



**RESEARCH PAPER**

**Examining the Non-linear Relationship between Corporate Governance and Firm Performance in Pakistan**

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**ABSTRACT**

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This study looks into the impact of board structure, reporting and disclosure and transparency on the success of family businesses in Pakistan. It also examine if the relationship between corporate indices is linear or non-linear in nature? BOD index, reporting index, and disclosure index are constructed based on governance practices. The dependent variable is return on assets (ROA), and the relationships are estimated using GMM. The findings reveal a strong relationship between each governance index and ROA. Further, the findings confirm the presence of non-linearity of the CG indices-performance relationships. Family firms are prone to extreme agency disputes, and both internal and external governance is needed to protect minority shareholders' interests from the family firm's entrenched ultimate controllers. The results show that good corporate governance practices have a significant positive monitoring impact on the success of family businesses in Pakistan.

**Introduction**

Corporate governance has recently attracted the interest of scholars in the area of corporate finance. Since ownership and management are different in the company, corporate governance considerations are of greater concern to academics, administrators, and policymakers. For the protection of fund providers' equity stakes, it is critical to improve the firm's internal governance mechanism as well as the consistency of its external governance structure. Various studies have looked at various facets of corporate governance (CG) issues such as board composition, board independence, board control level, and board meeting frequency, and found that these factors have a direct effect on a firm's success (Vafeas, 1999; Ryan & Wiggins, 2004). Board structure such as leadership and director composition is said to influence corporate outcomes (Daily & Dalton 1994 & 1995; Dalton et al., 1998), as well as institutional investor participation and shareholder activism (Davis &

Thompson, 1994). As a result, global stock exchanges and regulatory bodies have proposed governance practices to address agency problems, resulting in the development of a controlling management structure to improve efficiency (Brown & Caylor, 2009). These activities have resulted in numerous developments such as the separation of the CEO and chairman, the majority of independent directors, and the inclusion of nominees in the board, among others, but a straightforward picture of board leadership styles and practices remain elusive (Dalton et al., 1998).

Corporate governance is concerned with reporting as a means for management to communicate to potential investors the extent of governance and internal financial results. The majority of non-executive directors of the board of directors are responsible for financial statements (Beasley, 1996). Corporate reporting (Eccles, 2004) is the availability of financial and non-financial information outside regulations to all stakeholders, which emerged when corporate reporting was limited only to financial reporting, ignoring environmental and social propositions (Deegan, 2004), and ignoring the views of many scholars who treated a firm as a social institution rather than a private institution (French, 2004). Furthermore, corporate disclosures are essential for a well-functioning market because they tend to reduce agency tensions between management and external investors and symmetry the details (Healey & Palepu, 2001; Eloisa, 2010).

On a sampling of family firms, the contribution is in building CGI across three areas, including BOD, transparency and disclosure. In the Pakistani business sectors, family businesses are the most visible (Waseemullah & Hasan, 2016, 2017 & 2018). Controlling and minority shareholders of family firms have serious agency disputes among themselves. Internal and external governance are key in these companies to avoid agency issues (Waseemullah et al., 2017). The impact of the BOD index, reporting index, and transparency index on the success of family businesses has never been studied in Pakistan.

### **Literature Review**

According to La Porta et al. (1996) and Shleifer & Vishny (2007), firms working in weak investor protection system have a more concentrated shareholder structure. As a result, we might contend that the family owner's long-term perspective lowers agency costs (Hsu, Chen, & Lin, 2007) and leads to higher results (Mazumdar, Sarin, & Sengupta, 2002). The Turkish evidence also supports this point of view. Independent board members have a detrimental relationship with firm results, according to Ararat, Orbay, and Yurtoglu (2010). Their extensive analysis into the association between independent board members and their companies' performance shows that a significant number of these board members do not meet the independence criteria and are not effective regulators in the spirit of the corporate governance guidelines.

Aside from family influence, foreign ownership is a major component of firm's ownership structure. The majority of studies show that it has a positive effect.

