ROLE OF CAPITAL STRUCTURE BETWEEN CORPORATE GOVERNANCE AND FIRM PERFORMANCE: EMPIRICAL EVIDENCE FROM PAKISTAN

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Abstract

This study examines the role of capital structure (CS) in the relationship between corporate governance (CG) and firm performance. The empirical findings indicate that high-quality CG has a positive and significant impact on the performance of Pakistani non-financial firms listed on the Pakistan Stock Exchange (PSX) between 2017 and 2022. Moreover, the study shows that CS has a moderate reinforcing effect on this relationship. These results remain consistent across different econometric specifications and variable definitions. By using specific firm-specific characteristics to represent CS, this study contributes to the literature by demonstrating that CS can strengthen the association between CG quality and firm performance. These findings have important implications for CG practices in developing countries, as firms in these contexts can enhance their performance by implementing and adhering to good governance practices. Additionally, firms in developing countries should adopt effective financial strategies concerning CS to further enhance the relationship between CG quality and firm performance. For potential investors, it is recommended to consider the debt level in the CS of non-financial firms in Pakistan when making investment decisions.

***Keywords**: Capital Structure, Corporate Governance, Firm Performance, Pakistan Stock Exchange*

INTRODUCTION

Given the volatile condition of Pakistan capital market and the distinctive institutional environment of listed firms in Pakistan, there is a growing interest in understanding the impact of corporate governance (CG) on firm performance. Pakistan's capital market has witnessed a significant influx of foreign investment, hence there is a need to improve CG quality in order to accommodate the increasing openness of Pakistan's capital market to foreign investors (Rehman & Jan, 2022). Effective governance practices establish fairness, transparency, and accountability within the business environment (Khan et al., 2020), while weak governance can lead to inefficiencies, mismanagement, and corruption (Ullah et al., (2021). Consequently, a country without sound CG practices may be susceptible to financial crises. Notably, the global financial crisis of 2008 was largely attributed to deficiencies or the absence of proper CG processes and practices (Ullah et al., 2020). Therefore, this study aims to investigate the influence of CG quality on firm performance in this distinct context (Hussain & Gul, 2023). Specifically, it explores the relationship between CG, measured as a composite indicator, and the performance of Pakistani firms from the perspective of capital structure (CS).

Agency theory suggests that there should be a positive relationship between the quality of corporate governance (CG) and firm performance, as it helps reduce conflicts of interest between principals and agents. Consequently, numerous researchers have extensively studied the impact of CG quality on firm performance worldwide. Some studies have found a direct relationship between CG mechanisms and firm performance, while others have identified an indirect relationship. As a

result, the findings regarding the effect of CG on firm performance remain inconclusive. These inconsistencies may arise due to differences in sample size, industry sectors, time periods examined, or variations in performance measurement methods.

In cases where there is extensive inconsistency in the literature regarding the relationship between a dependent variable and an independent variable, Baron and Kenny propose that the inconsistencies could be explained by the indirect effects of a moderating variable. Inconsistent empirical results can be influenced by various factors, including firm-specific characteristics. Researchers suggest that the effectiveness of a CG system is contingent upon certain key firm-related variables, such as corporate social responsibility (CS). Previous research indicates that these mechanisms are interconnected, and firms can choose an optimal combination of them. While previous studies have primarily focused on examining the direct links between CG quality and firm performance, there has been limited research on the effect of CG on firm performance in the context of Pakistan.

Furthermore, only a few studies have investigated the role of moderating variables, which represents a gap that researchers in the field of CG have encouraged exploring due to the significant role that intervening factors may play. It would be valuable to understand whether CS influences the relationship between CG quality and firm performance. Previous literature has predominantly examined the correlations between each pair of these three factors separately, such as the effect of CG on firm performance, the effect of CG on CS, or the effect of CS on firm performance. However, from the perspective of CS, it remains unclear whether CG has a direct or indirect effect on firm performance, which is a central topic in the recent CG debate. Therefore, this study aims to bridge both theoretical and practical gaps by examining the moderating effect of CS on the relationship between CG quality and firm performance. It investigates this association from the perspective of CS, expecting a synergistic effect that enhances the relationship between CG quality and firm performance.

