Hennart & Park, 1994; Yu & Ito, 1988). The study aims at covering the gap in existing research by analyzing CG practices prevailing in the corporate world among different classes of firms based on location and Corporate Governance index (CGI) as proxy of CG quality to find its impact on firms' performance testing the following hypotheses:

H1: The financial performance of MNFs is stronger than that of DFs
H2: CG practices of MNFs are better than those of DFs
H3: CG practices of firms positively affect their financial performance

While there are obvious benefits for going international, MNFs faces extra costs related to transportation, staff posting abroad, hurdles related to language, traditions, and local rules and regula-tions. These firms are supposed to possess extra capabilities to compete and afford these additional costs. This dominance of MNFs may be associated with the progressive skills these foreign investors possess (Dimelis & Louri, 2002) and product differentiation (Barbosa & Louri, 2005). This point of view is equally applicable to MNFs working in developing economies.

Luo and Tan (1998) suggested more research to compare the operational policies of DFs with MNFs. All these studies have a consensus that the MNFs are more resourceful and performance wise better than DFs because of better CG practices, technical expertise, professional and competent human resources and the benefits of large scale economies. The results of this study can be easily applied in other countries because it covers CG practices of DFs as well as MNFs having a prominent role in influencing world economies.

Methodology

The sample size consists of 153 listed firms [5]. The sample does not include financial firms and

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[5] http://www.psx.com.pk

firms having no data of industrial averages. The secondary data has been obtained from "Balance Sheet Analysis" a publication of State Bank of Pakistan and firms' published data in the shape of annual reports. The data is provided in pooled form from different sectors including sugar, textiles, chemicals, cement and many others.

Variables used in the Study

Variables used in the study include Market to Book Ratio (MBR1) representing firms' performance as dependent variable, Dummy for Domestic and Multinational (DDM), representing location and CGI representing the quality of CG as independent variables and Market Capitalization (MC) showing firms' size and Sales Growth (SG) as controlled variables. CGI is used to determine the CG quality. For numerically valuing each CG practice, Likert scale (Likert 1932) has been used.

Research Model

The study uses the following model:

$$Yit = \beta0 + \sum_{i=1}^{n} \beta iXi + \varepsilon \dots \dots \dots \dots \dots \dots (1)$$

Wald (Wald 1943) and Hausman specification (Hausman 1978) tests have been used for selection of the following research model:

$$MBRit = \beta0 + \beta1 (CGI) + \beta2 (MC) + \beta3 (SG) + \varepsilon \dots \dots \dots \dots \dots \dots (2)$$

However, to bring conformity in the results and cover the deficiency of not accepting dummies (Deloof, 2003), the study uses the following random effect model to analyze the entire sample as a whole incorporating all the variables including dummy variable:

$$MBRit = \beta0 + \beta1 (DDM) + \beta2 (CGI) + \beta3 (MC) + \beta4 (SG) + \varepsilon \dots \dots \dots \dots \dots \dots (3)$$

Analysis and Results

Descriptive statistics indicates that average returns for DFs and MNFs are 1.12 and 3.1 respectively as compared to standard deviation of 2.44 for DFs and 4.91 for MNFs showing better firms' performance for MNFs as compared to DFs. Correlation analysis shows consistent, positive and significant results for both the independent variables which is in accordance with the previous studies (Eisenhardt 1989; Tallman & Li 1996; Lavelle 2002; Harford et al., 2008; Tariq & Abbas 2013).

Ratio Analysis

The study compares MBRs with their respective sample/industrial averages [6]. Firms with MBR more than or equal to industrial average are assumed to be good performers and less than industrial average or negative (even if it is more than industrial average), as weak performers. As reported in table 1, MNFs' financial performance is superior with 46% good performing firms to DFs with 42% good performing firms. This result has a support from previous studies (Ameer 2010).

Table 1
Firms' Financial Performance

Firm's category Segment	Firms with Good Performance		Firms with Weak Performance		Total firms	
	No	% age	No.	% age	No.	% age
DFs	47	42	65	58	112	100
MNFs	19	46	22	54	41	100
Small firms	10	22	36	78	46	100
Medium firms	22	36	39	64	61	100
Large firms	33	72	13	28	46	100
Overall firms	65	42	88	58	153	100

The quality of CG is assessed on the basis of ample average only because of non availability of industrial average. Firms having CGIs equal to or more than SAs are classified as following having better corporate governance system and firms with CGIs less than SAs or negative are grouped as firms having weak CG system. Table 2 reports better quality of CG for DFs (with 33% firms having good governance practices) as compared to MNFs (with 12% firms having good governance practices).

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[6] Comparing profitability and CG variables with industrial/sample averages is in line with previous studies (Singh, 2011).

Table 2
CG Quality Wise Firms Distribution

Category	Good Governance		Weak Governance		Total	
	No.	%	No.	%	No.	%
Domestic	37%	33%	75%	67%	112%	100%
Multinationals	5%	12%	36%	88%	41%	100%
Small	20%	43%	26%	57%	46%	100%
Medium	13%	21%	48%	79%	61%	100%
Large	9%	20%	37%	80%	46%	100%
All	42%	27%	111%	73%	153%	100%

Regression Results

VIF values ranges from 1.001 to 1.09 (table 3), hence no multicollenearity problem exists.

