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Corporate Governance and Firm Performance: Exploring the Mediating Role of Financial Slack

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ABSTRACT

Purpose: Generally, prior literature merely focuses on the direct nexus of governance-performance, while ignoring the precise channels through which corporate governance has an effect on the firm performance. Specifically, this study has taken up this issue to capturing the governance-enterprise valuation following the indirect channel of financial slack in Pakistan.

Design/Methodology/Approach: The study examined the corporate governance and enterprise performance linkage, employing financial slack as a mediating variable. A market-based performance measure "Tobin's Q" and corporate governance index are used. For the years 2005-2019, this empirical study looks at a large number of 180 firms in the Pakistani non-financial sector. For analysis, a variety of alternative specifications and estimate approaches of panel data analysis are used.

Findings: The empirical findings support the hypothesis that the association between corporate governance and Tobin's Q is likely to be significant. The novelty of the study lies in the governance-value linkage considering financial slack resource as mediator. The study also confirms partial mediation of financial slack, between CG and FP.

Implications/Originality/Value: This study examines the corporate governance standards in Pakistan, a developing nation with a fledgling stock market. The findings show that the organizations with effective corporate governance principles strive to deliver the best financial and market performance. It emphasizes that efficient corporate governance policies curtail the agency conflicts and costs. It is also argued that firms with effective corporate governance can enhance the efficiency of financial slack resources to enhance the efficiency of the firms.

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Introduction

Agency theory has found widespread applicability in recent years looking into the significant role of good governance regarding investment of organization's financial resources, operating performance and growth of corporations. Whenever a significant amount of capital is easily accessible to executives and managers, issues of corruption and misuse of resources are likely to occur (Joh, 2003). They can employ cash flows readily available to invest in negative NPV or positive NPV projects (Jensen, 1993). Supporters of these ideas claim that resource exchange would boost or motivate firms to trade and develop in competitive ecosystems. This research article is multidimensional: resource influence on management objectives. Resources enable individuals to embrace new experiences, experiment and accept risks to make proactive and decisive judgments. When market downturns occur, valuable resources are employed to increase an organization's competitive skills, preserve its relationships, and align personal and financial goals. They also pointed out that financial resources significantly impacted corporate performance (George, 2005). Studies typically neglect listed corporations, leaving a knowledge gap about how slack in the financial system could benefit numerous companies. Because this study encompasses everything we know about this link, it could finally include the important intervening function of finance.

Empirical and Theoretical Gaps

Studies so far have focused on the direct link between corporate governance and firm performance, forgetting to look at the other factors that impact company performance. To evaluate a connection between company governance and performance using a mediating variable that connects the concepts of agency and behavior (Lee, 2012; Shaikh et al., 2016). Here, we're dealing with an issue that has not been focused on earlier. we are examining the link between governance and performance indirectly by analyzing the financial slack channel in a developing country such as Pakistan. According to basic agency theory, all shareholders and managers know how to correctly allocate financial slack resources despite their differences. The conclusion is that this reasoning is incoherent and doesn't favor riskier and more technologically savvy firms. Decisions on exploiting the financial slack could cause investor conflicts of interest (Davis & Stout, 1992). Moreover, decisions on the amount of slack a company needs could vary (Rudyanto, 2019). Also, this study looks at how to best cope with extra company slack. Managers might use business resources as a political bribe to secure personal gains. Another unanswered question is the dispute between international and domestic investors over investment philosophy. International investors choose to minimize risk and loss by investing in short-term funds since national investors favour long-term investment. Basic agency theory merely stresses principal-agent conflict and ignored the principal-principal conflicts regarding the allocating of a firm's financial slack resources. In line with the above argument, corruption, money laundering, and political impulsiveness in Pakistan blame the oscillations in the financial market, leading to financial and economic instability. Firms in Pakistan focus on acquiring a solid presence in the global market but remain unable to accomplish their strategic goals due to reporting issues. Corporations in Pakistan feel that they have no independence and that board members are not free to make choices (Ferreira et al., 2011).

