The Impact of Corporate Governance and Firm Financial Performance on Foreign Institutional Ownership in Pakistan Equity Market.

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The Impact of Corporate Governance and Firm Financial Performance on Foreign Institutional Ownership in Pakistan Equity Market.

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Dedicated To

MY PRAISE WORTHY MOTHER

DEARLY LOVED FATHER (LATE)

Abbreviations

Electrical Machinery & Apparatus (Household goods)	EM & A (HG)
Information & Comm. & Transport (fixed line telecommunication)	IC & T (FLT)
Other Non-Metallic Mineral Products (cement)	ONMM (Cement)
Textile Sectors (Spinning, Weaving & Finishing)	TS (S,W & F)
Textile Sectors (textile articles) personal goods	TS (TA)
Chemicals & Pharmaceuticals	CP
Food (Other Food Products)	F (Other Food Products)
Food (Sugar)	F (S)
Fuel & Energy (oil & gas producers)	F & E (O & GP)
Miscellaneous	M
Motor Vehicles, Trailers & Auto parts	MVT & A
Other Manufacturing	OM
Other Non-Metallic Mineral Products (Mineral Products)	ONMM (MP)
Other Services Activities	OSA
Textile (Other Textile)	T (Other Textile)

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Abstract

The aim of the study is to empirically explore the impact of firm level corporate governance and firm financial performance on foreign institutional ownership. Statistical sample of the study includes 70 listed companies from Karachi stock exchange. The sample period consists of 6 years from 2007 to 2012. Descriptive statistics, the correlation matrix, panel unit root test and common effect model is used as most appropriate techniques to determine the impact of board size, board independence, audit committee independence and firm financial performance (independent variable) on foreign institutional ownership (Dependent variable). Size, leverage, growth rate and dividend cover ratio are used as control variables. Results indicate that board size has significant and negative impact on foreign institutional investors. Board independence has significant and negative impact on foreign institutional ownership. Audit committee independence has significant and positive impact on foreign institutional ownership. In this study two proxies are used to measure firm financial performance. (1) Return on equity (ROE) for measuring firm's internal financial performance and Tobin's Q ratio (TQ) for measuring firm's external financial performance. Return on equity has significant & negative impact on foreign institutional ownership. Similarly Tobin's Q ratio has significant negative impact on foreign institutional ownership. In this study Tobin's Q ratio consider as an appropriate proxy for measuring firm financial performance because it explains 34% model of the study while return on equity explains only 32% model of the study. Among control variables size of the company shows significant and positive impact on foreign institutional ownership. Similarly second control variable leverage ratio of the company is also explains significant and positive impact on foreign institutional ownership. Third and forth control variable growth rate and dividend cover ratio depicts insignificant results. According to this study these two control variables have not any impact foreign institutional ownership.

This study employs industrial dummies for capturing the industrial effect. According to results food (sugar) sector depicts significant negative results while Motor Vehicles, Trailers & Autoparts sector shows significant positive result. Other non metallic mineral product sector and textile sector (spinning, Weaving & finishing) sector show significant and negative results. It indicates that these industries have different behavior from reference industry. The behavior of other ten industries aligns with the behavior of reference industry.

CHAPTER 1

INTRODUCTION

1.1 Background/Historical overview of the study

Foreign ownership impediments have dramatically reduced with the introduction of financial market liberalization. The opening of domestic stock market for foreign investors is called market liberalization (Chen et al., 2013). Market liberalization increases the investor's activities in capital market and also enhances the overall market value (Luan et al., 2012; Kim & Singal, 2000). In 1990s, foreign institutional investment was the most forceful source of capital in emerging markets (Prasanna, 2008). In 2002, 'Business Week' the international magazine declared KSE as the best performing stock market. Since then foreign investors consider Pakistan stock market in their investment decisions (Pakistan Economic Survey 2011-12). Moreover Alam (2013) in recent times purported that KSE has become the best performing market in the world by obtaining 15% gain in dollar terms on its benchmark index from last quarter of fiscal year 2013. The two main events, market liberalization (1991) and the announcement of corporate governance reform (2002) attract more foreign investors in Pakistan stock market. According to Nishat & Shaheen (2004) the most important reform in Pakistan was the opening of economy for foreign investors on very liberal terms in 1991 and this reform produced positive results. This reform has increased the direct and indirect investment by foreign institutional investors in Pakistan capital market; the foreign exchange reserve of the country has increased from $2279.2 million (1998-99) to $12327.9 million (2003-04) (Nishat & Shaheen, 2004).

In a conference held on 11 June 2013, the chairman of KSE Muneer Kamal highlighted the performance of stock market in Pakistan. He stated that strong corporate fundamental creates bullish trend in Pakistan stock market. Financial globalization guides many firms to implement better corporate governance mechanism for attracting foreign capital (Aggarwal et al., 2010). According to McKinsy and company survey on corporate governance (2002) quoted that "our investment group would never approve an investment in a company with bad corporate governance", Investors state that they are ready to pay more premiums for companies with strong corporate governance and consider it as a heart in their investment decisions. Recent empirical findings also support this claim (Giannetti & Simonov, 2006). La Porta et al., (1998) mentioned Pakistan as a common law country and assigned score of 5 in their anti-directors right index therefore Pakistan should be a country with greater investor protection attracting a huge amount of investment. But in reality Pakistan is lagging behind in attracting foreign investors as compare to other Asian economies (Chaudary et al., 2006). According to Javid and Iqbal (2008) poor investor protection exists in Pakistan. The poor investor protection can be a major reason behind less investment by national and foreign investor in Pakistan capital market (Shah, 2009). Poor legal protection at country level to minority shareholder was a hurdle to elevate the foreign capital (Reese Jr & Weisbach, 2002; Giannetti & Koskinen, 2010). According to the Uwalomwa and Olamide (2012) individual investors avoid investing in emerging markets because lack of strong legal protection and a large scale of uncertainty in their investment environment. Douma et al., (2006) explained that foreign shareholders reluctant to invest in companies with poor performance. Institutional investors have direct and indirect impact on firm performance, through ownership they can directly influence the manager's activities and through trading shares of the company they can indirectly impact on company performance (Gillan & Starks, 2002). As regard the impact of foreign investment on firm performance, it was asserted that foreign owned firms performed well in productive sector (Griffith, 1999; Oulton, 2000) and firms that are controlled by foreign shareholders perform well in the market (Chhibber & Majumdar, 1999).

1.2 Gap Identification

Following studies discussed foreign institutional investor's preferences with respect to firm characteristics (Fang & Stilz, 1997) from Finnish stock market (Liljeblom & Loflund, 2005) and from Korean stock market (Kim & Yoo, 2009). Foreign investors bring changes in corporate governance structure of the company (Fogel, 2013; Choi & Kim, 2013). A study from Taiwan stock market explored foreign ownership in context of informational asymmetry. Researcher indentified firm characteristics that attract foreign ownership (Lin and Shiu, 2003). Similarly from China, a paper discussed the effect of state ownership on local and foreign institutional investors with respect to informational advantages (Ding & Ni, 2010). A study from emerging market (Korea) answer the question why financial impact of liberalization in developing countries are not as large as mentioned in theory. They discussed the cross firm variation in corporate governance before and after the equity market liberalization (Bae & Goyal, 2010). A study investigated the role of institutional investors in promoting corporate governance and convergence of corporate governance practices across 23 countries from developed market (Aggarwal et al., 2010).

In Nepal researcher investigated the impact of corporate governance mechanism on performance of the financial institutions. The study was conducted on 29 commercial banks of Nepal (Poudel & Hovey, 2013). Similarly in Kenya researcher explored the impact of ownership structure, corporate governance on bank's performance (Mangunyi, 2011). A study from Sri Lanka stock market investigated the impact of ownership structure on financial performance of the firm (Wellalage & Locke, 2010). A study conducted in Taiwan stock market and captured 241 electronic firms. The researcher core intention was to examine how corporate governance (transparency, disclosure) attracts the foreign institutional investors and the impact of foreign investment on firm performance (Luan et al., 2012). In Sweden stock market Bjuggren et al., (2007) explored the impact of ownership structure on investment decision of the firms and ultimate impact of these decisions on firm's performance. A study from Turkish stock market observed the relationship between corporate governance and firm performance and impact of institutional ownership (domestic, foreign) on firm's financial performance (Gurbuz et al., 2010). A study from emerging market (South Korea) observed the role of institutional ownership in relationship between ownership structure (concentration ownership and identity of ownership) and corporate performance (Lee, 2008). In Kenya researcher examined the affect of ownership structure on firm's performance (Ongore et al., 2011). Kumar (2001) examined how the ownership structure impact on performance of 2478 firms from Indian stock market. Wahyuni & Prabowo, (2012) examined the relationship between shareholders having control on corporation operations and firm's performance in Indonesia. A study examined the association between corporate governance and foreign investment from 29 emerging and developed countries (Leuz et al., 2006). A study investigated the association between corporate governance structure and foreign ownership by considering 31 listed companies of financial sectors from Nigeria stock market (Uwalomwa & Olamide, 2012). Douma et al., (2006) examined the impact of foreign institutional corporation on firm's performance in emerging markets. A study explored the relationship between foreign investor and corporate governance in Korean stock market (Kim et al., 2010).

O'Connor et al., (2013) investigated the association among firm level corporate governance and its value, country level investor protection, and investable premia in emerging markets. La Porta et al., (2000) highlighted the association between investor protection and corporate governance. A study from emerging markets examined the relationship between corporate governance and cost of equity capital with interactive terms of country level legal protection of investors (Chen et al., 2009). A study explored the relationship between ownership structures (a key mechanism of corporate governance) investor protection and firm performance from 26 emerging markets (Boubakri et al., 2003). Another study was conducted in emerging markets, captured the relationship between firm level and country level variables. These variables were related with financial and corporate governance structure (Aggarwal et al., 2003).

Giofre (2013) analyzed the impact of investor protection laws on foreign investment (foreign equity portfolio investment, foreign bond portfolio investment). A study from 30 emerging markets explored the affect of country level and firm level factors on investment decisions of 114 U.S. mutual fund institutions (Aggarwal et al., 2005). A study investigated impact of investor protection on relationship between firm level reporting standards and foreign ownership by taking data of 54000 firms from 72 countries (Hansen et al., 2013).

