CORPORATE GOVERNANCE AS A PREDICTOR OF LIQUIDITY MANAGEMENT

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Abstract

This paper is based on a novel theoretical model derived by the researchers to explain the patterns of corporate governance, firms' financial policies and liquidity position. A deductive approach has been adopted to reconcile and examine the model. The study has concluded that corporate governance is a significant variable in determining the liquidity position of firms. In this way, corporate governance becomes a crucial determinant of the liquidity management. This study also indicates that capital structure and the patterns of ownership play important roles in the determination of corporate governance of an institution. This is a value addition study in the existing literature in a sense that corporate governance is an exogenous as well as an endogenous variable in the model. The issue of liquidity crisis in the form of circularity debt, exist in the Energy sector of Pakistan, must be readdressed with the view point of corporate governance rather than from the aspect of financial management.

Keywords: Corporate Governance, Liquidity Management, Circular Debt, Ownership Concentration

JEL Classification: G330

Introduction

It is astonishing that there is no globally accepted one definition of corporate governance. It unlocks the door to academic researchers and practitioners to explore the area in depth. Much of the literature divulges the variety of explanations. Corporate governance in Pakistan is in its developing stage and therefore its definition varies from institutions to institutions. It is the manner by which operations of companies should be conducted (Manual of CG, SECP, P5). The OECD provides its principles, addressing the corporate governance. All definitions have a basic idea of a system through which corporations are directed as well as controlled. Furthermore, corporate governance has many roots to relate, starting from firms' performance to economic growth. The formal and informal institutions in a country progress to undertake different economic activities. Practically, problem arises when some informal activities are found within the formal system of organizations. At times, organizations may be involved in these informal economic activities. They may take undue benefits of

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concentrated ownership, poor protection of shareholders in minority and accepting projects which may destroy the wealth of shareholders. These activities are termed as a problem of corporate governance. Economic governance studies the institutions and organizations while corporate governance deals with internal management of a corporation (Dixit, 2008). This paper takes up corporate governance perspective to support the argument that it can lead to proper liquidity management in a corporation.

The aim of this paper has two folds. First, it attempts to investigate the corporate governance practices being followed in the public listed firms in Pakistan. Some big families in Pakistan have more than one business. Transfer of one CEO to another company is a common practice which hinders the corporate governance practices. Similarly, managerial remuneration is also biased due to relationship based corporate governance structure. Salaries and other requisites are not performance based, rather determined either on political or relationship grounds. Therefore, Managerial remuneration scaled by capital is taken as the proxy of corporate governance. Secondly, the study aims to examine the issue of liquidity problem exists in the form of circularity debt exist mainly in the energy sector of Pakistan in relation to corporate governance. It is an attempt to explain not only the factors contributing good corporate governance but also to seek an understanding of its relationship with liquidity crisis with respect to circularity debt. The study has a fundamental premise that bad corporate governance is responsible for the existence of circularity debt. Pakistan has been facing this phenomenon for almost one decade. There were several solutions given but no one was long run. This study is an endeavor to recommend a long lasting as well as beneficial solution for both the government as well as all stakeholders.

Though, the energy sector of Pakistan can be described as the best case study to describe the role of financing and liquidity crisis where circularity debts have been highly debated in the public media. The outcome and conclusions are equally applicable in the rest of sectors and have their global implications in case of other countries also.

It is noteworthy that all efforts to resolve liquidity crisis and managing the circularity debt in energy sector have gone in vine. Why political will have become in vein? Why managerial and administrative measures have failed? Why issue has become chronic? Why the theories of financial management have failed in the practice? A gap has been ascertained in this research. It was pointed out that in applying the financial theories and taking managerial actions, the role of governance cannot be isolated. The bad governance is the root cause of economic deterioration, while governance is not a financial problem; it is a managerial issue.

Literature Review

Corporate governance has been defined by various researchers. Some researchers went on the agency problem due to the separation of ownership from agent i.e. management (Roe, 1994). Others discussed the phenomenon with reference to the methods that people employ to guard their happiness in social exchange (Li & Filer, 2007). Shleifer & Vishny (1997) demonstrated a comprehensive definition of corporate governance by combining the above two. They explained it as the usefulness of mechanisms that lessen agency conflicts while putting particular emphasize on the legal mechanisms that thwart the expropriation of minority shareholders.