However, two significant concerns scholars encounter while trying to solve governance-performance issues in Pakistan include: First, the study considers overall CG's influence on listed enterprises' performance. Additionally, the CG-performance coupling leaves the financial slack unanswered. Another scholarly effort will show where past empirical and theoretical work failed.

A good governance policy for Pakistan is suitable for both local and global investors. Combining these CG regulations and whistleblower protection legislation with the firm will curb misbehavior and raise the country's economic prosperity (Rehman, 2019). Corruption, money laundering, and political impulsiveness produce instability in the financial market, resulting in negative growth because of weak laws. Pakistan-based enterprises' goal is to maintain an influential international competitive position. However, they still could not accomplish their strategic goals because of accounting concerns. Many believe that Pakistani businesses aren't autonomous, with board members not having absolute power.

The current study works to resolve two disputes and problems related to governance-performance linkages in Pakistan. Firstly, the impact of overall CG on listed organizations' performance. Secondly, the missing channel of financial slack indirectly addresses the CG-performance association. The investigation would show the missing gaps of previous empirical and theoretical literature. This is terrific news for foreign and local investors, who have implemented sound corporate governance procedures in Pakistan. CG rules and whistleblower protection legislation will discourage bad behavior and boost performance, which will benefit the country's economy (Rehman, 2019).

Jensen and Meckling (1976), maintained the notion in AT that slack financially impedes a firm's efficacy. Separating ownership and control hypothesis also supports the argument AT overlooks the conflict between local and international investors about the allocation of slack resources (Kim et al., 2008; Shaikh et al., 2018). Cyert and March (1963) state in behavioral theory that financial slack increases business value (George, 2005). In addition to investigating the role of financial slack on business performance, this study also analyses the diverse governance and ownership arrangements in Pakistan (Kim et al., 2008). However, rare literature is available on this context. The few research sources in the underdeveloped world, such as Pakistan, where a cross-examination has been undertaken, offer very little.

Review of Literature and Construction of Hypotheses

Corporate Governance and Firm Performance

The term "corporate governance" is frequently used in conjunction with the "principal-agent" dilemma. At the firm level, a "principal-agent" is a person who owns a business however it is not the same person who controls it (Lee, 2011; Shleifer & Vishny, 1997). Corporate governance, according to this logic, originates in the private sector and is traditionally defined in terms of the corporation-shareholder relationship. The OECD (2004) defines corporate governance as "the comprehensive set of relationships between a firm's management, board of directors, shareholders, and other stakeholders." It provides the framework within which the company's objectives are defined, as well as the means for achieving those objectives and monitoring performance." Corporate governance, likewise, refers to how an organization interacts with its numerous stakeholders. According to the World Bank (1999), corporate governance can be viewed from two perspectives: external and internal. Outside governance is linked with stakeholders outside the firm, whereas inside CG is associated with the board of directors and the gain of investors (Morse et al., 2002). Similarly, (Herdjiono & Sari, 2017) observed that in the Indonesian economy, rare CG attributes affect the firm value. Although this is a limited study that focused exclusively on Indonesia's manufacturing sector, however, the findings indicate that directors' on the board has a sizable positive impact firm value of the business. So even though, after conducting a simultaneous analysis, it was established that the size of the board of directors, the audit committee, managerial ownership, and institutional ownership affect the financial performance of the firm (Ferreira et al., 2011; Salehi, 2018; Shaikh & Peters, 2013). Keeping in view the related studies, the following hypothesis is developed for this study:

Hypothesis 1: Corporate governance index positively affects firm performance.

The Financial Slack

(Berle & Means, 1991; Hessen, 1983) Initially, the whole focus of CG was documented solely on companies in some advanced countries like the USA. Then, in the early 1990s, other exploratory areas were started to investigate the possible impact of divergent institutions. CG's mechanisms and effectiveness, activated by globalisation and internationalisation (Denis, 2001; Denis & McConnell, 2003; Denis et al., 2003). Slack is a pool of potentially valuable resources that can be distributed or re-distributed to identify the horizons of improvement. Bourgeois III and Singh (1983) split slacks into various available, recoverable and potential slacks categories. Bourgeois II I (1981) differentiates between this company slack. (Singh, 1986) further divides slack into two subcategories: absorbed slack in costs and unabsorbed slack in an unengaged liquid resource of the company" (George, 2005; Lee, 2012; Shaikh et al., 2018).