In Pakistan a study was conducted on 60 non financial firms of Karachi stock exchange. Researcher aim was to capture the factors that affect to access external finance (Javid & Iqbal, 2010). Most related studies have done in United States and discussed the role of country level and firm level financial and corporate governance attributes in attracting foreign institutional investors (Aggarwal, 2003; Ferreira & Matos, 2008; Ferreira & Matos, 2006; Klapper & Love, 2004; Dahlquist et al., 2003). Hasan et al., (2011) examined the relationship between firm level corporate governance, country level corporate governance (Investor Protection) and firm performance in MENA region. Only one study from India explored the relationship between firm level corporate governance factors, firm specific financial performance factors and foreign institutional ownership (Prasanna, 2008). To the best of researcher knowledge, no study theoretical and empirically explored the relationship between firm level corporate governance structure, firm specific financial performance factors and foreign institutional ownership in Pakistan. Moreover the impact of corporate governance mechanism and firm financial performance on foreign institutional investors is not yet clear in Pakistan equity market. This study is going to fulfill this gap by incorporating the impact of corporate governance structure and firm financial performance on foreign institutional ownership in Pakistan equity market.

1.3 Justification of the study

In past, researchers have defined the relationship between country level corporate governance, firm level corporate governance and its impact on foreign institutional investors in developed markets (Aggarwal et al., 2003; Ferreira & Matos, 2008; Ferreira & Matos, 2006; Klapper & Love, 2004, Kim et al., 2010, and Dahlquist et al., 2003). Only one study from developing market particularly in India captured the relationship between corporate governance, firm performance and foreign institutional ownership (Prasanna, 2008). It is also important to examine this issue in Pakistan stock market because of following reasons. First, Corporate governance has become most important issue in different countries after financial accounting scandals (Guruz et al., 2010). Second, only few studies have discussed corporate governance in Pakistan stock market (Shah, 2009; Javid & Iqbal, 2010). Third, there is prevailing different corporate governance mechanism at a firm level from developed markets. Fourth, there exist different rules and regulatory laws at the country level. Fifth, at a firm level every country has specific type of ownership structure. Sixth, investment environment in Pakistan stock market for foreign investors is quite different as compare to other markets because of government interference. Because of above discrepancies, it is important to check out the association between firm level corporate governance, firm financial performance and foreign institutional investment in Pakistan equity market. Therefore, it is immense important to find out what factors at a firm level are helpful for attracting foreign investors in Pakistan equity market. Lastly corporate governance and firm financial performance factors make this work unique from other studies.

1.4 Motivation of the study

The main motivation of this study is the lack of theoretical and empirical evidence on issues related to the corporate governance structure, firm financial performance, and foreign institutional investors in developing countries like Pakistan. Investor's protection at firm level in listed companies of Karachi stock exchange is the most imperative subject in this respect. Thus the findings of this study is important because it provides the depth understanding about how the firm-level corporate governance and firm financial performance can attract foreign investors in Pakistan equity market which has become a crucial issue after financial accounting scandals.

1.5 Theoretical Foundation

Principal and agent conflict is a central issue in corporate governance (Mangunyi, 2011). This principal and agent problem occurs when owners (Principal) have different objectives and preferences from the managers (Agent) of the firm. This divergence of interest is called agency theory. In this study foreign institutional ownership (the principal) linked with firm level corporate governance adopted by the controlling shareholders (the agent) through principal-agent theory. Separation of ownership from controls creates agency problems between shareholders and managers. Same types of conflict can arise between shareholders and creditors (Jensen & Mechling, 1976). The major reasons behind this divergence are wealth expropriation and risk shifting (Jensen & Mechling, 1976). In the absence of proper corporate governance mechanism managers get a chance to precede their own interest on shareholder's interest (Berle & Means, 1932). Better ownership structure reduces the agency cost that is associated with separation of ownership from control and this cost can be used to protect the property rights of the firm (Barbosa and Louri, 2002).

Foreign ownership plays a vital role in corporate governance reforms and in monitoring the activities of the management (Dahlquist & Robertsson, 2001). Institutional investors play dominant role in changing corporate governance structure of any country (Gillan & Starks, 2002). They directly (through their ownership) can affect the manager's activities and indirectly (through trading shares) can affect the company performance (Gillan & Starks, 2002). According to institutional theory, institutions can pressurize firms to adopt better accounting standards and principles (Collin et al., 2009). Past studies empirically have supported this assertion that institutions have power to influence firm's value (Lee & Pennings 2002; Thornton 2002).

The impact of foreign shareholders on firm performance can be explained through resource-based theory. According to this theory, a firm can get competitive edge on same type of others firms through different tangible and intangible resources which are costly and not access able for other competitors. In emerging markets, foreign and domestic shareholders are important source of capital for firms and have different impact on firm performance (Douma et al., 2006). Resource based concept of the firm explained that firm can collect resources and enlarged their business activities. Foreign institutional investors are the major source of capital and bring improvement in board structure (Gillan & Starks, 2002) and ownership structure (Gillan & Starks, 2002) which ultimately enhance firm performance (Luan et al., 2012).

According to signaling theory informational asymmetry could be reduced by sending signals to concern parties (Yi et al., 2011) and in this respect corporate disclosure is a proper source of providing information (Sharma, 2013). According to Black et al., (2003) better corporate governance structure not only solve the problem of information asymmetry between inside and outside investors but also plays as a leading role in enhancing firm's performance. According to signaling theory, companies with superior informational transparency signals having better corporate governance structure (Duztas, 2008) and better corporate governance structure signals better firm performance in the market (Chiang, 2005). Its company's responsibility to provide proper information to concern parties (Spence, 1973) so that they can understand real situation of the company's operations and make better investment decisions (Poitevin, 1990; Ravid & Saring, 1991). A company with good financial performance does not hesitate to disclose information in the market (Duztas, 2008).

1.6 Problem Statement

Since 2008 foreign investment has stagnated in Pakistan. From last five years foreign direct investment inflows has dropped from $5.4 billion in the fiscal year 2007-08 to $760.7 million in fiscal year 2011-12 (Erum Zaidi, 2013). Due to energy crises, political situation, poor conditions of country laws and high corporate taxes, it has become an important issue how to attract foreign investment in Pakistan equity market. Chief executive officer of AKD security limited explained that due to poor laws, incompatible reform implementation, energy crises, instability in political and social conditions, the capital market of Pakistan faces serious challenges how to attract foreign investors (Alam, 2011). The measures can be adopted at the country level and at a firm level (Aggarwal et al., 2003). The government through improvement in economic governance and by providing investor protection can promote atmosphere that encouraged the foreign investment in the country (Erum Zaidi, 2013). In this respect, corporate governance plays a significant role in emerging and less developed markets like Pakistan (Shah, 2009). Due to weak investors protection Pakistan failed to attract external finance both at domestic and foreign level (Shah, 2009). The work should be done to sort out this problem otherwise it will cause corporation failure (Monks, 1996) and a big crash (Claessens et al., 2000; Mitton, 2002; Baek et al., 2004) in Pakistan. Effort should be made not only to improve country level laws but also at micro level (firm level) (Hasan et al., 2011). Firm level effort should be made to improve corporate governance; it will help to foster the foreign investment (Kim et al., 2010; Klapper and Love 2004; Hasan et al., 2011). Instead of waiting for reforms at country level firms can provide protection to their investors through better implementation of corporate governance mechanism (Hasan et al., 2011; Klapper & Love 2004). O'Connor et al., (2013) purported that firm level corporate governance matters a lot for foreign investors in countries with weak investor protection rights. Corporate governance attributes both at the country and firm level are important for attracting foreign institutional investors (Aggarwal et al., 2003). Foreign investment, corporate governance and firm financial performance are the core issues in Pakistan stock market; however theoretical and empirical findings on these issues are still few in developing countries like Pakistan (Shah, 2009; Javid & Iqbal, 2010). Pakistan represents an ideal setting to address these issues because it features weak investor protection (Shah, 2009; Javid & Iqbal, 2008; Chaudary et al., 2006), low law enforcement (Sun, 2009), weak internal and external corporate governance structure (Sheikh & Wing, 2012) and low foreign investment (Shah, 2009). Thus the fundamental issue is **How to**

attract foreign investors in Pakistan equity market and what measures should be taken by the firms for attracting foreign institutional investors.

1.7 Research Question

This study empirically explores this question: **what is the role of firm-level corporate governance and firm financial performance factors in attracting foreign institutional investors?** This study captures firm level corporate governance elements and firm financial performance factors that helps for attracting foreign institutional ownership. The core intention of this study is to uncover what are the firm specific factors that can attract more foreign investment and how companies can contribute in this relationship by providing investor protection through better implementation of corporate governance mechanism in Pakistan equity market.

1.8 Objectives of the study

This study has following objectives:

- To determine the impact of corporate governance on foreign institutional ownership
- To find out the impact of firm financial performance on foreign institutional ownership

1.9 Significance of the study

1.9.1 General Benefits

Multinational institutions expand their operation in different countries. They must understand the governance structure of the respective country so that they can properly manage their activities. It is immense important for investor to understand the corporate governance and financial performance of the companies before making any investment decisions. This study can be helpful for finance contributor to invest their money in a company with good corporate governance and in country where their rights were not expropriated.

This study can be helpful for promoters to know about the corporate governance status and firm financial performance of the company, where they are going to associate.

1.9.2 Specific Benefits

1.9.2.1 Academic Contributions

This study incorporates two points in literature, firstly by checking the impact of corporate governance on foreign institutional ownership in Pakistan. Secondly by checking the impact of firm financial performance on foreign institutional ownership which was avoided in past studies.

1.9.2.2 Practical Contributions

The results of this study can be useful for policy makers. If weak corporate governance is a major reasons behind lower foreign capital then they should make polices for improving corporate governance structure in Pakistan.

The empirical results of this study provide support to regulatory authorities. For attracting foreign investors in Pakistan equity market they must be ensured proper implementation of corporate governance structure and strong legal system of protection for foreign investors.

1.10 Organization of the study

The rest of the study is organized as follows. Section 2 provides related past studies and theoretical framework. Section 3 is based on data and methodology while empirical findings and conclusion will be discussed in 4 & 5 section of the study respectively.