Foreign equity investment, as Shleifer and Vishny (2007) show, results in improved monitoring of the executives. Foreign investors will drive out incumbent management and replace them with more effective directors by using their voting rights. In developing nations, corporate governance has been ignored. Two big causes for imminent corporate governance reforms in developing markets are Asian financial crises and capital market globalization (Tsamenyi, Noormansyah, and Uddin, 2008).

Waseemullah, Safi, and Shehzadi (2015) investigated the impact of earnings management on company results in Pakistan and discovered that it has a substantial positive impact on Return on Assets (ROA). The findings suggested that family-owned businesses, which are common in Pakistan, motivate controlling shareholders by checking subordinates and preventing them from engaging in out-of-line earnings management activities. The effect of corporate governance and earnings control on the financial performance of manufacturing companies in Nigeria was investigated by Hassan and Ahmed (2012). (Mansur & Tangl, 2018) The CG arrangement denotes the division of duties and rights among different members in the company, such as an external auditor, the board of directors (BOD), management, and shareholders. In terms of corporate shareholders, CG defines the rights of the shareholders and ensures that the company and its shareholders work together effectively.

The CG establishes the framework by which organisations' priorities are set in relation to management and boards of directors. When it comes to external auditors, organisations with a strong CG structure make it easier for auditors to do their jobs if they operate honestly and diligently. Organizations can fail due to a lack of a strong CG infrastructure, and it is essential to establish a CG framework in order to improve the organization financial outcomes (Arora & Sharma, 2016). In comparison to a poor CG structure, Berkman, Zou, and Geng (2009) claim that a strong CG structure helps to minimize accounting earnings manipulations. Another research find that companies with a poor CG system had a lot of agency issues, and that managers in these organizations get more personal benefits (Core, Holthausen, & Larcker, 1999). According to agency theory, BODs are far more vigilant about their personal property or assets than with other shareholders' funds (Letza, Sun, & Kirkbride, 2004). To protect the interests of investors, the agency theory proposes that managers' opportunistic actions be restricted. Furthermore, management should be controlled to prevent personal gain at the cost of the company's profitability.

The board's main responsibility is to improve the firm's efficiency in order to maximize shareholder returns. Additionally, it successfully tracks and manages administrative activities (Sheikh & Wang, 2012). The majority of recent research has been unable to find a consensus on the relationship between board size and company results. Some of these studies support agency theory; for example, Uadiale (2010), Jackling & Johl (2009), and Belkhir (2009) found a strong positive correlation between board size and company results. Rashid, Zoysa, Lodh, and Rudkin (2010)

found a connection between board structure and firm performance that was negative. Larger boards are inefficient in general so reaching a majority at the decision is very difficult for them.

In today working environment, CFO role is not limited to a functional level; the position also requires a strategic capacity to enhance the efficiency level. CFO is not only limited to the finance but also to decision making in order to forecast and maintain the financial changeovers, engulfing the market in the coming times. The ability of a CFO to predict financial variations is highly associated with the keeping the firm value higher. According to the survey studies in USA, UK and other developed countries, the CFO is not limited to functional, strategic roles only but also in leadership role. The importance of this position made it a part of corporate governance proxy.

The condition known as CEO duality occurs when the CEO and chairman of a company are the same individual. The majority of recent study has focused on the effect of integrated leadership functions on corporate financial efficiency. The agency principle adds to the two-tier system by segregating the CEO and chairmanships to increase independence for stronger oversight and management, resulting in improved firm performance. The number of independent directors to total directors, or board independence, has long been thought to be an important factor in financial success. In addition, according to Mura (2007), board independence is linked to firm performance. The involvement of independent directors guarantees board accountability by unraveling oversight and task execution, which is the fundamental justification for this positive association. In addition, by eliminating the internal conflict of interest, the relationship between management and stockholders can be strengthened.

Internal audit committee is the integral part of corporate governance system (Klein, 2000). The composition and independence of audit committee is very important otherwise it will be ineffective. Cadbury report recommends that audit committee should comprising of independent non-executive directors not less than three persons who should perform the supervision responsibility while preparing financial statements. Audit committees enhance investors' trust on financial statements and improve the integrity and credibility of financial statements which will ultimately contribute to higher firm performance (Kam & Li, 2008). The auditor remuneration should be approved by the board and there should be no involvement of executives in any way that could affect the auditor performance as a result of any favoritism. There should be proper disclosure of members of internal audit committee, remuneration of external auditors' and other key executives' is essential for the awareness of concerned stakeholders. The disclosure of transparent information is expected to affect firm performance positively.