It is practically experienced in Pakistan particularly and the world, in general, that the corporate governance practices, in organizations differ significantly. In every country, there are companies which are being operated with different ownership structure, capital structure, board size, number of independent directors and the like. Cara, Tarek, Chong and Brian (2005) confirmed these variations which occur as a result of differences in institutional arrangements connected to business systems. These differences were also confirmed by Aguilera and Gregory (2003) and concluded that institutional differences matter by their capacity to support different modes of interaction among stakeholders at the firm level.

There are varying corporate governance systems and models. Relationship-based model and market model, which differs in relative efficiency, is an essential issue for many corporate governance researchers (John & Senbet, 1998). This issue becomes more enticement when these suitable corporate governance systems are selected by emerging markets to seek the implementation. Generally, market structures of emerging market differ from those of developed market and conventional governance systems show litter effectiveness. Majumdar and Pradeep (1999) focused the corporate governance in India and suggested that state ownership in financial institutions must be readdressed. Pakistan is a country where ownership is concentrated which distort the good corporate governance practices (Javid & Robina, 2010). Whenever debt is needed, banking channel is preferred as loan on a premium interest rate. This leads to a conclusion that relationship based model of corporate governance is preferred in Pakistan. Managers used to enjoy the relation with bankers and take loans to increase the market value of the firm which may result the bankruptcy in future. The only objective of managers is to receive high perquisites without considering the future outlook of the firm. As compared to external governance mechanisms, internal governance mechanisms of control are dominated in firms. Capital market is in its development stage, weak-form of efficient stock market and lack of an active market of corporate control due to concentrated ownership. Furthermore, market incentives are poor due to the existence of market anomalies and misconduct.

The corporate sector of Pakistan is dominated and controlled by founder families or group of families. For instance, one family owns several firms not only in the same industry but also diversified in other industry as well. Ownership is surrounded among them and their decisions are dictated. Oman, Fries and Buiter (2003) revealed that the main impending conflict of interest in the market of developing, transition and emerging countries are likely to mount not between manager and owners of a corporation as seen in the US and the UK but among controlling shareholders and other scattered shareholders.

Liquidity Problem in the Form of Circularity Debts

Circular debt arises when one entity faces problems in its cash inflows and consequently fails to discharge its obligations. Similarly, second entity does not receive its payments; it further withholds the disbursement to other entity. As a result, this perturbs all segments of the payment chain. Payable of one organization becomes receivable for another organization. When subtract one from the other, these should be cancelled out or the difference should be smaller in number. In case of energy sector in Pakistan, this amount was estimated to be Rs.537 billion as on June 30, 2011 and Rs.872 billion as on June 30, 2012, account for roughly 4% of the nation GDP (Planning Commission of Pakistan, 2013). How much liquid balance is held by a corporation is influenced by factors such as transaction costs, opportunity costs and informational asymmetries (Bruinshoofd & Kool, 2004). Informational asymmetries between firms and capital markets are an important precautionary motive for corporate liquidity demands. Opler, Pinkowitz, Stulz and Williamson (1999) introduced a useful structure for opinion about the possible factors because of which firms hold cash. Liquidity management of firms is essential as it is the base of arguments of overinvestment or understatement (Jensen, 1986; Jensen & Meckling, 1976; Myers & Majluf, 1984). The significant value of cash cannot be denied and therefore a liquidity management practice of a firm is vital for success of a firm. Kim, David and Ann (1998) developed a model based on cost-benefit trade-off between the holding cost of liquid assets and benefit of minimizing the need of profitable investment opportunities with costly external financing. The results show positive relationship between liquidity and cost of external financing. The study found that firms with hither market to book ratio have larger liquid assets while firm size is negatively related to liquidity.

Pakistan Electric Power Company (PEPCO) is an umbrella company which is responsible to collect tariffs from its customers and Government and disburse to its suppliers like IPPs, Oil and Marketing Companies (OMC) and gas companies. Cash outflows of the PEPCO are sure because these are obligation which has to be fulfilled. Cash inflows are uncertain because of absence or delay in tariffs payments. Sometimes government delays in subsidies while on the other hand, some powerful individual and government institutions withhold their payment. Ultimately this accumulates the receivable amount in the PEPCO account which results delay in payment to its suppliers which in turn seize payment to top of the segment. This imbalance of cash flows is one of the reasons of circularity debt. Table 1 shows the receivables from all distribution companies, called DISCOs from 2008-09 to 2011-12 alongwith their share in the total receivables. This is evidenced in the table 1 that poor revenue collection by PEPCO from DISCOs is one of the causes of circularity debt.