According to, Jensen (1986) the principal-agent model of CG exclusively emphasizes the controversies owing to conflicting motives. This controversy certainly curbs a firm's resources and ultimately performance. Managers are induced to invest in low return projects, even invest slack resources in negative NPV projects to hunt personal welfare (Kim et al., 2008; Lee, 2012). Peng et al. (2010) conducted a study in China focusing on the role of CEO duality and different types of ownership structure. For this purpose, two types of firms POEs and SOEs have been considered and a comparative analysis has been made. The findings of the study showed that CEO dual response might be apposite for private firms, whereas, unfortunate for government firms while deciding the allocation of financial slack resources. Few studies argued that slacks impact firm value directly (Daniel et al., 2004). However, this impact boils down to how the firm uses its slack. Since the CEO plays a key role behind decisions on how to deploy slacks. CEO duality may influence how the firm uses its slack (Boyd, 1995). Additionally, the role of the CEO in different ownership firms is very complex and understandable regarding the decision about allocation of slack resources. Because family owners prefer slacks to invest in long-run projects whereas, foreign investors prefer short-run investments. (Kim et al., 2008) demonstrated that, in emerging economies, local institutional shareholders and overseas shareholders pursue short-run orientations due to weak investor's protections (La Porta et al., 2000). Due to the expropriation threat by majority shareholders, these outside investors may prefer to seek quick return through dividends from financial slacks (La Porta et al., 2000).

Ashwin et al. (2016) concluded that the effect of the board attributes in allocating financial slacks in different investment projects, especially in the Indian emerging economy, taking seven-year panel data of 172 firms. Study results favor the board as a resource providing by the directors of the board, which is attributed to the emerging economy context. This investigation also signified how diverse corporate governance features do for instance as the director's independence, the board size, and interlocks impact financial slacks in several investment plans by the firms. These directors of the board ought to check executives. Hence, they do not go for under or overinvest in a firm's performance increasing or damaging policies. Nevertheless, the board impacts indirectly through the channel of financial slacks on firm performance while making investments in highly profitable NPV investment projects (Deutsch, 2005; Gangi & Daniele, 2019).

Hypothesis 2: Corporate governance positively impacts financial slack.

Financial Slack and Firm Performance

According to resource and Behavioral theories of the firm, there is a positive relationship between slacks and firm value. Whereas, in the light of the agency model, there is a negative linkage between slacks and the financial performance of the firm due to the high degree of the boss and subordinate individual motives and disputes and high costs (Hailu, 2019). Though (Barnard, 1968) specified the idea of slacks more clarity and attributed it with the purpose of administrators. Later on, (March, 1991) and (Simon, 2013) has explored the role of slacks in-

depth and with more clarity. Resources-based (Penrose & Penrose, 2009) and advocates of firm theories (Augier & March, 2008). Pfeffer and Salancik (2003) elucidated the idea of firm thoroughly. The slack is referred to as a protective measure to empower a firm to regulate efficiently in a challenging world (Bourgeois III, 1981; Nohria & Gulati, 1997). In the light of the resource-based hypothesis, slacks resources can benefit the firm (Penrose & Penrose, 2009), safeguard the firms from environmental uncertainties and upsurge the firm's strategies and plans. Exclusively during the chaos, slacks can help firms to survive (Sharfman et al., 1988). Bourgeois III (1981) pointed out that the efficient use of slacks would positively strengthen firm value. Extra accumulation of lacks would affect performance negatively. A little number of slacks can be better performed during the chaos and financial crisis (E. T. Penrose, 1959; Pitelis, 2009).