CHAPTER 2

LITERATURE REVIEW

2.1 Foreign Institutional Ownership

Institutional investors are rapidly escalating in emerging market economies (Khorana et al., 2005). They play a vital role in their domestic stock markets (Faias et al., 2012) and more likely to invest out of the country as compare to individual investors (Ferreira & Matos, 2006). Mostly public trading companies of many countries have institutional investors as largest minority shareholders (Ferreira & Matos, 2006). Institutional investor such as insurance companies, mutual funds, and non financial corporation plays an important role in equity market of any country (Faias et al., 2012). In United States, major portion of institutional assets are owned and controlled by pension funds, mutual funds and banks (Gillan & Starks, 2002). Institutional investors are an important source of corporate financing (Shinada, 2009).

According to the security exchange commission of Pakistan institutional ownership includes all publically and privately owned financial and non financial institutions. Foreign investors can be divided into two categories (1) foreign institutional investor and (2) individual investors (Luan et al., 2012). This study focuses on foreign institutional investors because institutional investors have competitive edge on individual investors. As mentioned in study institutional investors are the combination of heterogeneous people; they can make better tradeoff between risk and return through diversification, lower transaction cost and has an informational edge on individual investors (Bjuggren et al., 2007). In emerging markets, foreign institutional investors are less affected by higher cost of transaction than individual investors (Aggarwal et al., 2003). Institutional investors are able to get proper information related to stock prices and thus this availability of information leads towards lower monitoring cost and ultimately results better corporate governance structure and better monitoring of managers (Gillan & Starks, 2002).

For surviving in the economy, external finance is more important source of financing for firms (Kelley & Woidke, 2007). As domestic sources are not sufficient to finance corporations, it has become an important issue for companies how to attract foreign investors (Leuz et al., 2008). Foreign institutional portfolio investment from developed market is a major source of finance for developing countries (Girisha, 2012). Stulz (1999) in a review of literature explained that financial liberalization reduces the cost of capital for the firms without any bad effects on its equity market. In recent times, countries and firms are more interested in attracting foreign capital because it reduces the cost of capital for firms and give them competitive edge on overall market and consequently promote that specific country (Aggarwal et al., 2003). According to Aggarwal et al., (2003) developed markets have greater capability of attracting foreign capital as compare to less developed markets. As mentioned in a study foreign institutional investors reluctant to invest in countries with lower information related to firms and high level of cultural differences because these deficiencies are major hurdles in forecasting future return on investment (Baik et al., 2013). Investment by foreign multinational companies are also important for less developed markets where poor investor protection exists because they bring improvement in firm's overall activities (Kelley & Woidke, 2007).

Thus it is an important issue in developing countries like Pakistan: How to attract foreign investors and what factors should be considered at firm level for attracting foreign investors. This study is conducted to explore these issues to some extent.

2.2 Corporate Governance

Corporate governance has become an essential issue after accounting scandal of Enron Corporation, Adelphia, Health South, Tyco, Global Crossing, Cendant and WorldCom (Ongore et al., 2011; Gurbuz et al., 2010; Duztas, 2008; Kumar). Corporate governance has become dominant issue after the takeover waves in 1980's and after the East Asian Crisis in 1997 (Becht et al., 2002). Rapid technology changes and escalating global competition are also a driving force of good corporate governance (Yoshikawa & Phan, 2001).

Researcher has defined corporate governance in different ways but all definitions explain same meaning. The most widely acceptable definition stated by OECD, "Corporate governance mechanism involves a set of relationship between a company's management, board, shareholders and its other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set and it is the means of attaining those objectives and monitoring performance are determined (OECD, 2004, p.11)".

Following definitions have taken from literature:

Shleifer and Vishny (1997, p.737) defined corporate governance in terms of economic interest of finance contributor "corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment." According to this definition corporate governance is a mechanism through which suppliers of finance can control managers, are able to get the surety of return on their investment and can prevent the managers to expropriate their rights. Another definition found from literature, according to the researcher corporate governance includes the system of laws, rules, and factors that control operations of a company.

Recently all investors and concern parties demand greater accountability from firm's board of directors and from audit committee which enhances the quality of managerial stewardship and ultimately leads towards efficient capital market (Cohen et al., 2002). Shareholder appoints directors to protect their tights (Fama and Jensen, 1983) but if the board is inefficient what will be the other mechanism that resolve this problem? Corporate governance tries to answer this question (Weston et al., 2001). According to Tricker and Lan (1994) corporate governance plays as the role of umbrella in companies that makes interaction among senior management, shareholders, board of directors and other corporate stakeholders. Strong corporate governance structure improves the firm's performance and can attract investors (Duztas, 2008). It has become a most important factor for stabilizing, strengthen the equity market of any economy and for providing the protection to investors (Duztas, 2008). According to International Chamber of Commerce (2006) corporate governance helps the firms in understanding their objectives, provide protection to their shareholder's rights, performed according to nation's enforced laws and exhibit in front of general public how they are conducting their business. A study claimed that better corporate governance practices gives less chance to controlling shareholders expropriate the right of outside investors in countries where investor protection laws and its enforcement is very poor (Doidge et al., 2001) which ultimately enhances the firm performance and market value of the firm (Doidge et al., 2001).

2.3 Firm-Level Corporate Governance and Foreign Institutional Ownership

Investor protection is not only important at country level but it is also an important element at firm level (Himmelberg et al., 2002). In literature there has founded that corporate governance at firm level play dominant role in attracting foreign investors. Corporate governance practices have received much attention with respect of external financing (Javid & Iqbal, 2010). Good corporate governance affects the external financing decisions of any company (Hasan & Butt, 2009). Corporate governance attributes both at the country and firm level are important in attracting foreign institutional investors (Aggarwal et al., 2003). Firm level and country level mechanism are substitute for each other rather than complementary (Ferreira & Matos, 2008). Investors must consider firm level corporate governance in their investment decisions because there is possibility of existing good firms in bad countries (Ferreira & Matos, 2008). A study investigated the relationship between foreign investors and corporate governance in Korean stock market. Researcher explored that improvements in corporate governance can attract foreign investment (Kim et al., 2010). Another study found close relationship between corporate governance and portfolio composition detained by foreign investors (Dahlquist et al., 2003). Mostly portfolio holding investors didn't prefer to invest in companies with weak corporate governance structure (Giannetti & Koskinen, 2010). Outside investors assign immense importance to corporate governance in their investment decisions moreover institutional investors asserted that they avoid to invest in firms governed under poor corporate governance mechanism (Leuz et al., 2008). A study explained that foreign and domestic portfolio investors avoid investing in Swedish companies because of weak corporate governance system (Giannetti and Simonov, 2006). Investors from U.S. avoid investing in companies with poor investor protection (Leuz et al., 2009). In U.S. investors prefer to invest in Korean firms because of better corporate governess structure (Kho et al., 2009). McKinsey & Company (2002) proposed that majority of the chief financial officer from European private banks support this statement "I simply would not buy a company with poor corporate governance." According to Giofre (2009) an investor protection law of any country has significant impact on foreign investment. Researcher explained that corporate governance structure of any company differently affect on domestic and foreign shareholders. If legal system of the country does not provide protection to outside investors, corporate governance mechanism of that specific country does not perform well and face difficulty for attracting external finance (La Porta et al., 2000). McKinsey and company in their recent survey (2003a, b) reported that domestic and foreign portfolio holding investors consider corporate governance as a heart of their investment decisions. Investors claimed that they prefer to decrease holding or even avoid investing in countries and companies with weak investor protection rights (McKinsey, 2003a & b).

Corporate governance plays significant role in emerging and less developed markets like Pakistan (Shah, 2009). Due to weak investors protection Pakistan failed to attract external finance both at domestic and foreign level (Shah, 2009). Institutions from countries which provide strong protection to their minority shareholders would cause improvement in corporate governance while institutions from countries with weak protection to minority shareholders are not (Aggarwal et al., 2010). Reese Jr and Weisbach (2001) demonstrated that firms face difficulties to collect external capital if they belong to a country which provide weak protection to their minority shareholders as compare to similar firms which belongs to a country with strong investor's protection rights. Greater investor protection increases the eagerness of the foreign investors to invest at a low cost and ultimately enhances the flow of external finance (La Porta et al., 1998).

Good corporate governance is a key weapon of any company for attracting domestic and foreign investors even if the country level laws did not provide protection to investors (Klapper & Love, 2004; Hasan et al., 2011). Strong investor protection provides an infrastructure for firm level corporate governance to perform well (Zhang and Uchida, 2010). Under strong corporate governance structure investors feel himself more secure and ready to invest more in firm. In order to make the firm profitable, it is necessary for companies provide protection to investor's rights (Rehman & Mangla, 2010). According to Leuz et al., (2008) foreign investors avoid investing in countries with poor outside investor protection rights, in firms with poor disclosure rules and ownership structure that have governance problem.

2.3.1 Board Size and Foreign Institutional Ownership

Board can be defined as internal governed mechanism of firm's governance that gives direct access two other axes variables in corporate governance triangle: managers and shareholders (Desender, 2009). The main purpose of board is to work for best interest of the company (Nicholson & Kiel, 2003). Board plays following three functions in any firm: (1) control the overall activities of the organization (2) gives suggestion to the management (3) assists the firm through their personal and business contacts and provide resources (including finance and informational resources) (Nicholson & Kiel, 2003).

Shareholders choose the individuals who represent them on board (Ferkins et al., 2005; Van Ees et al., 2009). The board is elected for the purpose to safeguard the rights of shareholders (principal) from managers (agent) (Fama and Jensen, 1983) who are considered to expropriate the right of owners (Ferkins et al., 2005). The board is considered as most important component of corporate governance structure and its major responsibility is to monitor the manager's activities and provide protection to the shareholders (Ferkins et al., 2005) and plays an intermediary role between shareholders and mangers (Ongore et al., 2011; Li, 1994). Board of directors have direct impact on governance mechanism of the company because they set corporate policies and capable for providing protection to shareholders from the adverse action of the managers (Gillan & Starks, 2002). Another factor that can influence the corporate governance structure of many countries is called institutional investors (Gillan & Starks, 2002). Board of directors has greater impact on financial decision making of any company (Hasan & Butt 2009). Corporate board structure plays an important role in preventing the controlling shareholders from expropriating the rights of minority shareholders (Fama, 1980; Fama and Jensen, 1983). Different mechanisms are used in companies to minimize the agency cost, Board size is one of them (UgÏurlu, 2000). Corporate board helps to mitigate the agency conflict (Gillan, 2006) that may be raised between principal (shareholder) and agent (manager) (Ongore et al., 2011). According to proposed theory of board by Thomsen (2008) board's members have competitive edge on managers in some tasks of the firms; they can hire a new manager, can fire the manager on his bad performance, define the executive pay and rectify the important decisions of the company which managers themselves cannot handle because of interest divergence. The board structure comprises upon some top managers as well as outside directors (Li, 1994). Inside directors well informed about the company's activities while outside directors contributes through their skills and efficiency (Li, 1994). According to resource based views of the Barney (1991) heterogeneity of the people give competitive edge to the firms thus board with unique combination of the skillful members can enhance the company's performance (Nicholson & Kiel, 2003).