Table 1
Receivables from DISCOs (Million Rs.)

DISCOs	2008-09	2009-10	2010-11	2011-12	% Share
PESCO*	26,809	32,902	41,282	51,360	26%
HESCO*	18,856	25,454	33,344	44,237	22%
QESCO	4,297	5,238	24,780	48,193	24%
LESCO	10,957	15,968	17,081	23,080	12%
GEPCO	3,585	5,322	5,631	5,912	3%
FESCO	3,719	5,676	5,866	7,068	4%
IESCO	2,287	2,286	2,762	2,703	1%
MEPCO	7,252	10,505	11,900	14,638	7%
Total	**77,762**	**103,351**	**142,646**	**197,191**	**100%**

Source: Monthly Economic Review Saturday, 29th November 2014
*PESCO includes TESCO and HESCO includes SEPCO

It is reality that there is bulk amount of receivables in the books of PEPCO from DISCOs but on the other hand, DISCOs also have a huge amount of receivable from different provinces of Pakistan. Table 2 gives the fact of these receivables.

Table 2
Receivables of DISCOs from Provinces and AJK (Million Rs.)

Province	2005	2006	2007	2008	2009	2010	2011	2012
Punjab	(481)	(9)	(381)	162	(7)	3,263	5,371	5,842
KPK	239	398	652	254	601	1,144	19,427	19,792
Baluchistan	538	119	146	709	1,064	2,419	4,662	52,696
Sindh	341	2,382	3,224	7,603	14,241	25,790	39,230	6,200
AJ&K	(50)	485	756	1,216	2,391	4,393	9,888	15,953
Total	**587**	**3,375**	**4,397**	**9,944**	**18,290**	**37,009**	**78,578**	**100,483**

Source: PEPCO DISCOs Performance Statistics Report (FY 2005 – FY 2012)

Table 3 shows some highlights of the receivables and payables of public corporation in Pakistan for 2010 and 2011. It can easily be comprehended that receivables are greater than payables which implies that circularity debt is the governance issue which can be overcome through good governance. Zheka (2007) suggested positive relationship between improved liquidity position and good corporate governance practices. García-Teruel, Pedro and Juan (2009) found inverse relation between accounting accruals quality and the cash level by firms.

Table 3
Distribution of Circularity Debt Receivables (Billion Rs.)

Company	**Receivables**	**Payables**	**Net Position**		**Change**
			30-Apr-11	**30-Apr-10**	
PSO	149	98	51	30	21
SSGCL	51	44	7	-1	8
SNGPL	11	25	-13	-9	-5
PEPCO	304	302	3	-40	42
OGDCL	116	0	116	80	36
PARCO	38	-	38	30	8
KESC	68	40	28	-24	51
GHPL	10	-	10	11	-1
PPL	22	-	22	26	-4
KW&SB	7	8	-1	0	-1
Grand Total	**775**	**517**	**259**	**104**	**155**

Source: Ministry of Finance

Methodology

Data, Variables and Technique

This research is aimed at studying and exploring the corporate governance and liquidity crises through a model. In order to achieve these objectives, secondary data was collected through audited annual accounts of sampled companies from 2005 to 2011. Since some of government owned firms do not get their financials and other information disseminated, we have included only those firms for which audited annual accounts are available. Mainly, we focused on energy sector as it has been facing the liquidity problem in terms of circularity debt for many years. In order to separate government-owned firms from IPPs, firms with more than 60% shares are assumed to be government owned. Because of the nature of the models, 2-stage least square regression is appropriate to explain the phenomenon. Because of the binary dependent variable in the second model, logit regression was applied. Table 4 explains the variables measurement.

Table 4
Variables

Dependent Variable	Determinants	Independent Variables	Determinants
Corporate Governance	➢ A Ratio of Salary & Other Perquisites of Management to Capital	➢ Type of the organization	➢ Government or Non-government
		➢ Ownership Concentration	➢ Percentage of shares held by directors
		➢ Capital	➢ LTD+Equity
		➢ Distribution of Assets	➢ Current Asset / Fixed Assets
Liquidity	➢ Circularity debt 1= circularity debt exist 0= otherwise	➢ Corporate Governance	➢ From Model 1
		➢ LTD	➢ Long Term Debt
		➢ Cash Generated during the year	➢ Cash Flow to Noncash Assets
		➢ Corporate Assets	➢ Fixed Assets to Noncash Assets
		➢ Sales	➢ Log of Sales

Propositions

Proposition 1

- Firm specific factors explain corporate governance practices.