Table 3
Multicollinearity

Segment	DDM	CGI	MC	SG
DFs	--	1.033	1.034	1.001
MNFs	--	1.036	1.041	1.007
Small firms	1.012	1.013	1.003	1.003
Medium firms	1.014	1.002	1.002	1.010
Large firms	1.081	1.070	1.015	1.006
Overall firms	1.083	1.015	1.090	1.001

The models used in the study estimate the results in a better way as shown by F-Statistics and p values. For model stability check, Cumulative sum (CUSUM) recursive residuals test (Garbade 1975; Xiao & Phillips 2002) is used. These results show the stability of the models used in the study. Table 4 reports regression results.

Table 4
Regression Results

Variables	Firms' category	Coefficient	Standard Error	t-Statistic	Prob.
C	Domestic	1.163	0.614	1.894	0.059
	Multinationals	-3.319	1.315	-2.524	0.012
	Small	-1.716	0.711	-2.415	0.016
	Medium	0.242	0.334	0.726	0.468
	Large	-32.358	4.118	-7.858	0.000
	Overall	-0.821	0.567	-1.449	0.148
DDM	Domestic	--	--	--	--
	Multinationals	--	--	--	--
	Small	0.164	0.413	0.396	0.692
	Medium	0.146	0.163	0.892	0.373
	Large	2.164	0.438	4.939	0.000
	Overall	1.990	0.378	5.260	0.000
CGI	Domestic	-0.060	0.262	-0.228	0.820
	Multinationals	2.245	0.545	4.118	0.000
	Small	0.789	0.305	2.590	0.010
	Medium	0.285	0.140	2.039	0.042
	Large	.873	0.464	1.880	.061
	Overall	0.7896	0.228	3.470	0.001
MC	Domestic	0.001	0.001	9.118	0.000
	Multinationals	0.001	0.001	10.840	0.000
	Small	0.001	0.001	3.640	0.0003
	Medium	0.001	0.001	5.872	0.000
	Large	1.379	0.170	8.117	0.000
	Overall	0.001	0.001	9.788	0.000
SG	Domestic	0.136	0.105	1.294	0.196
	Multinationals	0.007	0.159	0.042	0.967
	Small	0.011	0.137	0.082	0.935
	Medium	0.077	0.084	0.910	0.363
	Large	-0.303	0.389	-0.778	0.437
	Overall	0.030	0.090	0.336	0.737

Since both the models (FE and RE) do not accept dummy variable(s) when DFs or MNFs are exclusively analyzed (because of the same value '0' or '1') for the entire segment (as already mentioned), we excluded DDM from the model only for these segments. However, estimating the results of overall sample, DDM has a strong significant and positive relationship with the firms' performance. Overall, CGI has a positive and significant relationship with firms' financial performance. This finding supports our hypothesis 3 that "CG practices of firms positively affect their financial performance".

Location wise regression results show that CGI is positively and significantly related with firms' performance significant in multinational enterprises suggesting an important role of CG in these firms. The possible reasons for negative relation between CGI and DFs' performance are: firstly, local firms are not yet fully aware of the benefits of CG, secondly, attention to CG started only very recently in Pakistan and thirdly, the local CG code is inadequate and disclosure requirements for local firms are very rudimentary. MC representing firms' size and used as controlled variable is positively and significantly related with firms' performance in all categories of firms. Regression results further indicate a positive and significant relationship of CGI with firms' performance suggesting an important role of CG on the basis of size.

Conclusion

The study investigated causes and effects among location, CG and financial performance of manufacturing companies operating in Pakistan. Descriptive statistics show better firms' performance and better CG practices for MNFs and larger firms as compared to DFs and smaller firms as well as better SG in MNFs than DFs. Correlation results indicate a positive and stronger relationship of CG and size with financial performance of MNFs as compared to DFs. Correlation analysis also indicates a positive and stronger relationship of location and size with performance in larger firms than smaller firms.

Clubbing the results of ratio and regression analyses, we are of the view that MNFs performance is better not because of good governance, rather it is better because of location. The quality of CG is not necessarily better in MNFs of all sizes and it does not have a positive relationship with the profitability of MNFs of all sizes operating in Pakistan. Smaller firms appear to have a better quality of CG than larger firms and considering that most DFs are smaller in size of operations than MNFs, the inference is quite clear. Our research has raised some issues that challenge the commonly held views on relationship between CG quality and financial performance. More research in this area will help us all to have a more clear and meaningful picture.

Limitations of the Study

The following are a few limitations and constraints of the study:
1. Based on data availability, the sample size was restricted to 153 firms.

2. Quality of CG was determined on the basis of sample average (SA) only as data on industrial average was not available.

Foundation for Future Research

Further research may be carried out by:
1. Addition of other criteria of firms' classification.
2. Addition of other variables .
3. Extending the scope of research to cover other countries.
4. Adding primary data in addition to secondary one.

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