Investors are becoming more conscious about how well board is running in the companies in which they are going to invest (Ongore et al., 2011). Institutional investors demand active board of directors (Wan & Ong, 2005). Foreign institutional investors prefer to invest in firms with appropriate board size (Aggarwal et al., 2010). Foreign investors mostly favor the companies which have friendly board structure (Aggarwal et al., 2010). According to Bhattacharyyal and Rao (2003) the board consists of experts from different field of management helps to make accurate strategic decisions but too few members of board can't provide such strategic direction to the company. In contrast, the board comprises upon large members may create the problem of communication and coordination that ultimately enhance the inefficiency of the company (Bhattacharyyal & Rao, 2003). According to Pearce and Zahra (1991) small board is less efficient and powerless as compare to large board but according to Gul et al., (2010) small board can reduce the agency cost. Jensen (1993) mentioned that the ideal setting of board size would be 7 to 8 members. A study from Turkey manufacturing firms explored the interrelationship between control mechanisms that are used to minimize the agency cost. Researcher disclosed that small board size is complement with foreign institutional shareholders. Thus as the board size decreases foreign institutional ownership increases (Ugĭurlu, 2000). Matsumoto and Uchida (2010) discussed the role of internal corporate governance and the behavior of foreign investors in Japanese companies. The companies with small board and adopt stock option plan perform well than firms with large board. Findings indicate that non Japanese investors who face the problem of information asymmetry want to invest in firms with small board.

From above debate, it is concluded that there is no directional hypothesis between board size and foreign institutional ownership. Hence it can be hypothesized that:

$H1_0$: Board size has not an impact on foreign institutional ownership

$H1_a$: Board size has an impact on foreign institutional ownership

2.3.2 Independent Board of Directors and Foreign Institutional Ownership

According to security exchange commission of Pakistan, the code of corporate governance encourages the independent non executive directors in the board structure. Commission explains that every listed company must have one independent director in their board structure which represents the interest of the institutional investors [section (b) of clause (i)]. The board of the corporation because of its independence, legal power and skills is considered a powerful component of the corporate governance mechanism (Li, 1994). The agency theory supports outside directors in board structure because they perform independently from managers of the firm (Ongore et al., 2011). According to UgÏurlu (2000), Fama (1980), Fama and Jensen (1983) and Lins (2003) board structure with outside directors can minimize agency cost of the firm. Fama and Jensen (1983) explained that greater independency of directors in board structure can improve the monitoring and controlling role of the board. Contradict views asserted by Gulati and Westphal (1999) according to them independent board is not able to gives better suggestion or advice to the chief executive officers of the company because according to Nicholson and Kiel (2007) as inside directors have direct contact with the operations of the company so they can better understand the operations of the business than outside directors and are able to make better decisions. Another study Rashid et al., (2010) reported that there is greater informational asymmetry between inside and outside directors because of the outside directors have lack of knowledge about the firm's inside operations so they are not able to make better decision. The independent board plays an important role in developing and emerging countries where other mechanisms are weaker for controlling expropriating behavior of the insiders (Claessens & Yurtoglu, 2013).

Corporate governance mechanism at a firm level can better explain the investment behavior of institutional investors (Ding & Ni, 2010). With respect to composition of board, the firms having foreign outside directors in their corporate board structure can attracts more fund from foreign investors (Kim et al., 2010). Foreign institutional owners mostly prefer the board with majority of independent directors and appropriate numbers of directors (Aggarwal et al., 2010). In state owned enterprise firms with high board independency and superior audit quality reduces the informational advantage of local institutional investors and gives positive signal in the market for attracting finance from foreign institutional investors (Ding & Ni, 2010). The proportion of foreign ownership is high in firms which have independent board as well as independent internal and external auditors. Both these two components of corporate governance are complement with high foreign ownership (Desender et al., 2013). A study disclosed the valuation impact of independent outside directors in Korean stock market after Asian financial crises. Findings indicate that presence of foreign membership increases the board independence. The independency of board positively related with foreign investors holding (Choi et al., 2007). Foreign ownership enhances the outside and foreign directors in board structure of the firm and ultimately causes independent board of directors (Jeon & Ryoo, 2013). A study from the context of Korea found significant and positive relationship between appointment of outside directors in Korean firm's board structure and foreign ownership (Chizema and Kim, 2010).

From above literature it is hypothesized that:

H2: Independent board of directors has significant positive impact on foreign institutional ownership

2.3.3 Audit Committee Independence and Foreign Institutional Ownership

Sometimes board of director fails to protect the right of shareholders thus they become threat for shareholders, at that point shareholders incur agency cost and appoint an external independent party (auditors) who work for the best interest of the shareholders (Ongore et al., 2011). According to audit committee in U.S. auditor's firm perform following functions: to monitor the performance of the directors, review and express an opinion on the method of auditing, for shareholder's protection prepare report on performance of the company (Desender et al., 2013).

The most important role of auditor is to mitigate the conflict of interest between shareholder and manager (Mohiuddin & Karbhari, 2010). External auditors has power to access financial statement of the company (Dopuch & Simunic, 1982), can prevent the managers from providing biased financial statement (Becker et al., 1998; Kim et al., 2003; Beasley, 1996), can better monitor the manager's actions because they have not any direct relationship and link with management (Abbott et al., 2004) and thus they can reduce the informational asymmetry problem between managers and shareholders (Dopuch and Simunic, 1982). Due to high agency cost outside investors demand quality auditors (Watts and Zimmerman, 1986; DeFond, 1992). Audit quality can be defined as combine effort of audit committee to detect and report on financial statement errors (DeAngelo, 1981; Choi et al., 2008). High audit quality forces the companies to disclose full information related to companies within timeline (Fan and Wong, 2005). In emerging markets, where concentrated ownership structure is high, outside investors assign more weight age to the companies which hire Big 4 auditors (Fan and Wong, 2005). Audit committee is a more important component of corporate governance (Zhou & Chen, 2004) and a crucial issue (Yakhou and Dorweiler, 2005). According to Siagian and Tresnaningsih (2011) independent board of directors and audit committee can improve the reporting system of the firm and the quality of earnings reporting because they have not any conflict of the interest which might reduce their management capacity. Amba (2012) asserted that committee should consist of independent board of directors because they are more conscious about their ethical reputation and capable to take right decision for best interest of the firm. Islam et al., (2009) proposed that an independent audit committee can satisfy the requirements of both internal and external users of the financial statements.

In past literature positive relationship has found between audit committee independence and foreign ownership. When the percentage of foreign and institutional ownership increases, companies try to hire quality auditors. Both Foreign individual and institutional investors assigned more weight age to the firms hired quality auditors (Zureigat, 2011). Audit committee independence and external auditor both play complementary role when foreign ownership is high (Desender et al., 2013). A study from the context of U.S., independent directors in board and audit committee are the most important channel through which U.S. institutions can influence the non U.S. investors in the market (Fang et al., 2013). In Amman Stock Exchange all listed companies have significant positive relationship between audit quality and foreign ownership (Zureigat, 2011). Audit committee system is most likely adopted by the experienced, globally renowned companies and companies who possess greater proportion of foreign ownership (Chizema & Shinozawa, 2012). Past studies have recommended that audit committee independence positively associated with better corporate governance mechanism (Poudel & Hovey, 2013).

From above literature it is hypothesized that:

H3: Audit committee independence has significant positive impact on foreign institutional ownership

2.4 Firm Financial Performance and Foreign Institutional Ownership

Owners from different identity (financial, non financial, government, foreign and individual) due to aims discrepancy have different impact on performance of the firm (Douma et al., 2006). Foreign investors bring managerial skills and made more expense on research and development which ultimately enhances firm's performance. Foreign institutional investors are the major source of capital and brings improvement in board structure (Gillan & Starks, 2002; Luan et al., 2012; Choi et al., 2007) ownership structure (Gillan & Starks, 2002; Luan et al., 2012) and corporate governance mechanism and its outcomes (Ferreira & Matos, 2008; Aggarwal et al., 2011) that ultimately enhance firm performance (Luan et al., 2012). If firm's monitoring function is performed by the foreign investors, they enhance the firm performance (Dahlquist and Robertsson, 2001). Following researchers claimed that foreign institutional investors not only invest their capital but also perform the monitoring function for avoiding risk (Pound, 1988; Douma et al., 2006; Ting et al., 2008; Gillan & Starks, 2003). The entry of foreign investors through their stake in equity of the firm develops better firm's performance (Oxelheim & Randoy, 2003; Stultz, 1999). Foreign institutional investors played dominant role in improving firm's performance (Luan et al., 2012). Foreign institutional ownership has significant positive impact on firm's value (Ferreira & Matos, 2006). A study claimed that foreign shareholders reluctant to invest in a company with poor performance (Douma et al., 2006). They preferred to leave the company rather than to work for improvement of the manager (Aguilera & Jackson, 2003). In past studies, researcher observed significant positive relationship between foreign institutional ownership and firm performance (Ongore et al., 2011; McConnell & Servaes, 1990; Dahlquist and Robertsson, 2001; Ferreira & Matos, 2008; Aggarwal et al., 2011; Huang and Shiu, 2009; Gurbuz et al., 2010).