  Firm specific factors include type of the organization (ORGTYP), ownership concentration (OWNCONCT), log of capital (LOGCAP) and distribution of Assets (CAFA).

$$CG = \alpha_0 + \alpha_1 ORGTYP + \alpha_2 OWNCONCT + \alpha_3 LOGCAP + \alpha_4 CAFA \ldots\ldots\ldots\ldots\ldots (1)$$

Where α is the parameter

This proposition leads to the following corollaries.

Corollary 1

Public sector ownership of a firm affects the pattern of institutional governance.

Corollary 2

Ownership concentration distorts the corporate governance practices.

Corollary 3

The combination of debt and equity plays a pivotal role in determining the governance practices.

Corollary 4

High amount of current assets lead to higher expenditures on top management.

Proposition 2

- Good corporate governance leads to better liquidity management in a firm.

  Circularity debt (CD) is the proxy of liquidity

$$CD = \beta_0 + \beta_1 CG + \beta_2 LOGLTD + \beta_3 CFTNAST + \beta_4 CAPEXPTNAST + \beta_5 LOGSALES \text{ .... (2)}$$

By incorporating model 1 into it, we have;

$$= \beta_0 + \beta_1(\alpha_0 + \alpha_1 ORGTYP + \alpha_2 OWNCONCT + \alpha_3 LOGCAP + \alpha_4 CAFA) + \beta_2 LOGLTD + \beta_3 CFTNAST + \beta_4 CAPEXPTNAST + \beta_5 LOGSALES$$

So we have

$$= \beta_0 + \alpha_0\beta_1 + \alpha_1\beta_1 ORGTYP + \alpha_2\beta_1 OWNCONCT + \alpha_3\beta_1 LOGCAP + \alpha_4\beta_1 CAFA + \beta_2 LOGLTD + \beta_3 CFTNAST + \beta_4 CAPEXPTNAST + \beta_5 LOGSALES$$

While CG is the predicted values of corporate governance taken from model 1
Where α and β are the parameters

Followings are the corollaries of the proposition 2

Corollary 1

Circularity debt problem can be mitigated by good corporate governance practices. It will lead them to take decisions, for instance leverage, which is aligning with all the shareholders of the firm.

Corollary 2

Decisions of board of directors like investment in fixed assets, management of cash flow and growth in sales are very much related to liquidity management.

Table 5
List of Abbreviations of Variables

S.No.	Variable	Description
1	CG	Corporate Governance
2	ORGTYP	Type of the Organization
3	OWNCONCT	Ownership Concentration
4	LOGCAP	log of Capital
5	CAFA	Current Assets divided by Fixed Assets
6	CD	Circularity debt
7	LOGLTD	Log of Long Term Debt
8	CFTNAST	Cash Flow to Net Assets
9	CAPEXPTNAST	Capital Expenditure to Net Assets
10	SALES	Sales Revenue

Theoretical Model

The model starts from the premise that corporate governance can be explained by firm specific as well as some exogenous variables. Any change in any of the exogenous explanatory variable will automatically change the corporate governance settings. The second part explains the causes of circularity debt which results the liquidity problem among firms. These causes are exogenous variables along with the predicted values of corporate governance taken from the first model. It is hypothesized that corporate governance can mitigate the problem of rising circularity debt exist in the economy.