Hypothesis 3: Financial slack positively affects firm performance

Corporate Governance, Financial Slack and Firm Performance

Among researchers' governance has remained a long-lasting debate in corporations and amongst policymakers after the financial crisis of 2007-08. It has been objected to the failure of corporate governance monitoring mechanisms. Past research studies related to corporate governance have focused on the dispute of managerial behavior regarding the availability of slacks and its impact on the financial health of an enterprise. Financial slacks maybe call leftover funds or "spare funds that are necessary to survive the business" (Augier & March, 2008). This is a kind of organization slack, which is well-defined in organization's theories as "those resources which an organization has attained which are not put into essential outflows" and "can be used in a discretionary manner". Several firm theories and models deal with the subject of firm slack resources. Generally, firm slack resources are supposed to wreak firm behavior and consequently, firm performance. Therefore, it is considered, that firm financial slack affects firm profitability and performance. Conversely, various researchers do not agree with the notion and having conflicting views that whether these financial slack resources have positive or negative effects on performance (Lee, 2012, 2015).

(Lee, 2012) conducted a study empirically considering the slacks-performance association by employing panel data of the United States and the Britain companies. Applying GMM methodology, the findings shows the conflicting results due to different governance structure. The association of slacks and financial performance of the firm in the United States is negative due to agency issues dominant. Whereas, the slacks-performance association is positive in the United Kingdom following the Behavioral school of thought. However, rare literature is available altogether, on the governance, slack resources and company valuation linkage (Liu et al., 2015; Zhang et al., 2021).

Behavioral Theorists, Cyert and March (1963) and L. S. Penrose (1959) presented Behavioral theory and documented that firm is a collection of certain participants having conflicting motives. In this perspective, slacks mean "the outflows to the participants of the pool" Hence, are used to resolve the disputes among the managers and other stakeholders. (Putri et al., 2019) noted that financial slack is employed as an instrument to resolve conflicts, to undermine disputes and political clashes among various groups for enhancing the value of the firm consistent with the. Therefore, companies use slack for optimization meaning that, maximization of financial and economic benefits at minimum cost (Zona, 2012).

Conversely, agency theorists, Jensen and Meckling (1976) contend, that with the popularity of the corporate sector, governance has got a pivotal role. The advocates of this model strain on principal-agent association. Theorists also maintain that firms with fewer slack resources perform better. Moreover, adding that managers could not be able to exploit the firm's resources for their lavishness. Additionally, if a firm would have an abundance of resources the managers may

invest excess resources in deadly projects of negative NPV to get benefited themselves. The manager's use firm slacks as a political bribe to maintain private relations at the costs of shareholders wealth. This selfish strategy will compromise the holder's wealth and the demise of firm value. (Jensen, 1986), consistent with (Shaikh, 2013). Considering the empirical studies and theoretical differences following hypothesis regarding the mediating role of financial slack in the association between CG and performance is developed:

Hypothesis 4: Financial slack partially mediates, governance-firm performance association.

Data & Methodology

Yearly data for the sample of 180 non-financial concerns listed at the Pakistan Stock Exchange (PSX) has been collected for the period 2005 to 2019. Data sets were compiled from the annual audited financial reports available on each company website and Financial Statement Analysis published by the State bank of Pakistan. Firm Performance (FP) is the explained variable and measured by market-based performance measure: Tobin's Q is consistent with (Khan & Malik, 2020; Kyere & Ausloos, 2021; Latif et al., 2017; Waheed & Malik, 2019). Overall CG is quantified as an index using Principal Component Analysis (PCA). Financial slack is taken as mediator for the investigation of mediating of CG on FP following (Hayes & Preacher, 2014). To control the effect of other endogenous factors, the study considers the effects of sales growth prospect, firm size, and firm age following Latif et al., (2017) and Feng et al. (2018). For estimating the indirect effect between overall CG and FP, the methodologies suggested by (Hayes & Preacher, 2014), for unbalanced panel data is employed. The following are the econometric models of this study.