In different countries most of the studies have found significant positive relationship between firm financial performance and foreign institutional ownership. A study from Nigeria stock market by examining 31 listed companies from financial sectors purposed significant positive relationship between corporate performance and foreign ownership (Uwalomwa & Olamide, 2012). Following studies from Korea stock market investigated the impact of foreign equity ownership on firm performance. They proved that foreign equity investment boosts the firm's performance and found significant positive relationship between firm performance and foreign ownership (Choi & Yoo, 2005; Choi et al., 2007). Studies from emerging markets noted positive association between firm performance and outside ownership (Mitton, 2002; Lins, 2003; Douma et al., 2006). Another study from emerging market discovered positive relationship between foreign institutional ownership and Tobin Q's ratio (Khanna & Palepu, 1999). A study from Sri

Lanka stock market investigated the impact of ownership structure on firm financial performance. Researcher argued that most of the companies in Sri Lanka are owned by foreign institutional investors and foreign ownership enhances the firm's financial performance. Foreign ownership positively associated with firm's financial performance (Wellalage & Locke, 2010). A study from Sweden stock market examined how the ownership structure particularly the institutional investors influence the investment decision of the firms and its ultimate impact on firm performance. Result shows corporate performance is positively influenced by institutional and foreign investors (Bjuggren et al., 2007). A study was conducted on Turkish companies to find out the impact of foreign ownership on firm's performance. Result indicates that companies with foreign investors experience higher return on asset than domestic ownership. Final finding was foreign ownership positively associated with higher firm performance (Aydin et al., 2007). A study investigated the impact of foreign ownership on firm value in Japan. Researcher proposed that large foreign institutional investors preferred to invest in well performing firms (Park, 2002). A study on non financial firms from Turkish stock market explained that foreign owned firms have superior financial performance than those local owned firms (Gurbuz & Aybars, 2011).

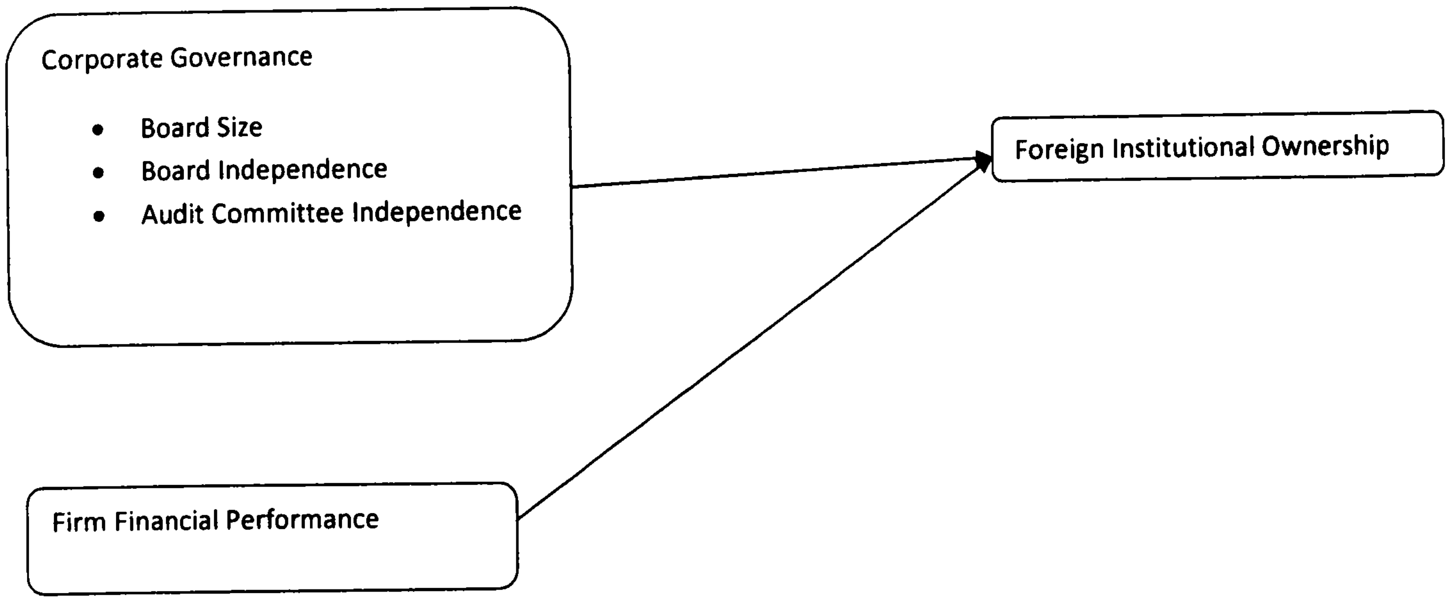
In contrast, Kumar (2001) examined the impact of ownership structure on corporate performance on a sample of 2478 Indian firms. Results indicate that foreign ownership and corporate shareholders did not influence the firm performance. Another study examined the impact of different type of foreign owners on firm's financial and economic performance of Romanian manufacturing companies listed in Bucharest stock exchange. Final findings were there is no significant link between firm's performance and different types of foreign owners (Mihai & Radu, 2012). A study from Tehran stock exchange investigated the impact of ownership structure on firm's performance. Researcher asserted significant negative relationship between foreign institutional investors and firm's performance (Namazi & Kermani, 2013). A study from emerging market (South Korea) observed the role of institutional ownership in relationship between ownership structure (concentration ownership and identity of ownership) on corporate performance. Results claimed that foreign ownership and institutional ownership has insignificant impact on firm performance (Lee, 2008).

From above debate, it is concluded that there is no directional hypothesis between firm financial performance and foreign institutional ownership. Hence it can be hypothesized that:

$H4_0$: Firm financial performance has not an impact on foreign institutional ownership

$H4_a$: Firm financial performance has an impact on foreign institutional ownership

2.5 Theoretical Framework



2.5.1 Agency Theory

2.5.1.1 Board Structure

Corporate board structure plays an important role in preventing the controlling shareholders from expropriating the rights of minority shareholders (Fama, 1980; Fama and Jensen, 1983). Corporate board is an important component of corporate governance that can mitigate the agency conflict (Gillan, 2006) that may arise between principal (shareholder) and agent (manager) (Ongore et al., 2011). Different mechanisms are used in companies to minimize the agency cost, Board size is one of them (UgÏurlu, 2000). Board structure with larger outside directors relate to agency cost theory. This theory based on separation of ownership from control. According to this theory manager due to their higher firm specific knowledge prefer their own interest and try to expropriate shareholder's interest (Ongore et al., 2011). This theory support outside directors in board structure because they can perform independently from firm managers (Ongore et al., 2011). If majority of stocks is controlled by insiders, it gives them chances to expropriate the rights of outside minority shareholders, this type of agency problem can minimize through outside block shareholders, who have ability to spur the managerial performance and enhances the value of firm (Shleifer and Vishny, 1986).

2.5.1.2 Audit Committee Independence

Sometimes board of director fails to protect the shareholder's right thus they become a threat for shareholders, at this point they incur agency cost to appoint an external independent party (auditors) who worked for best interest of the shareholders (Ongore et al., 2011). The most important auditor role is to mitigate the interest conflict between shareholder and manager (Mohiuddin & Karbhari, 2010). Efficient audit committee has significant positive impact on curtailing agency problem, protecting the interest of stakeholder consequently increase the overall value of the firm (Mohiuddin & Karbhari, 2010).

2.5.2 Institutional Theory

Foreign ownership plays a vital role in corporate governance reforms and in monitoring the activities of the management (Dahlquist & Robertsson, 2001). Institutional investors play dominant role in changing the corporate governance structure of any country (Gillan & Starks, 2002). They directly (through their ownership) can affect the management's activities and indirectly (through trading shares) can affect the company's performance (Gillan & Starks, 2002). According to institutional theory, institutions can pressurize firms to adopt better accounting standards and principles (Collin et al., 2009). Past studies empirically supported this assertion that institutions have power to influence firm's value (Lee & Pennings 2002; Thornton 2002).

2.5.3 Stakeholder Theory

Kumar explained in his article Governance Risk and Ethics, institutional investors are the major stakeholder of any corporation. According to stakeholder theory the interest and satisfaction of all stakeholders must be considered by the company (Freeman et al., 2004). This theory makes alignment between the interest of shareholders and their satisfaction (Freeman et al., 2004). Foreign investors prefer to invest when they are satisfied that their interest is protected by the managers (Freeman et al., 2004). According to Udayasankar & Das (2007) both institutions and the concept of stakeholder theory can force firms to adopt such corporate governance mechanisms that are conform to the rules and regulations of that specific country and acceptable for all organizational authorities. Similarly (Kumar) in his article Governance Risk and Ethics asserted that Institutional investors have greater power over the company in which they invest and able to promote good corporate governance mechanism in the company.

2.5.4 Resource Dependence Theory

In emerging markets, foreign and domestic shareholders are important source of capital for firms and have different impact on the performance of the firm (Douma et al., 2006). The impact of foreign shareholders on firm performance can be explained through resource-based theory. According to this theory, a firm can get competitive edge on same type of others firms through different tangible and intangible resources that are costly and not access able for other competitors (Douma et al., 2006). Resource based concept of the firm explained that firm can collect resources and can enlarge their business activities (Douma et al., 2006). Foreign institutional investors are the major source of capital and bring improvement in board structure (Gillan & Starks, 2002) and ownership structure (Gillan & Starks, 2002) which ultimately enhance firm performance (Luan et al., 2012). According to Pfeffer and Salancik (1978) when an organization appoints an individual as a board member it was expected that, it will try to resolve the organization's problems; it will support the organization through financial aid and favorably present the organization in front of others. Consequently this support from board's members enhances the performance of the firm (Juliarto et al., 2013). Resource dependence theory emphasize upon the competency of human capital in any firm's governance structure and consequently its impact on firm's performance (Juliarto et al., 2013). The promoter of this theory asserted that firms can enhance their performance through proper utilization of their board member's strengths and skills (Juliarto et al., 2013).

2.5.5 Signaling Theory

Due to recent accounting scandals investors demand transparency from companies (Chiang, 2005). In economics and finance transparency can be defined as "a process by which information about existing conditions, decisions and actions is made accessible, visible and understandable" (Working Group, 1998, p.44). It is a process of sharing information among interested parties and performing in an open manner (Chiang, 2005). Foreign investors demand for transparency that may diminish asymmetric information and ultimately provides protection to outside investors (Juliarto et al., 2013). As asserted by Brennan and Cao (1997) that domestic investor has more informational competitive edge on foreign investors. Similarly Covrig et al., (2001) found that local investors have more information about stocks than foreign investors. According to signaling theory informational asymmetry can be reduced by sending signals to concern parties (Yi et al., 2011) and corporate disclosure is a proper source of providing information to concern parties (Sharma, 2013). According to Black et al., (2003) better corporate governance structure not only solve the problem of information asymmetry between inside and outside investors but also plays as a leading role in enhancing the firm performance. According to signaling theory, companies with superior informational transparency signals, having better corporate governance structure (Duztas, 2008) and moreover better corporate governance structure signals better firm performance in the market (Chiang, 2005). Its company's responsibility to provide proper information to concern parties (Spence, 1973) so that they can understand real situation of the company's operations and can make better investment decisions (Poitevin, 1990; Ravid & Saring, 1991). A company with good financial performance does not hesitate to disclose information in the market (Duztas, 2008).