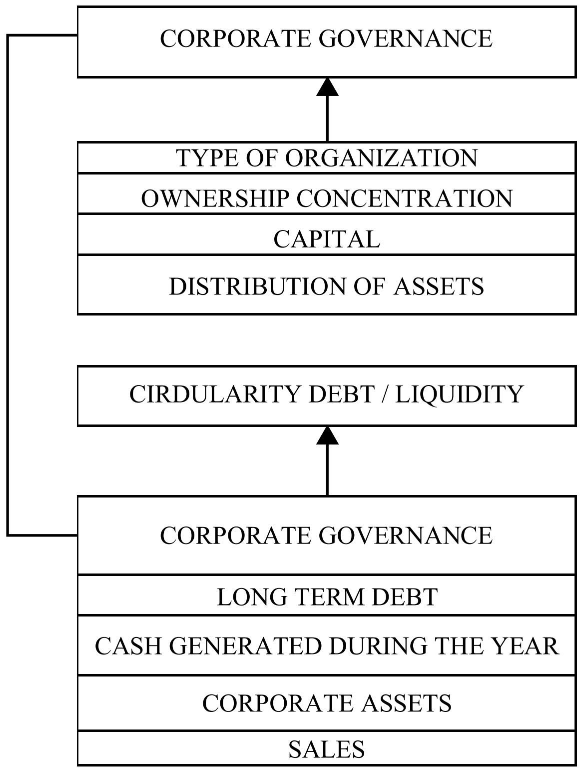

Figure 1: Theoretical Model

Results and Analysis

Determination of Corporate Governance

Table 6 illustrates the results of proposition 1. Type of organization is introduced as a dummy variable, taking the value of 1 in case of government-owned listed firms and 0 for private-owned listed firms. The results show that in the absence of private-owned listed firms, there is positive and significant relationship with the corporate governance proxy. It reveals that directors in the government-owned listed firms get benefit by increasing their salary and other perquisites. This evidence is supportive of the general arguments prevailed in the market and among institutional as well as individual investors. This depicts the bad corporate governance being practiced in government-owned firms. This is also one of the reasons as to why this sector is not helping common people in the form of providing proper electricity in the country.

Ownership concentration has a negative impact on corporate governance practices of firms. Corporations with concentrated ownership allow directors to get maximum benefit from the firm. Their salary and other perquisites are increased for nothing. If some controlling shareholders are dominant in the firm, they will enjoy this opportunity to be benefited from this option.

Capital also has negative and significant impact on corporate governance state of firms. As the capital increases, the ratio of salary and other perquisites of directors will be in a declining position and vice versa. Capital may be enhanced by increasing the debt or by issuing shares and raising the capital. Debt increase will also enhance the fixed costs of the company and can lead to bankruptcy position in future. It also strikes investors to start demanding higher equity return in the market. Share issue has an initial cost but feasible to most of the investors. It is, therefore, difficult to explain that this negative relationship is due to debt or equity level in the capital.

Investment decisions show the strategic direction of a firm. Larger investment in liquid assets restricts the firm to get benefit from growth opportunities exist in the market. Moreover, liquid assets also include cash balance which may be used to undertake any project without going into the market, hence no more monitoring by outside investors are needed. The result reveals that firms heavily invest in current assets as compared to fixed assets. It may be deduced that directors use this money on their discretion.

Table 6

Results

Proposition 1 Corporate Governance			**Proposition 2 Liquidity as Circularity debt**		
Variables	**Coefficient**	**Std. Error**	**Variables**	**Coefficient**	**Std. Error**
Intercept	-0.462	0.584	Intercept	-45.893	8.291
TORG	0.175* (1.941)	0.090	PREDCG	-2.547*	1.294
OWNCON	-0.012* (-4.744)	0.003	LOGLTD	1.845*	0.464
LOGCAP	-0.148* (-2.200)	0.067	CFTNAST	0.041*	0.016
CA/FA	0.015* (4.868)	0.003	CAPEXTNAST	-0.014*	0.008
			LOGSALES	4.201*	0.952
Adjusted R2	0.276				
F Statistics	16.837				

* Significant at the 5 percent levels
t statistics are in parenthesis

Reasons of Circularity debt

Since dependent variable in the second proposition is dichotomous, we applied logistic regression. Circularity debt is taken as a proxy of liquidity problem exists in public listed firms of Pakistan. It takes the value of 1 if any company faces this phenomenon and 0 otherwise. As expected, the negative sign of the corporate governance shows the acceptance of our hypothesis that circularity debt exists because of bad corporate governance in the energy sector of Pakistan. As discussed that the figures of circularity debt are the accounting treatment of receivables and payables. Since table 3 shows positive difference, it is evidenced that this problem is not because of financial management but of corporate governance. Corporate governance (PREDCG) is the predicted values taken from model 1 which means that it is itself the function of some exogenous variables. In other words, variables which explain the phenomenon of corporate governance is badly managed which causes the increase in circularity debt.