This approach was chosen because firms in developing countries, faced with weak corporate governance (CG) systems, often heavily rely on debt to finance their corporate social responsibility (CS) initiatives (high gearing). This reliance on debt increases the risk of financial crises (Ateeq et al., 2022). The financial decisions made by firms regarding CS are becoming increasingly crucial for their survival, development, and value maximization (Gul et al., 2022). According to agency theory, CS can help reduce agency costs (Ullah et al., (2019), while the trade-off theory of CS suggests that firms with optimal debt ratios in their CS can maximize tax shield benefits while mitigating the costs of bankruptcy associated with debt financing (Ullah & Hamdard, 2019). As a result, many researchers argue that an optimal CS is vital for a firm's success due to its connection with risk and reward (Ullah et al., 2019). Through the imposition of stringent debt covenants, a well-controlled CS can reduce opportunistic management behavior and agency costs, thereby enhancing profitability and performance (Arif & Syed, 2015). Consequently, the contingent role of CS in the relationship between CG quality and firm performance is considered evident.

Most studies on CG have focused on examining individual characteristics. However, this study takes a different approach by developing a composite governance measure called the Corporate Governance Index (CGI). To the best of our knowledge, no previous study has used panel data to evaluate these mechanisms and explore their impact on corporate performance in the context of Pakistan. Thus, this study is pioneering in that it investigates the moderating effect of CS, which remains a gap in the existing literature. Additionally, most previous studies on CG and firm performance have been conducted in developed countries, such as the United States and the United Kingdom. In contrast, this study focuses on Pakistan as a developing country with a unique institutional environment. Therefore, generalizing the findings of prior studies to emerging or developing markets like Pakistan may not be appropriate. The CG system is relatively new in the Pakistani context, and the capital market is not as extensive and deep as those in developed countries. It is argued that emerging markets vary significantly due to cultural, economic, and political systems, highlighting the necessity of country-specific governance studies (Babu & Sharma,

2018) to determine the significant CG mechanisms for different types of firms and settings (Okiro, 2015).

The selection of firms listed on the Pakistan Stock Exchange (PSX) was based on the PSX's reputation as one of the efficient stock markets in Asia [Ateeq et al., 2022; Ullah et al., 2022]. Non-financial firms, including both industrial and service firms, were specifically chosen due to their significant role as sources of employment and drivers of economic growth in Pakistan. These firms play three crucial roles: producing goods and services, investing in non-financial assets, and borrowing from financial markets. Moreover, they have recently faced numerous challenges and difficulties stemming from regional instability (Hussain & Gul, 2023)
adversely impacting their performance.
Hence, this study aims to provide a unique understanding of the impact of CG quality on firm performance, considering the specific strategies and financing decisions adopted by individual firms. By doing so, it will contribute a fresh perspective to the existing theories in this field. Furthermore, the findings of this study are expected to hold relevance for legislators, shareholders, and other stakeholders of non-financial firms in Pakistan. The insights gained from the study can potentially guide efforts to enhance CG quality and corporate financial decision-making, thereby improving overall outcomes for these organizations.