CHAPTER 3

RESEARCH METHODOLOGY

3.1 Research Design

3.1.1 Data sources

This study explores the impact of firm-level corporate governance, firm financial performance on foreign institutional ownership. The sample for study includes 70 listed companies from Karachi Stock Exchange. Convenient sampling technique is used for collecting the data. The data was extracted from annual reports of each company. This study excludes the financial sector (banks, insurance companies) because valuation ratios of financial firms are not comparable to non financial firms (Javid & Iqbal, 2008), Tobin's Q ratio is not a suitable valuation measure for financial firms (Lins, 2003) and moreover financial companies have different capital structure from other non-financial companies. This study also excludes financially distress firms because of illiquidity and incompletion of the data. The sample period consists of 6 years from 2007 to 2012. In Pakistan, corporate governance code is announced in 2002 and its implementation started in 2003, moreover data on ownership structure of listed firms also available in 2003 after the implementation of Corporate Governance Practices.

There are two ways to collect the data, primary and secondary. This study used secondary data to conduct the research because according to the corporate governance code in Pakistan all listed companies mentioned their data of board size, board independence and audit committee independence in their annual reports.

This study applies board size, independent board directors and audit committee independence for measuring corporate governance structure. Two proxies (Return on equity and Tobin's Q ratio) are used for measuring the firm financial performance. Size of the company, leverage, growth rate and dividend covering ratio is used as the control variables. This study employs industrial dummies for capturing the industrial effect.

3.1.2 Specification of the Econometric Model

Panel data technique is used for measuring the dependency of foreign institutional ownership on corporate governance components and firm financial performance in Pakistan equity market. As the data of this study comprises upon both cross section (companies) and time series (2007-12) so that's why this technique is applied for capturing the effect.

The simple form of OLS regression model is:

$$\mathbf{FIO}_{it} = \beta_o - \beta_3\,\mathbf{(BS)}_{it} + \beta_4\,\mathbf{(BI)}_{it} + \beta_5\,\mathbf{(ACI)}_{it} + \beta_7\,\mathbf{(ROE)}_{it} + \beta_8\,\mathbf{(TQ)}_{it} + \beta_9\,\mathbf{(SZ)}_{it} + \beta_{10}\,\mathbf{(LEV)}_{it} + \beta_{12}\,\mathbf{(AGR)}_{it} + \beta_{13}\,\mathbf{(DIV)}_{it} + \beta_{14}\,(\sum \mathbf{D_I})_{it} + + \varepsilon_t$$

Where

FIO = Foreign Institutional Ownership

BS = Board Size

BI = Board Independence

ACI = Audit Committee Independence

ROE = Return on Equity

TQ = Tobin's Q

SZ = Size of the Firm

LEV = Leverage

AGR = Assets Growth Rate

DIV = Dividend Cover Ratio

D_1 = Industry Dummy

ε = Error Term

β_o = Intercept of the equation

β_i = Marginal Effect of Independent Variables on Dependent variable

3.2 Description of Variables

3.2.1 Dependent Variable

3.2.1.1 Foreign Institutional Ownership

Foreign investment is an important source of finance (Prasanna, 2008). In this study it is calculated by dividing the no. of shares held by foreign institutional ownership.

3.2.2 Independent Variables

3.2.2.1 Board Size

Board size is measured as the natural log of board members followed by (Shah, 2009; Hasan & Butt, 2009).

3.2.2.2 Board Independence

The proportion of independent board directors give good signal in the market; lenders consider companies with independent directors more credit worthy than other companies (Hasan & Butt, 2009). It ultimately helps in generating long term finance for the firms (Hasan & Butt, 2009). It is calculated by dividing number of non executive directors in board to total number of directors followed by (Shah, 2009; Hasan & Butt, 2009).

3.2.2.3 Audit Committee Independence

Audit committee independence is an important component of corporate governance mechanism (Islam et al., 2009). It is calculated by dividing non executive directors in audit committee to total no. of directors in audit committee followed by (Shah, 2009; Forker's 1992).

3.2.2.4 Return on Equity

In this study return on equity is used as proxy to measure the firm's internal financial performance. It is calculated by dividing the net income to book value of total equity.

3.2.2.5 Tobin's Q Ratio

In this study Tobin's Q is used to measure the market valuation of the firm. According to the Khanna and Palepu (2000) and Demsetz and Villalonga (2001) Tobin's Q can be calculated by dividing the sum of the market value of common stock and book value of preferred stock and total liabilities on book value of total assets. Douma et al., (2006) also applied similar method for measuring firm financial performance.

3.2.3 Control Variables

3.2.3.1 Size of the company

Ln of total sales is used to measure the size of the firm following by Masnoon & Anwar (2012). In this study size of the firm is applied as control variable to check whether foreign investors want to invest in big companies or small companies.

3.2.3.2 Leverage

Debt to equity ratio is used for calculating leverage following by Hassan & Butt (2009). It is used as control variable to check whether foreign investors prefer to invest in debt base companies or equity base companies.

3.2.3.3 Assets Growth Rate

Assets growth rate calculated through this formula, Current assets minus previous year assets divided by previous year assets following by Abrar-ul-haq et al., (2015). In this study it is applied as control variable to check whether foreign investors prefer to invest high growth rate companies or low growth rate companies.

3.2.3.4 Dividend Cover Ratio

Following formula is applied for calculating dividend cover ratio. Profit after tax - Dividend paid on irredeemable preference shares / Dividend paid to ordinary shareholders. Investors consider this ratio to check out the risk associated with the receipt of investment on their investment. A low dividend cover ratio indicates company is not able to pay dividend out of profit and this downward trend in profit can be impact on valuation of shares in future.

Firm Financial Performance proxies			
Return on Equity	ROE	Net income/Total Equity	(Dahlquist & Robertsson, 2001) (Ko et al., 2007) (Ferreira & Matos, 2006) (Ongore et al., 2011) (Luan et al., 2012) (Kumar, 2001); (Shah, 2009).
Tobin's Q Ratio	TQ	Market value of Common stock+ Book value of preferred stock+ total liabilities/Book value of total assets	(Nguyen, 2012) (Ferreira & Matos, 2008) (Aggarwal et al., 2010) (Klapper & Love, 2004) (Choi & yoo, 2005) (Douma et al., 2006) (Wellalage & Locke, 2010)
Control Variables			
Size of the firm	SZ	Ln of total sales	(Masnoon & Anwar

			2012)
Leverage	LEV	Total Debt / Total Equity	(Hassan & Butt, 2009)
Assets Growth Rate	AGR	Current assets minus previous year assets / Previous year assets	(Abrar-ul-haq et al., 2015)
Dividend Cover Ratio	DIV	Profit after tax - Dividend paid on irredeemable preference shares / Dividend paid to ordinary shareholders	(Saleem et al., 2013)

CHAPTER 4

RESULTS AND DICUSSIONS

There is discussed the results of the study. The impact of board size, board independence, audit committee independence and firm financial performance on foreign institutional ownership were examined on 70 listed companies of Pakistan equity market. This chapter consists of two sections.

- Corporate governance structure and foreign institutional ownership
- Firm financial performance and foreign institutional ownership

As the data of this study comprises of both cross section (companies) and time series (2007-12) so panel data technique is applied for capturing the effect. The results of descriptive statistics, correlation matrix, panel unit root test and the common effect model are mentioned in the tables below respectively. In this study industrial dummies are introduced for checking the industrial effect.

Table 2: Descriptive Statistics

	FIO	*BS*	*BI*	*ACI*	*ROE*	*TOBIN_S_Q*	*SIZE*	*LEVERAGE*	*GROWTH_RATE*	*DIVIDEND*
Mean	0.125	2.082	0.581	0.788	20.315	1.778	14.781	1.653	0.200	1.498
Median	0.026	1.946	0.571	0.667	13.605	0.966	14.708	1.190	0.037	0.590
Maximum	0.902	2.565	1.833	1.000	212.040	37.375	20.352	15.830	11.673	10.080
Minimum	0.000	1.792	0.000	0.000	-160.810	0.000	0.000	-10.170	-1.000	0.000
Std. Dev.	0.213	0.168	0.267	0.205	41.374	3.362	2.397	2.070	0.714	2.051
Skewness	2.227	0.911	0.088	-0.929	1.330	6.262	-1.547	1.974	11.165	1.704
Kurtosis	7.261	2.942	3.147	4.847	8.954	50.413	12.656	19.099	171.713	5.958
Jarque-Bera	626.790	54.791	0.870	113.189	701.614	39679.019	1696.335	4533.565	477884.616	336.040
Probability	0.000	0.000	0.647	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Sum	49.531	824.420	229.936	312.200	8044.770	704.113	5853.417	654.450	79.208	593.170
Sum Sq. Dev.	17.967	11.146	28.207	16.630	676179.705	4464.440	2269.166	1693.075	201.190	1660.866
Observations	396	396	396	396	396	396	396	396	396	396

4.1 Descriptive Statistics

The mean value of FIO (Foreign Institutional Ownership) is 0.125 lowest mean values as compare to other variables and the maximum value is 0.901. The above table show that ROE (Return on Equity) has highest mean value of 20.315, size of the company shows second highest mean value that is 14.781 after that board size indicates highest mean value 2.082. It indicates that financial performance of the company plays an important role in attracting foreign investors in Pakistan equity market. The size of the company is the second important variable for foreign investors and next considerable variable is board size of the company.

According to results return on equity (41.374) and Tobin's Q ratio (3.362) shows second highest standard deviation. It means that return on equity and Tobin's Q ratio has more deviation and these are risky measures. Whereas foreign institutional ownership (0.213) board size (0.167), board independence (0.267), audit committee independence (0.205), leverage (2.070) and growth rate (0.713) shows less variation. It means that the data for these measures are smooth and consistent. Instead of audit committee independence and size of the company all other variables are positively skewed. Board independence is slightly skewed.