Annual general meeting allows shareholders to have an opportunity to be a part of the decision making and to make a relative change in their benefits. Shareholders have the option to retain their best people in the board or to change

those persons who are unable to provide any benefit to them. This allows the shareholders to change the direction of the company. The annual general meeting provides the supervision means and discloses the internal capability of holding operations which would help to improve the performance of the company.

Many corporate governance scholars highlight the significance of wide community as a major stakeholder of the firm, suggests: firm's responsibility is not just serving the shareholders but to all stakeholders whose investment is necessary for the accomplishment of business activities. Firms should acknowledge and fulfill corporate social responsibility that will in turn attract the society toward business environment positively (Balabanis, Philips and Lyall, 1998). Numerous studies find a significant impact of corporate social responsibility on the performance of financial market (Spicer, 1978; Anderson and Frankle, 1980; Shane and Spicer, 1983). Some other studies find evidences regarding the higher performance impacts in developing markets than developed markets.

### Material and Methods

The study employs 184 non-financial family firms listed on PSX. In order to estimate the impact of BOD sub-index, reporting sub-index, disclosure & transparency sub-index and ownership sub-index on firm performance, GMM is used.

### Regression Models

#### Model 1

$$ROA_{it} = B_0 + \beta_1 BOD\ Index_{it} + \beta_2 Size_{it} + \beta_3 Leverage_{it} + \beta_4 Growth_{it} + \epsilon_{it}$$

#### Model 2

$$ROA_{it} = B_0 + \beta_1 Reporting\ Index_{it} + \beta_2 Size_{it} + \beta_3 Leverage_{it} + \beta_4 Growth_{it} + \epsilon_{it}$$

#### Model 3

$$ROA_{it} = B_0 + \beta_1 Disclosure\ Index_{it} + \beta_2 Size_{it} + \beta_3 Leverage_{it} + \beta_4 Growth_{it} + \epsilon_{it}$$

#### Model 4

$$ROA_{it} = B_0 + \beta_1 BOD\ Index_{it} + \beta_2 Reporting\ Index_{it} + \beta_3 Disclosure\ Index_{it} + \beta_4 Size_{it} + \beta_5 Leverage_{it} + \beta_6 Growth_{it} + \epsilon_{it}$$

**Model 5**

$$ROA_{it} = B_0 + \beta_1 BOD\ Index_{it} + \beta_2 BOD\ Index^2_{it} + \beta_3 BOD\ Index^3_{it} + \beta_4 Size_{it} + \beta_5 Leverage_{it} + \beta_6 Growth_{it} + \varepsilon_{it}$$

**Model 6**

$$ROA_{it} = B_0 + \beta_1 Reporting\ Index_{it} + \beta_2 Reporting\ Index^2_{it} + \beta_3 Reporting\ Index^3_{it} + \beta_4 Size_{it} + \beta_5 Leverage_{it} + \beta_6 Growth_{it} + \varepsilon_{it}$$

**Model 7**

$$ROA_{it} = B_0 + \beta_1 Disclosure\ Index_{it} + \beta_2 Disclosure\ Index^2_{it} + \beta_3 Disclosure\ Index^3_{it} + \beta_4 Size_{it} + \beta_5 Leverage_{it} + \beta_6 Growth_{it} + \varepsilon_{it}$$

**Results and discussion**

Table 1 presents descriptive statistics for ROA, governance variables and control variables. Mean (median) values are 13.5708 (12.5000), 10.2578 (10.0000) & 22.7645 (23.0000) respectively for BOD, reporting & disclosure index respectively. The correlations & VIF are given in Table 2 & 3 respectively. The results show that all of the governance indices are positively associated with ROA. These results confirm the results of earlier studies (for instance Javid & Iqbal, 2008). However, the correlation coefficients suggest that there is no strong relationship among the explanatory variables. Further, VIF results also confirm that there is no serious problem of multicollinearity.