LITERATURE REVIEW

Corporate governance (CG) is recognized as the foundation for the survival and growth of organizations, playing an essential role in achieving organizational goals across all sectors worldwide. The importance of CG in instilling investor trust in financial markets has been acknowledged, particularly in light of past financial scandals, technological advancements, market liberalizations, and trade and capital mobilization. Academics, legislators, and business practitioners consider CG as a significant concern within corporate structures (Claessens, Djankov & Lang, 2000).
Weak CG practices raise doubts about a corporation's trustworthiness, reliability, and commitment to shareholders. Scandals like Adelphia Communications, Kmart, Chiquita Brands Int, Enron, WorldCom, One.Tel, Kabul Bank, Pacific Gas, and Electric Company, and Wells Fargo (Baydoun, Maguire, Ryan, & Willett, 2013) demonstrate that inadequate CG systems fail to prevent fraud, deception, corruption, and insider trading. These scandals severely shook investor trust in capital markets. Regulatory authorities worldwide responded by making it mandatory for corporations to comply with CG codes and best practices to ensure accountability, transparency, and fairness for shareholders. These practices help mitigate agency costs, as proposed by Jensen and Meckling (1976). The prevalence of corporate scandals and the Jensen and Meckling theory have been key drivers in the global spread of CG codes.
CG first gained prominence in the United States in the 1970s, while the Securities and Exchange Commission of Pakistan issued its CG code in 2002. The primary purpose of CG codes worldwide is to ensure transparency and accountability in all aspects of a firm's operations, protecting the interests of various stakeholders, including shareholders, governments, creditors, employees, society, customers, and the business community at large. It is observed that the rights of minority stakeholders are often violated (Agyei & Owusu, 2014). The mechanisms of CG can vary significantly depending on how corporate owners incentivize managers (Brown & Caylor, 2004). CG systems also differ among countries due to variations in capitalist systems (Hermalin & Weisbach, 2001). Consequently, different models of CG exist globally, each with distinct characteristics (Hasan, Kobeissi, & Song, 2011). Davies, Hillier, & McColgan (2005) identified two corporate structure models: the stockholders' model, which focuses on enhancing shareholder value, and the stakeholders' model, which emphasizes the welfare of all stakeholders.
Every organization strives to achieve its goals and objectives by effectively and efficiently deploying its resources to compete in domestic and international markets and maximize returns for investors. It has been observed throughout history that properly directed and controlled firms have

achieved their goals, while those lacking proper direction and control have vanished from the markets. Many researchers refer to the functions of directing and controlling corporate affairs as CG. CG encompasses the mechanisms through which organizations are directed and controlled, emphasizing the need for checks and balances in corporate governance processes (Gompers, Ishii, & Metrick, 2013). This aligns with the definition provided by the Audit Commission (2009), which emphasizes accountability and control as central aspects of CG. Proper direction and control are crucial for firms to attain their objectives (Butt, 2012). Thus, the mechanism through which companies are directed and controlled is termed as CG (Barbosa & Louri, 2005). This definition underscores the necessity of effective governance practices in administering corporate affairs. The Australian Standard (2003) defines corporate governance (CG) as the mechanism through which companies are directed and controlled. It encompasses the legitimate authority for directing and controlling corporate operations. This definition emphasizes the need for checks and balances in the administration of corporate affairs (Gompers, Ishii, & Metrick, 2013). It aligns with the definition provided by the Audit Commission (2009), which focuses on accountability and control as central aspects of CG. Proper direction and control are essential for organizations to achieve their objectives.

One of the primary goals of any business organization is to maximize shareholders' wealth, which is accomplished through financial soundness. Financial performance (FP) significantly influences corporate goodwill and investor trust. The FP of an organization is reflected in its operations, whether it is generating profits or incurring losses. Profit generation or sustained losses indicate the FP of a firm (Chugh, Meador & Kumar, 2009). Organizations that yield higher profits demonstrate good FP, while those experiencing losses exhibit weak FP. Sound FP leads to higher returns for investors, timely repayment of principal and interest, and long-term growth. Investors in stock markets prefer corporations with high returns and low risk. Rational investors employ various approaches to thoroughly analyze firms before making investments. Therefore, companies need to generate sufficient profits to retain current investors and attract more domestic and foreign investors to meet their operational, fixed asset, and financing needs. Bhagat & Bolton (2008) noted that price-earnings ratio, return on assets (ROA), return on investment (ROI), earnings per share (EPS), and dividend yields indicate a firm's productivity, profitability, and growth. Increasing corporate sales, improving ROA, ROE (return on equity), and efficiency demonstrate strong FP (Cheema & Din, 2014). Firms that practice CG effectively tend to have better FP (Edwards & Nibler, 2000). Organizations that are properly directed and controlled generate higher returns for investors, achieve higher ROA, and ultimately enhance their reputation. Proper governance is crucial for companies to enhance FP, maximize market share, and thrive in domestic and international markets.

Studies have consistently demonstrated a direct positive relationship between corporate governance (CG) and the financial performance (FP) of companies worldwide. Proper CG practices are known to enhance FP, and there is a positive correlation between CG and the FP of corporations (Azeem, Hassan, & Kouser, 2013). For example, Javed and Iqbal (2006) conducted research on fifty non-financial firms listed on the Pakistan Stock Exchange (KSE) over a ten-year period and found a positive impact of CG on FP. Similarly, Baydoun, Maguire, Ryan, & Willett (2013) investigated the association between CG and FP in business organizations across five Gulf countries and found a positive relationship. Chugh, Meador, and Kumar (2009) also stated that effective CG implementation enhances FP, while weakly governed organizations face higher risks.