Estimation Methods

$$TQ_{i,t} = \gamma_0 + \gamma_1 OCG_{i,t} + \gamma_2 Size_{i,t} + \gamma_3 Sales\ Growth_{i,t} + \gamma_4 Age_{i,t} + \mu_{i,t} \dots \dots \dots 1$$

$$FS_{i,t} = \gamma_0 + \gamma_1 OCG_{i,t} + \gamma_2 Size_{i,t} + \gamma_3 Sales\ Growth_{i,t} + \gamma_4 Age_{i,t} + \mu_{i,t} \dots \dots \dots 2$$

$$TQ_{i,t} = \gamma_0 + \gamma_1 Slack_{i,t} + \gamma_2 Age_{i,t} + \gamma_3 Size_{i,t} + \gamma_4 Sales\ Growth_{i,t} + \mu_{i,t} \dots \dots \dots 3$$

$$TQ_{i,t} = \gamma_0 + \gamma_1 OCG_{i,t} + \gamma_2 Slack_{i,t} + \gamma_3 Age_{i,t} + \gamma_4 Size_{i,t} + \gamma_5 Sales\ Growth_{i,t} + \mu_{i,t} \dots 4$$

The firm is denoted by the subscript "i" while the period is denoted by the subscript "t".

Mediating Variable

"Financial slack is the excess capacity of underutilized financial resources. In other words, financial slack is a measure of the amount of cash and cash equivalents. (Kim et al., 2008). This study uses potential slack and to estimate potential slack, we utilize the debt-to-equity ratio (Lee, 2012). Potential slack is the capability to get funds from externally instead of insiders. It is measured with a proxy, leverage divided by total assets (Bromiley, 1991; Shaikh et al., 2018) or Debt-to-Equity is used as a proxy to compute potential slack (Chen et al., 2020).

Fig 1. Conceptual Framework

Fig 1 establishes the complete framework of mediation analysis. The study emphasizes either direct and indirect effect of CG on performance of the company through "l" and "m" pathways.

Following Hayes and Preacher (2014), all pathways such as “l,” “m” and “n” can be evaluated employing regression models through which CG causes enterprise’s performance.

Control variables

Age of Firm (AGE)

It is the period considered when the firm was once established (Kamran & Shah, 2014)

Size of the Firm (FSZ)

In this study, the firm size will be used to control the effect of firm size on the performance of the firms (García-Ramos & Díaz, 2020). The firm size (FSZ) would be measured by taking a natural log of the firm’s total assets (LTA) (Latif et al., 2020).

Sales Growth Prospects

Consistent with (Abbott et al., 2004), this variable is used to control the impact of speedy growth, measured as the relative increase in the sales from the preceding year (Salehi et al., 2018).

Results and Discussion

Descriptive Analysis

Table 1. represents the basic statistics values which are the primary measures to analyse the data. The descriptive values show that all variables are subject to normal ranges. Data can therefore be utilized for even more analysis from the endogenous construct.

Table 1. Summary Statistics

	Tobin's Q	CG-Index	D/E	Firm Size	Sales-Growth	Firm Age
Mean	1.4090	0.5090	0.2600	2.2500	6.5820	1.5170
Maximum	5.4340	1.0000	1.79579	8.4580	9.0760	2.1210
Minimum	0.1330	0.0000	-1.6050	1.1060	2.1700	0.4770
Std. Dev.	1.4890	0.1930	2.8860	1.7200	0.8440	0.2090
Observations	3126	3126	3126	3126	3126	3126

Correlation Analysis

The correlation matrix is a table showing the correlation coefficients of variables in a correlation research.

Table 2 shows no multicollinearity problem from either the correlation analysis. we can deduce a significant relationship of Tobin’s Q continues to exist with all variables other than Debt-to-Equity. However, overall CG is positively correlated except for the age of the firm. Debt to equity and Sales are significantly associated. Age is positively associated except CG-Index and debt to equity ratio.