**Table 1**  
**Descriptive statistics for family firms 2004-2012**

Growth	Leverage	Size	Disclosure Index	Reporting Index	BOD Index	ROA	Variable
0.1669	0.6623	7.7756	22.7645	10.2578	13.5708	0.0335	<b>Mean</b>
0.1372	0.6364	7.7827	23.0000	10.0000	12.5000	0.0293	<b>Median</b>
0.9951	1.9989	10.9515	30.0000	25.0000	27.5000	0.3085	<b>Maximum</b>
-0.6126	0.0316	2.5486	4.0000	0.0000	2.5000	-0.2578	<b>Minimum</b>
0.3402	0.3090	1.4276	3.6517	5.3376	5.7569	0.1070	<b>Std. Dev.</b>
964	964	964	964	964	964	964	<b>Observations</b>

**Table 2**  
**Correlation**

Growth	Leverage	Size	Disclosure Index	Reporting Index	BOD Index	ROA	Variable
						1	ROA
						-----	
					1	0.1605	BOD Index
					-----	0.0000	
				1	0.2447	0.3664	Reporting Index
				-----	0.0000	0.0000	
			1	0.3433	0.2760	0.1554	Disclosure Index
			-----	0.0000	0.0000	0.0000	
		1	0.3697	0.2402	0.2049	0.1768	Size
		-----	0.0000	0.0000	0.0000	0.0000	
	1	-0.1358	-0.0989	-0.1719	-0.0843	-0.3941	Leverage
	-----	0.0000	0.0021	0.0000	0.0088	0.0000	
1	-0.1101	0.0239	-0.0899	0.0636	-0.0060	0.2550	Growth
-----	0.0006	0.4595	0.0052	0.0485	0.8518	0.0000	

All coefficient values greater than 0.05 are significant at 5% level

**Table 3**  
**Variance Inflation Factor**

Centered VIF	Coefficient	Variable
1.1244	0.0000	BOD Index
1.2088	0.0000	Reporting Index
1.3188	0.0000	Disclosure Index
1.2000	0.0000	Size
1.0527	0.0001	Leverage
1.0320	0.0001	Growth
NA	0.0005	Constant

Table 4 reports regression results using GMM estimation method. The coefficient value of BOD index is 0.0020 with significant p-value at 1% level as given in model 1. Similarly, coefficient values of reporting index & disclosure index are 0.0057 & 0.0032 respectively with significant p-values at 1% level as shown in regression model 2 & 3. The results portray that relationship between BOD index & reporting index remain significantly positive whereas it is insignificantly positive for disclosure index as presented in model 4. These findings clearly confirm strong positive relationship between corporate governance index and firm performance in Pakistan. These findings support previous studies' findings for instance Javed and Iqbal (2007), Arora and Bodhanwala (2018) among others.

**Table 4**  
**Relationship between governance indices and firm performance**

Model 4	Model 3	Model 2	Model 1	Variable
0.0012**			0.0020***	<b>BOD Index</b>
0.0357			0.0008	
0.0048***		0.0057***		<b>Reporting Index</b>
0.0000		0.0000		
0.0004	0.0032***			<b>Disclosure Index</b>
0.6765	0.0007			
0.0023	0.0049	0.0040	0.0052	<b>Size</b>
0.4822	0.1906	0.2148	0.1338	
-0.1050***	-0.1199***	-0.1084***	-0.1204***	<b>Leverage</b>
0.0000	0.0000	0.0000	0.0000	
0.0632***	0.0742***	0.0702***	0.0726***	<b>Growth</b>
0.0000	0.0000	0.0000	0.0000	
-0.0013	-0.0096	0.0049	0.0343	<b>Constant</b>
0.9694	0.8000	0.8795	0.3283	
0.2859	0.2202	0.2841	0.2210	<b>Adjusted R-squared</b>
11.2400	7.2840	6.1648	9.2146	<b>J-Statistics</b>
0.1285	0.2004	0.2905	0.1008	<b>Prob. J-statistics</b>

\*\*\*, \*\* & \* denote significance at 1, 5 & 10% level.