Financial scandals in various developed and developing economies have revealed that weak CG practices were a fundamental cause of fraud, bankruptcy, and collapse in these firms. Weak CG practices increase the risk profile of a firm, making weakly governed organizations more vulnerable compared to soundly governed ones. CS has emerged as a widely adopted financing strategy across various sectors, including the non-financial sector (Hussain & Gul, (2023). It is considered a mechanism that can help mitigate agency problems (Ateeq et al., 2022). Moreover, the adequacy of CS is recognized as a significant factor in determining firm performance (Prasetyo, 2019). However, the role of CS as an intervening factor has been largely overlooked in the literature on corporate

governance (CG). In social sciences, the incorporation of moderating variables into models has become a common methodology to enhance understanding of the causal relationship between variables (Ullah et al., 2020). While the literature has explored the moderating role of different mechanisms on the relationship between CG quality and firm performance, the moderating role of CS has been largely neglected. This is surprising considering that CS could offer valuable insights into comprehending the causal relationship between CG mechanisms and firm performance, particularly given the inconclusive empirical results on this relationship (Ullah et al., 2019).

Several studies have highlighted the interrelated nature of governance mechanisms and the potential for firms to choose an optimal combination that aligns with their specific circumstances (Azeem, Hassan, & Kouser, 2022; Hussain & Gul, 2023) . This argument is rooted in agency theory, which posits that CS can reduce agency costs (Okiro, 2015), while CG aims to address agency problems. Therefore, good governance practices and CS are intertwined through their association with agency costs.

Despite these recommendations, previous literature has primarily focused on examining the correlation between individual pairs of three factors: the impact of corporate governance (CG) on firm performance (Hussain & Gul, 2023), the influence of CG on customer satisfaction (CS) (Mansur and Tangal, 2018), and the effect of CS on firm performance (Masnoon and Rauf, 2013). However, it is anticipated that corporate financial decisions (CS) would strengthen the relationship between CG and firm performance (Azeem, Hassan, & Kouser, 2022). CS serves as a governance mechanism by actively reducing agency costs associated with unrestricted cash flows, thereby preventing investments in projects with negative net present value (Okiro, 2015). Consequently, an optimal CS could limit managerial discretion over free cash flows (Hussain & Gul, 2023). Therefore, CS functions as a complementary control mechanism, enhancing the efficacy of other governance mechanisms.

Hypotheses

H_1: CG has a significant and positive impact on Firm Performance.

H_2: CS significantly moderates the impact of CG on firm performance.