Table 3: Correlation Matrix

	FIO	*BS*	*BI*	*ACI*	*ROE*	*Tobin's Q*	*Size*	*Leverage*	*Growth Rate*	*Dividend*
FIO	1									
BS	-0.03539	1								
BI	-0.06961	0.24874	1							
ACI	0.045158	0.263278	0.4547	1						
ROE	-0.01754	0.209132	0.024645	0.092617	1					
Tobin's Q	-0.07292	0.031246	-0.1571	-0.05748	0.479257	1				
Size	0.05736	0.22248	0.12911	0.084686	0.421053	0.357554022	1			
Leverage	-0.00565	0.069995	0.055738	0.103152	-0.1408	0.014683914	-0.13633	1		
Growth Rate	-0.01729	0.003779	-0.05601	-0.06325	0.035995	-0.01735176	0.016445	0.04407419	1	
Dividend	0.145332	-0.09056	0.016311	-0.08453	0.276289	0.025311076	0.281842	0.12979916	-0.031880073	1

4.2 Correlation

Correlation technique is applied for checking the correlation between independent variables. There is found negative relation between FIO and BS, the strength of relationship is .035. Above mentioned table shows negative relation between FIO and BI, the strength of relationship is .069. There is a positive relationship between FIO and ACI, the strength of relationship is .045. There is found negative relationship between FIO and ROE, the strength of relationship is .017. There is negative relationship between FIO and Tobin's Q ratio, the strength of relationship is .072. There is found positive relationship between FIO and size of the company, the strength of relationship is .057. There is negative relationship between FIO and Leverage, the strength of the relationship is .005. There is found negative relationship between FIO and growth rate, the strength of relationship is .017. There is found positive relationship between FIO and dividend cover ratio, the strength of relationship is .145. There is no strong correlation found between independent variables.

Table 4: Panel Unit Root Test: Summary

	Null: Unit root (assumes common unit root process)	*Statistic*	*Prob.***	*Cross-sections*	*Obs*
FIO	Levin, Lin & Chu t*	83.7427	0.0000	67	319
BS	Levin, Lin & Chu t*	9.31255	0.0000	25	120
BI	Levin, Lin & Chu t*	4.72838	0.0000	44	211
ACI	Levin, Lin & Chu t*	1.40834	0.0795	28	136
ROE	Levin, Lin & Chu t*	19.9321	0.0000	70	334
TOBIN'S Q	Levin, Lin & Chu t*	19.9321	0.0000	70	334
SIZE	Levin, Lin & Chu t*	16.2828	0.0000	69	329
LEVERAGE	Levin, Lin & Chu t*	10.4947	0.0000	70	334
GROWTH RATE	Levin, Lin & Chu t*	28.6635	0.0000	67	319
DIVIDEND	Levin, Lin & Chu t*	36.1508	0.0000	42	205

Panel unit root test is applied for checking stationarity of the panel. Above mention table shows that all variables are unit root at level instead of audit committee independence. Audit committee independence is showing unit root at 8% that is near to 5%, so it is said to be unit root at level because audit committee independence has no change value.

Table 5: Common Effect Model

Variable	*Coefficient*	*t-Statistic*	*Prob.*
BS	-0.1659	-2.69713	0.0073*
BI	-0.072	-1.81148	0.0709**
ACI	0.119385	2.190201	0.0291*
TOBIN_S_Q	-0.01217	-3.54855	0.0004*
SIZE	0.011952	2.552376	0.0111*
LEVERAGE	0.007184	1.582397	0.114**
GROWTH_RATE	-0.01142	-0.87343	0.383
DIVIDEND	0.006297	1.315358	0.1892
CP	-0.01063	-1.33888	0.1814
EM & A (HG)	0.087203	0.966834	0.3343
F (Other Food Products)	0.075087	0.086308	0.3886
F (S)	-0.19284	-2.20853	0.0278*
F & E (OGP)	-0.13867	-1.67592	0.0946
IC & T (FLT)	-0.11592	-1.41062	0.1592
MVT & A	0.222314	2.77797	0.0057*
OM	-0.06437	-0.75518	0.4506
ONMM (Cement)	0.026746	0.290426	0.7717
ONMM (MP)	-0.14815	-1.187299	0.061**
OSA	0.045727	0.482198	0.6299
T (Other Textile)	-0.14198	-1.3024	0.1936
TS (TA)	-0.09589	-1.05347	0.2928
TS (S,W & F)	-0.15504	-1.89889	0.058**
C	0.302009	1.991377	0.0472
Adjusted R-squared	0.343007		
F-statistic	10.37383		
Prob(F-statistic)	0.00000		
Durbin-Watson stat	0.513913		

* Significant at 95% level of confidence

** Significance at 90% level of confidence

A panel data technique is applied for capturing the dependency of foreign institutional ownership on board size, board independence, audit committee independence, return on equity and Tobin's Q ratio (independent variable). Size, leverage, growth rate and dividend used as control variables. In this study industrial dummies are introduced for capturing the effect because the work cannot be done on company specific.

The null hypothesis tested were that the panel linear regression R^2 was equal to 0 and the regression coefficient (i.e slopes) were equal to 0.

4.3 Common Effect Model

The results of panel linear regression suggest that a significant proportion of the total variation in foreign institutional ownership was prescribed by F-statistics = 10.37 and P value is less than .05. Adjusted R^2 shows explanatory power of the model that is 34%. Additionally we find the following:

1. For board size, the slope (.165) is statistically significantly different from 0 (p = .007); with every one-point increase in foreign institutional ownership, board size decrease by (.165).
2. For board independence, the slope (.072) is statistically significantly different from 0 (p = .07); with every one-point increase in foreign institutional ownership, board independence decrease by (.072).
3. For audit committee independence, the slope (.119) is statistically significantly different from 0 (p = .029); with every one-point increase in foreign institutional ownership, audit committee independence increase by (.119).
4. For Tobin's Q ratio, the slope (.012) is statistically significantly different from 0 (p = .000); with every one-point increase in foreign institutional ownership, firm financial performance decrease by (.012).

5. For size of the company, the slope (.011) is statistically significantly different from 0 (p = .011); with every one-point increase in foreign institutional ownership, size of the company increase by (.011).
6. For leverage, the slope (.007) is statistically significantly different from 0 (p = .114); with every one-point increase in foreign institutional ownership, leverage increase by (.007).
7. For growth rate, the slope (.011) is statistically significantly not different from 0 (p = .383); with every one-point increase in foreign institutional ownership, growth rate decrease by (.011).
8. For dividend cover ratio, the slope (.006) is statistically significantly not different from 0 (p = .189); with every one-point increase in foreign institutional ownership, dividend cover ratio increase by (.006).
9. For chemical pharmaceutical (CP) sector, the slope (.010) is statistically significantly not different from 0 (p = .181); with every one-point increase in foreign institutional ownership, CP sector decrease by (.010).
10. For electrical machinery & apparatus (EM & A) sector, the slope (.087) is statistically significantly not different from 0 (p = .334); with every one-point increase in foreign institutional ownership, EM & A sector increase by (.087).
11. For food (other food products) sector, the slope (.075) is statistically significantly not different from 0 (p = .388); with every one-point increase in foreign institutional ownership, food (other food products) sector increase by (.075).

12. For food (sugar) sector, the slope (.192) is statistically significantly not different from 0 (p = .027); with every one-point increase in foreign institutional ownership, food (sugar) sector decrease by (.192).
13. For fuel and energy (oil & gas producer) sector, the slope (.138) is statistically significantly not different from 0 (p = .094); with every one-point increase in foreign institutional ownership, F & E (OGP) sector decrease by (.138).
14. For information comm. & transport (fixed line telecommunication) sector, the slope (.115) is statistically significantly not different from 0 (p = .159); with every one-point increase in foreign institutional ownership, IC & T (FLT) sector decrease by (.115).
15. For motor vehicles, tractors & auto parts sector, the slope (.222) is statistically significantly different from 0 (p = .005); with every one-point increase in foreign institutional ownership, MVT & A sector increase by (.222).
16. For other manufacturing sector, the slope (.06) is statistically significantly not different from 0 (p = .450); with every one-point increase in foreign institutional ownership, OM sector decrease by (.06).
17. For other non-metallic mineral products (cement) sector, the slope (.026) is statistically significantly not different from 0 (p = .771); with every one-point increase in foreign institutional ownership, ONMM (cement) sector increase by (.026).
18. For other non-metallic mineral products (mineral products) sector, the slope (.148) is statistically significantly not different from 0 (p = .061); with every one-

point increase in foreign institutional ownership, ONMM (MP) sector decrease by (.148).

19. For other services activities sector, the slope (.045) is statistically significantly not different from 0 (p = .629); with every one-point increase in foreign institutional ownership, OSA sector increase by (.045).
20. For textile (other textile) sector, the slope (.141) is statistically significantly not different from 0 (p = .193); with every one-point increase in foreign institutional ownership, F (other food products) sector decrease by (.141).
21. For textile sectors (textile articles), the slope (.095) is statistically significantly not different from 0 (p = .292); with every one-point increase in foreign institutional ownership, TS (TA) sector decrease by (.095).
22. For textile (spinning, weaving & finishing) sectors, the slope (.155) is statistically significantly different from 0 (p = .058); with every one-point increase in foreign institutional ownership, TS (S,W & F) sectors decrease by (.155).

4.3.1 Corporate Governance and Foreign Institutional Ownership

4.3.1.1 Board Size and Foreign Institutional Ownership

This model depicts that board size has negative and significant relationship with foreign institutional investors at 95% level of confidence. As P value is 0.007 less than tabulated value of 0.05 and the sign of coefficient is negative so the results are negative and significant. It means foreign investors prefer to invest in companies with small board size.

The result is in line with following past studies. Foreign institutional investors prefer to invest in firms with appropriate board size (Aggarwal et al., 2010). Foreign investors mostly favor the companies which have friendly board structure (Aggarwal et al., 2010). Jensen (1993) mentioned that the ideal setting of board size would be 7 to 8 members. A study from Turkey manufacturing firms explored the interrelationship between control mechanisms that are used to minimize the agency cost. Researcher disclosed that small board size is complement with foreign institutional shareholders. Thus as the board size decreases foreign institutional ownership increases (Ugǐurlu, 2000). Matsumoto and Uchida (2010) discussed the role of internal corporate governance and the behavior of foreign investors in Japanese companies. The companies with small board and adopt stock option plan perform well than firms with large board. Findings indicate that non Japanese investors who face the problem of information asymmetry want to invest in firms with small board. Reason could be in large board size foreign investors may face the problem of information asymmetry.