The results reported in Table 5 show the non-linearity of the CG sub-indices-performance relationships. The results of Model 5 confirm that BOD Index is non-linearly related with ROA of the family firms. All of the coefficient of BOD Index, BOD Index<sup>2</sup> & BOD Index<sup>3</sup> are significant at conventional levels. BOD Index is positively related whereas BOD Index<sup>2</sup> & BOD Index<sup>3</sup> are negatively related with ROA. These findings suggest that BOD Index at moderate level positively affects the performance and however, it negatively affects the performance both at initial levels & higher levels. Further, Reporting Index, Reporting Index<sup>2</sup> & Reporting Index<sup>3</sup> show positive relationship and however, the results are not significant at conventional levels as shown in Model 6. The results in Model 7 indicate that Disclosure Index is negatively associated whereas Disclosure Index<sup>2</sup> & Disclosure Index<sup>3</sup> are positively associated with ROA and however, results are not significant for Disclosure Index<sup>3</sup>. The findings confirms that Disclosure Index-ROA relation is negative at lower levels and it becomes positive at moderate level of Disclosure Index. These findings suggest that at lower levels of CG indices, these do not affect positively the ROA and these started to affect positively when the levels of the CG indices reach at moderate levels. Moreover, after a certain level, it again started to affect negatively or insignificantly the ROA at higher levels. The negative or insignificant performance impacts of CG indices both at initial level & higher level tend to show that CG practices may not necessarily improve the performance rather firms may not have adopted the CG practice in true spirit of law rather just for the compliance.



**Table 5**  
**Non-linearity of governance indices-performance relationships**

Model 7	Model 6	Model 5	Variable
		-0.0249***	BOD Index
		0.0004	
		0.0022***	BOD Index <sup>2</sup>
		0.0000	
		-0.0001***	BOD Index <sup>3</sup>
		0.0000	
	0.0027	Reporting Index	
	0.5055		
	0.0002	Reporting Index <sup>2</sup>	
	0.5566		
	0.0000	Reporting Index <sup>3</sup>	
	0.6077		
-0.0246*		Disclosure Index	
0.0755			
0.0013*	Disclosure Index <sup>2</sup>		
0.0804			
0.0000	Disclosure Index <sup>3</sup>		
0.1217			
0.0010	0.0041	0.0050	Size
0.7894	0.1948	0.1459	
-0.1250***	-0.1079***	-0.1223***	Leverage
0.0000	0.0000	0.0000	
0.0685***	0.0611***	0.0665***	Growth
0.0000	0.0000	0.0000	
0.1965**	0.0143	0.1249***	Constant
0.0137	0.6461	0.0017	
0.2178	0.2835	0.2329	Adjusted R-squared
39.7013	10.4836	12.8577	J-statistic
0.1035	0.1628	0.1075	Prob. (J-statistic)

\*\*\*, \*\* & \* denote significance at 1, 5 & 10% level.

## Conclusion

In family firms, conflicts are more common. Increased quality of internal governance and compliance of the provisions of the external governance, according to agency theorists, are the most important methods for reducing agency problems and improving firm performance (Waseemullah, 2017). The CG indices are built in three categories: BOD, reporting and disclosure, and their ultimate impact on company financial performance are investigated. Further, it is examined that if CG indices-performance relationships are linear or non-linear in nature? The GMM method is used to establish the relationships. The results show that each index and company performance have a clear positive relationship in family firms. The firms adopting both the internal and external governance practices yield improved performance. The findings provide regulatory bodies insight into how to improve external monitoring of the companies to increase their financial outcomes. It also directs the firm's management to follow sound CG procedures in order enhance

shareholders' confidence to avoid agency problems Further, CG indices (BOD Index & Disclosure Index) are positively associated with the performance only at moderate levels of indices. These affect negatively or these indices are ineffective at lower & higher levels. The results are also evident that family firms may not follow governance practice in true spirit but these adopt the practice only for complying the rule of law.

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