Conceptual Model

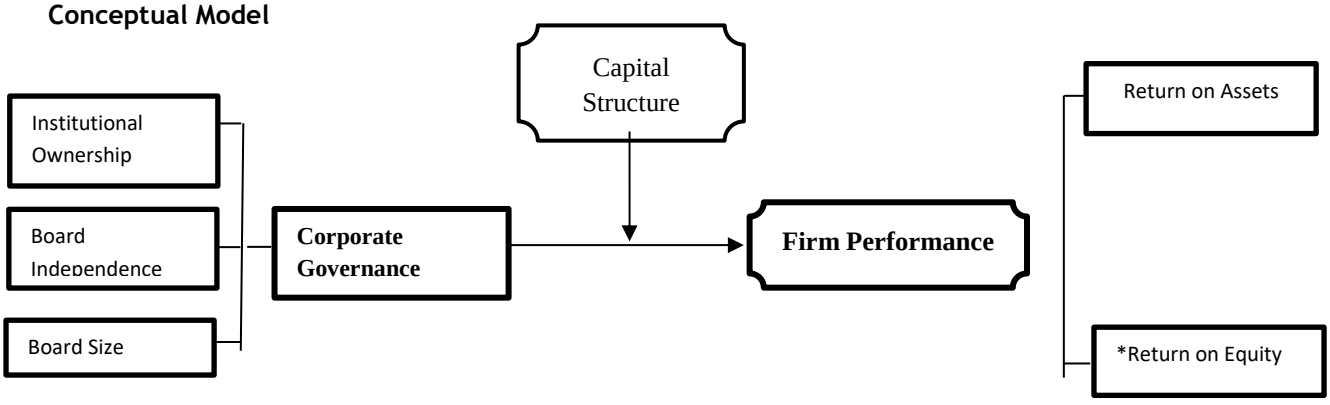

Figure 1: Conceptual Model

RESEARCH METHODOLOGY

To achieve the research objectives, the present study utilizes data from 2017 to 2022 pertaining to corporate governance, firm performance, and capital structure of non financial sector firms listed on the PSX. Annual audited reports served as a secondary data source for gathering data related to CG, CS, and FP. The data is analyzed using descriptive statistics, Pearsons correlations matrix, and regression. Stata version 17 is utilized for conducting the analyses.

Descriptive Statistics

Table 1.

Descriptive Statistic

Variables	Mean	Std Dvn	Mnm	Mxm
BS	0.56	0.30	0.01	3.97
BI	0.15	0.36	0.01	1.00
IO	0.21	0.06	0.17	3.13
RoA	035	0.14	0.10	2.19
RoE	0.29	0.29	0.03	2.09
D/E	1.48	0.19	0.06	1.48

Note. BS = Board Size, BI = Board Independence, IO = Institutional Ownership, RoA = Return on Asset, RoE = Return on Equity, Debt to equity = D/E

Correlation Matrix

Table 2 presented below demonstrates the positive correlation of certain aspects of corporate governance with firm performance, while indicating a positive association with capital structure. The findings indicate that an increase in board size is positively correlated with return on assets and return on equity: r = .18, .28, and 0.13). Similarly, the results demonstrate that institutional ownership is positively associated with RoA and RoE, (correlation coefficients: r = .20, .24, and 0.48). Moreover, the outcomes reveal that board independence is positively correlated with RoA and RoE: r = .49, 0.35, and 0.40).

Table 2. Correlation Matrix

Variables	BS	IO	BI	RoA	RoE	D/E
BS	--					
IO	.15	--				
BI	.18*	.11	--			
RoA	.18	.20*	.49**	--		
RoE	.28	.24**	.35**	.12*	--	
D/E	-13	.48*	.40**	.23**	.39**	--

Note. BS = Board Size, BI = Board Independence, IO = Institutional Ownership, RoA = Return on Asset, RoE = Return on Equity, Debt to equity = D/E

Table 3. Regression Analysis

FP	B	t	p-value
BS	0.15	2.25	0.025
BI	0.29	4.14	0.000
IO	0.26	3.83	0.000
F = 45, R^2 = 0.51 ΔR^2 = 0.48			

Note. **= *p<0.01,* *= *p<0.05,*

The findings presented in Table 3 shed light on the impact of corporate governance on firm performance. According to the results documented in the table, all aspects of CG collectively explain 48% of the variation in FP (R2 = .51, F = 45, ΔR2 = .48, P < 0.05). The outcomes also reveal specific beta values: 0.15 for board size (BS), 0.29 for board independence (BI), and 0.26 for institutional ownership (IO). Additionally, corresponding t-values are reported as 2.25 for BS, 4.14

for BI, and 3.83 for IO, with associated p-values of 0.025 for BS, 0.000 for BI, and 0.000 for IO. Overall, these results demonstrate that CG has a positive influence on FP, thereby supporting the first hypothesis that investigates the positive impact of CG on FP (Shahid et al., 2017; Wahla et al., 2012).

Table 4. Moderation Analysis

Firm Performance	Step 1 Control Variable		Step 2 Control Variable and Independent Variable		Step 3 Control Variable and Independent Variable and Moderator		Step 4 Control Variable and Independent Variable and Moderator Interaction	
	Coef.	t	Coef.	t	Coef.	t	Coef.	t
FSZ	1.435	4.20 *	0.942	2.66 *	1.7	4.86 *	1.66	4.84 *
FAGE	0.063	2.13 **	0.039	1.31 †	0.052	1.84 ***	0.045	1.64 †
SAGR	16.47	8.24 *	15.96	8.11 *	15.91	8.55 *	15.24	8.30 *
MTBA	2.75	4.88 *	2.39	4.27 *	2.89	5.43 *	3.005	5.72 *
CGI			26.50	4.24 *	24.86	4.21 *	27.49	4.70 *
CS					−15.40	−7.57 *	−15.69	−7.84 *
INTERACTION							94.25	4.14 *
R^2	0.2368		0.2649		0.3452		0.3683	
Adjusted R^2	0.2303		0.2571		0.3368		0.3589	
R^2 change			0.028		0.080		0.023	
F-change			17.987		57.324		17.143	
Significant F-change			0.000		0.000		0.000	