It is Interesting to note that an increase in long term debt is linearly related to the problem of circularity debt. Debt is used to finance any new project which is supposed to generate positive net present value in order to maximize shareholders' wealth. If LTD is used for this purpose, then there is economic significance of this result. This result does not follow either pecking order or free cash flow theory. The evidence of trade-off theory with respect to leverage is unknown. Poyry and Benjamin (2009) confirmed that in firms where state is the controlling shareholders, debt financing is seen more as compared to equity financing. Cash flow to noncash assets is also significantly positive which means circularity debt tends to increase with cash flows. This is consistent with the pecking order theory which implies that when cash flows are high, corporations use this cash to finance new projects, settle their liabilities, pay dividends and finally accumulate cash to manage working capital requirements. When we look at the result of capital expenditure to noncash assets (CAPEXTNAST), it is significantly negative, showing evidence that firms with high cash flows invest in fixed assets which cause to accumulate the amount of circularity debt. The remaining cash is kept a side for day to day activity.

Results show that an increase in sales also helps circularity debt to pile up. Since all sales are made on credit, we assume this result is as per our expectations. These credit sales are not converted into cash in near future, the amount of circularity debt increases. In other words, this result is following the pecking order as well as free cash flow theory. We can conclude this result by combining all variables into consideration. Companies make credit sales and somehow generate operating cash flows to fulfill the working capital requirements. Since this cash is not enough to finance new profitable projects, due to increase in receivables, they have to take long term loans.

Significant Contribution of Each Variables

Further, to check the significant contribution of each variable in the first proposition, this is divided into four parts, explaining the corporate governance phenomenon in details as presented in table 7. The first part shows that corporate governance is positively affected by the type of organization. Since the dummy variable takes the value of 1 in case of government organization, this is evidenced now that government influences over the implementation of corporate governance practices. In addition to type of organization, the second part also incorporates the ownership concentration but the TORG variable becomes insignificant here. Ownership concentration gives evidence of negative impact on corporate governance. As stated earlier that Pakistan is the country where concentration is evidenced, this result was as expected. Part 3 incorporates capital in addition to above two explanatory variables. All three variables are significant. As expected, the sign of ownership concentration is negative. Type of organization is significant in this model because of inclusion of capital. This is again evidence that government organizations heavily invest in salaries & other perquisites of managers. The negative sign of capital indicates that as the capital deceases, the proxy of corporate governance increases which shows bad corporate governance practices. Finally, part 4 includes all explanatory variables, showing significant results. Corporate assets (CA/FA) have a positive impact on the corporate governance, indicating that firms heavily invest in current assets instead of fixed assets.

Table 7

Significant Contribution of each Variable

Proposition 1 - LOGCG								
Variables	**Part 1**		**Part 2**		**Part 3**		**Part 4**	
	Coefficient	**Std. Error**	**Coefficient**	**Std. Error**	**Coefficient**	**Std. Error**	**Coefficient**	**Std. Error**
Intercept	-0.160	0.055	-0.012	0.062	1.248	0.498	-0.462	0.584
TORG	0.264 (3.050)*	0.087	0.118 (1.334)	0.088	0.222* (2.315)	0.096	0.175* (1.942)	0.090
OWNCON			-0.012* (-4.514)	0.003	-0.014* (-5.149)	0.003	-0.012* (-4.744)	0.003
LOGCAP					-0.183* (-2.552)	0.072	-0.148* (-2.200)	0.067
CA/FA							0.015* (4.868)	0.003
No. of Observations	166		166		166		166	
Adjusted R^2	0.053		0.148		0.175		0.276	
F Statistics	9.30		15.384		12.771		16.837	

* Significant at the 5 percent levels

t statistics are in parenthesis.

Conclusion

The present research is a blend of corporate governance and liquidity management. It develops a theoretical model, identifying antecedent variables which can better expound the given phenomenon. It has now come into the fact that liquidity crisis in firms can be managed if corporate sector plays its rigorous role to improve the governance state within the firm. Government of Pakistan must focus on the issue of circularity debt from the governance point of view rather from the perspective of finance. Government is responsible to create a business environment where transparent management of public finance becomes possible at the national level. In case the government regulation is not efficient, rules of conduct for the private sector are desired. Particularly, improving the corporate social responsibility and relevance of corporate governance are needed.

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