4.3.1.2 Board Independence and Foreign Institutional Ownership

Board independence has negative and significant relationship with foreign institutional investors at a level of 90%. As P value 0.07 is equal to tabulated P value 0.1 and the sign of coefficient is negative. It means that independency of board has impact on foreign investors but this result is contradicted from theory. According to theory board independence has positive and significant relationship with foreign investors.

Reason could be data of this study mostly include state owned enterprises. In state owned enterprises the share of foreign investors is considered very low.

4.3.1.3 Audit Committee Independence and Foreign Institutional Ownership

Audit committee independence has significant and positive relationship with foreign institutional ownership at 95% level of confidence. As P calculated value 0.02 is less than tabulated value 0.05 and the sign of coefficient is positive so the results are positive and significant. It means that every company having independent audit committee structure attracts more foreign investors.

This result is in line with Zureigat (2011) who argue that when the percentage of foreign and institutional ownership increases, companies try to hire quality auditors. Both Foreign individual and institutional investors assigned more weight age to the firms hired quality auditors. Audit committee independence and external auditor both play complementary role when foreign ownership is high (Desender et al., 2013). A study from the context of U.S. demonstrated that independent directors in board and audit committee are the most important channel through which U.S. institutions can influence the non U.S. investors in the market (Fang et al., 2013). In Amman Stock Exchange all listed companies have significant positive relationship between audit quality and foreign ownership (Zureigat, 2011). Audit committee system is most likely adopted by the experienced, globally renowned companies and companies who possess greater proportion of foreign ownership (Chizema & Shinozawa, 2012). Past studies have recommended that audit committee independence positively associated with better corporate governance mechanism (Poudel & Hovey, 2013).

Foreign investors demand independent audit committee the main reason behind this can be because external auditor has freely power to access financial statement of the company, can prevent the managers from providing biased financial statement, can better monitor the manager's actions because they have not any direct relationship and link with management, and thus they can reduce the informational asymmetry problem between managers and shareholders (Dopuch & Simunic, 1982; Dopuch & Simunic, 1982; Becker et al., 1998; Kim et al., 2003; Beasley, 1996; Abbott et al., 2004; Dopuch and Simunic, 1982). Due to high agency cost outside investors demand quality auditors (Watts and Zimmerman, 1986; DeFond, 1992).

4.3.2 Firm Financial Performance and Foreign Institutional Ownership

In this study two proxies are used to measure firm financial performance. (1) Return on equity (ROE) for measuring firm's internal financial performance and Tobin's Q ratio (TQ) for measuring firm's external financial performance. Return on equity has significant and negative relationship with foreign institutional ownership. As P calculated value 0.04 is less than P tabulated value (0.05). Similarly Tobin's Q ratio has significant negative relationship with foreign institutional ownership. As P calculated value 0.00 is lower than P tabulated value (0.05). So it means that firm financial performance through measuring Tobin's Q ratio as proxy has significant and negative relationship with foreign institutional ownership as the coefficient is negative. In this study Tobin's Q ratio consider as an appropriate proxy for measuring firm financial performance because it explains 34% model of the study while return on equity explains 32% model of the study.

These results are in line with Namazi & Kermani (2013), A study from Tehran stock exchange investigated the impact of ownership structure on firm's performance. Researcher asserted significant negative relationship between foreign institutional investors and firm's performance. Reason could be in Pakistan all foreign institutional investment is just for short term period, it results more volatility in the firm financial performance of the companies. Due to which negative and significant relationship is found between firm performance and foreign institutional ownership. Although theory does not support this phenomena but empirical evidence is in the support so firm should focus on this phenomena and try to hold foreign investment for a longer time period. If this occurs then empirical evidence of this study may support the theory.

4.3.3 Results of control variables

Among control variables size of the company shows significant and positive relationship with foreign institutional ownership. As P value of size of the company 0.011 is less than the tabulated value of 0.05 at a 95% level of confidence and coefficient sign is positive with value 0.011. It indicates that foreign investors prefer to invest in large companies. The result of this study is in line with following past studies. A study from Taiwan stock market explained that foreign investors prefer to invest in large companies due to the problem of information asymmetry. Foreign investors face higher investment hurdles in small companies than large companies (Lin & Shiu, 2001). According to the Daud et al., (2015) larger companies are consider to adopt good standards of corporate governance structure because they have to access more external finance. Similarly Dahlquist and Robertsson (2001) found that foreign investors prefer large companies for investment. Reason could be that large companies are able to adopt better standards of corporate governance structure because they are considered financially strong companies than small companies.

Similarly second control variable leverage ratio of the company is also explains significant and positive relationship with foreign institutional ownership. As P value of leverage 0.1 is equal to tabulated value 0.1 at a 90% level of confidence. It asserts that foreign investors prefer to invest in companies having high debt to equity ratio. Reason could be debt base companies is always gives positive signals in the market and let the foreign investors know that company possess good financial condition, so that's why financial institutions are ready to give loan to that specific company.

Third and forth control variable growth rate and dividend cover ratio depicts insignificant results. According to this study these two control variables have not any relationship with foreign institutional ownership.

This study employs industrial dummies for capturing the industrial effect. According to results food (sugar) sector shows significant negative relationship at 95% level of significance. As P value .02 is less than tabulated value .05. Motor Vehicles, Trailers & Autoparts sector depicts positive and significant result. As P value 0.00 is less than tabulated value 0.05 and coefficient is positive with value 0.22. Instead of these, non-metallic mineral products (Mineral Products) depicts significant and negative relationship at 90% level of significance as P value .06 is less than tabulated value 0.1. Another sector textile spinning, waving & finishing sector shows significant negative relationship at 90% level of significance as P value .05 is less than tabulated value .1. It asserts that above mentioned four industries shows different behavior from reference industry. The behavior of all other ten industries aligns with the behavior of reference industry.

CHAPTER 5

CONCLUSIONS

This study empirically explores the impact of corporate governance and firm financial performance on foreign institutional ownership in Pakistan equity market. Statistical sample of the study includes 70 listed companies from Karachi stock exchange. The sample period consists of 6 years from 2007 to 2012. To explore the impact of corporate governance, firm financial performance and foreign institutional ownership panel data technique is used.

Results indicate that board size has significant and negative impact on foreign institutional investors. It means that foreign investors prefer to invest in companies with small board size. Reason could be in large board size foreign investors may face the problem of information asymmetry. Board independence has significant and negative impact on foreign institutional ownership. This result is contradicted from theory. According to theory board independence has significant and positive impact on foreign investors. Reason could be data of this study mostly include state owned enterprises. In state owned enterprises the share of foreign investors is considered very low. Audit committee independence has significant and positive impact on foreign institutional ownership. It means that companies having independent audit committee structure attract more foreign investors. Reason could be external auditor has freely power to access financial statement of the company, can prevent the managers from providing biased financial statement, can better monitor the manager's actions because they have not any direct relationship and link with management and thus they can reduce the informational asymmetry problem between managers and shareholders. In this study two proxies are used to measure firm financial performance. (1) Return on equity (ROE) for measuring firm's internal financial performance and Tobin's Q ratio (TQ) for measuring firm's external financial performance. Return on equity has significant and negative impact on foreign institutional ownership. Similarly Tobin's Q ratio has significant negative impact on foreign institutional ownership. In this study Tobin's q ratio consider as an appropriate proxy for measuring firm financial performance because it explains 34% model of the study while return on equity explains only 32% model of the study. Reason could be in Pakistan all foreign institutional investment is just for short term period, it results more volatility in the firm financial performance of the companies. Due to which significant and negative result is found between firm performance and foreign institutional ownership. Although theory does not support this phenomena but empirical evidence is in the support so firm should focus on this phenomena and try to hold foreign investment for a longer time period. If this occurs then empirical evidence of this study may support the theory. Among control variables size of the company shows significant and positive relationship with foreign institutional ownership. It indicates that foreign investors prefer to invest in large companies. Reason could be that large companies are able to adopt better standards of corporate governance structure than small companies and they are considered financially strong companies than small companies. Moreover foreign investors prefer to invest in large companies due to the problem of information asymmetry in small companies. Similarly second control variable leverage ratio of the company is also explains significant and positive impact on foreign institutional ownership. It asserts that foreign investors prefer to invest in companies having high debt to equity ratio. Reason could be debt base companies is always gives positive signals in the market and let the foreign investors know that company possess good financial condition, so that's why financial institutions are ready to give loan to that specific company. Third and forth control variable growth rate and dividend cover ratio depicts insignificant results. According to this study these two control variables have not any impact foreign institutional ownership.

This study employs industrial dummies for capturing the industrial effect. According to results food (sugar) sector depicts significant negative results while Motor Vehicles, Trailers & Autoparts sector shows significant positive result. Other non metallic mineral product sector and textile sector (spinning, Weaving & finishing) sector show significant and negative results. It indicates that these industries have different behavior from reference industry. The behavior of other ten industries aligns with the behavior of reference industry.

5.1 Future Recommendations

1. It is found that the corporate governance practices in Pakistani listed companies are strong but it is not properly implemented. So the government of Pakistan makes sure proper implementation of good corporate governance structure.

2. Market performance of any company plays an important role in attracting investment from foreign investors. When market performance of the company is not good foreign institutional investors withdraw money from that specific company. So companies should work on improving their market performance.

5.2 Practical Implications

The results of this study can be useful for investors, policy makers, regulators. For investors, they should invest in companies which show proper monitoring of corporate governance and firm financial performance. For policy makers, if weak corporate governance is a major reason behind lower foreign capital then they should make polices for improving corporate governance structure. The empirical results of this study provide support to regulatory authorities. For attracting foreign investors in Pakistan equity market they must be ensured proper implementation of corporate governance structure and strong legal system of protection for foreign investors.

5.3 Limitations of the study

This study has some limitations:

- First, this study only focused on the major role of firm level variables in attracting foreign investment. In future research macro economic variables should also be considered such as inflation and interest rate.
- Second, the sample period of this study consists of 6 years from 2007 to 2012 due to unavailability of previous year's data. As in Pakistan, corporate governance code was announced in 2002 and its implementation started in 2003, so the data from previous years should also be considered in future research.
- Third, there exists other determinants of corporate governance like CEO duality and concentration ownership etc and other measures of performance like earning per share, return on asset that need to be investigated.

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