Table 4 provide additional support to the primary outcomes that CS functions as a moderating variable that positively influences the association between the CG and the FP of the company. As a result, this confirms the second hypothesis.

DISCUSSION

This study aimed to explore the role of capital structure (CS) in the relationship between corporate governance (CG) and the Firm Performance (FP) of non-financial listed firms on PSX. The findings demonstrated a positive effect of CG on future firm performance, consistent with previous research in developing countries. These results imply that CG principles are applicable in Pakistan and suggest that a comprehensive CG implementation improves FP by reducing agency costs and aligning managerial and shareholder interests. The study also highlights the relevance of agency theory in developing economies like Pakistan, despite differences in institutional contexts compared to developed countries.

The analysis revealed that as the level of CS in non-financial firms increases towards an optimal level, the positive impact of CG on performance indicators becomes more pronounced. This suggests that the combined influence of CG and CS plays a crucial role in reducing conflicts of interest between management and shareholders by mitigating agency costs associated with managers. The interaction term, representing the joint effect of CG and CS, enhances control over management, leading to reduced opportunistic behavior and minimized agency costs compared to the individual effects of each variable. Consequently, the interaction term demonstrates a significant marginal effect on performance indicators for Pakistani non-financial listed firms across various models. This highlights CS as a complementary control mechanism that enhances the effectiveness of CG quality. Additionally, the findings indicate that CS influences the relationship between CG quality and future performance, providing incremental information to explain variations in FP.

The findings of this study emphasize the significant role of CG quality and CS in improving firm performance. As a result, all stakeholders, including investors, should consider both CG quality and corporate financial decisions related to CS when making investment decisions in non-financial Pakistani firms. These results have crucial implications for regulators who aim to establish a robust regulatory framework that fosters investor trust and attracts foreign investments. It highlights the importance of ongoing reforms and updates to CG codes by legislators and policymakers in developing countries to enhance FP and prevent potential failures.

Furthermore, the insights provided by this research offer valuable guidance to policymakers addressing agency-based conflicts of interest within firms. It provides evidence for the effectiveness of employing complementary mechanisms such as CS to reduce agency costs.

The findings of this study have concrete implications for non-financial firms and investors interested in the non-financial sector in Pakistan. Firstly, the study highlights that firms can improve their performance by implementing high-quality CG practices and maintaining a balanced capital structure. It also indicates that increasing debt financing does not contribute positively to the performance of non-financial firms. Therefore, non-financial firms in Pakistan should prioritize optimizing their CS as a means to differentiate themselves in the market.

Furthermore, the composite measure of CG practices used in this study provides investors with a quantitative tool to assess the performance of non-financial firms. Consequently, investors are advised to consider a firm's governance score as a crucial factor before making investment decisions. By doing so, investors can make more informed judgments about the potential of non-financial firms in Pakistan.

CONCLUSION

During the period from 2017-2022, this study examined the effects of CG quality and CS on the performance of non-financial firms listed on the PSX. It also investigated how CS moderates the relationship between CG quality and firm performance. The results indicate that both the CG and CS significantly impact non-financial firms in this sector. Specifically, the findings support the notion that a composite measure of CG provides a more accurate assessment of CG quality. Non-financial firms with higher scores on the constructed CG demonstrated superior performance. Moreover, the results of the multivariate regression analysis revealed that the interaction between the composite measure of CG and CS has the potential to decrease conflicts of interest between management and shareholders by reducing agency costs associated with managers.This implies that better monitoring and control of managerial behavior, combined with stronger alignment with stakeholders' interests, translated into increased cash inflows and ultimately enhanced performance for non-financial firms listed on the PSX.

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