Table 2. Correlation Matrix

Variables	Tobin's Q	CG-Index	D/E	Firm Size	Sales-Growth	Firm Age
Tobin's Q	1.0000					
CG-Index	0.1400	1.0000				
D/E	-0.2003	0.1130	1.0000			
Firm Size	0.3300	0.5970	-0.177	1.000		
Sales Growth	0.6880	0.6904	0.301	0.3870	1.000	
Firm Age	0.1270	-0.2561	-0.425	0.1680	0.1590	1.000

Regression Estimation

Table 3 shows the findings of regression estimation models (I, II, III, and IV). Empirical analysis of model I divulges that the effect of CG-Index on firm performance is positive and significant at $\alpha = 0.05$, $P < 5\%$, depicting the positive effect of overall CG on Tobin's Q. Similarly, firm size and sales growth prospects are significant and positive, while the coefficient of firm age is positive but insignificant. Considering model II, the findings divulge that the effect of CG on D/E is positive and significant (Coefficient is 0.0920 and P-value is 0.0280, $< 5\%$). Similarly, firm size is positive and significant whereas, the age of the firm is negatively insignificant. However, sales growth is negatively significant at 5%. In line with this, model III is developed to capture D/E on firm performance (Tobin's Q). The coefficient of D/E is positive and significant (0.0350, P-value is 0.0080) meaning that D/E significantly affects Tobin's Q at a 5% level of significance. In model III all control variables i.e. size of firm, sale growth and firm age are positive and significant. In model IV the mediating effect of the D/E ratio is estimated in the association between (CG-Index) and performance of the firm (Tobin's Q). In model IV table 3, the total effect of both CGI and D/E on Tobin's Q has been captured and reported. The coefficient of CGI is positive (0.1540, P-value is 0.0520) while the coefficient of D/E ratio is also positive (Coefficient is 0.0350, P-value is 0.0080). It is observed that both direct and indirect effects are significant therefore it concludes the existence of partial mediation in the linkage between CGI and Tobin's Q.

Conclusion

This is a pragmatic research study conducted in an emerging country, Pakistan. The study used a large panel data set of 180 non-financial firms listed on the Pakistan Stock Exchange (PSX) for 15 years. The study employed panel regression, fixed effect model and Hausman test for estimation.

The study aims to investigate the mediating role of financial slack in the association between corporate governance and firm performance in Pakistan. As Pakistan has an evolving corporate governance structure as compared to the developed economies like UK and USA, having a developed corporate

Table 3. Fixed effect results of the mediation models (i, ii, iii and iv)

Variables	Tobin's Q as dependent		D/E as dependent		Tobin's Q as dependent		Tobin's Q as dependent	
	Fixed Effect Results		Fixed Effect Results		Fixed Effect Results		Fixed Effect Results	
	Coeff.	t-Stat	Coeff.	t-Stat	Coeff.	t-Stat	Coeff.	t-Stat
CG-Index	0.1590 (0.0530)	3.0320	0.0920 (0.0280)	3.3450			0.1540 (0.0520)	2.9460
D/E					0.0350 (0.0080)	-4.1630	0.0350 (0.0080)	-4.1680
Firm Size	0.0280 (0.0120)	-2.2620	0.1080 (0.0470)	2.2880	0.0510 (0.0180)	-2.8150	0.0510 (0.0180)	-2.8630
Sales Growth	0.0410 (0.0220)	1.8480	-0.3130 (0.0930)	-3.3710	0.1380 (0.0380)	3.6300	0.1350 (0.0380)	3.5560
Firm Age	0.5400 (0.0750)	7.1870	-2.3440 (0.2650)	-8.8570	0.5530 (0.1000)	5.5400	0.5560 (0.1000)	5.5810
R-squared		0.5400		0.5840		0.5430		0.5450
Prob(F-statistic)		0.0000		0.0000		0.0000		0.0000
Hausman Test		0.0000		0.0000		0.0010		0.0000

Governance system exists. The study covers the conflicting role of agency theory and behavioral theory. According to agency theory, there is a negative effect of financial slack on firm performance due to agency conflicts and agency costs (Jensen & Meckling, 1976).

On the other hand, behavioral theory contradicts this objection and argues that financial slack enhances the performance of the firm.

The novelty of this research investigation lies in the empirical and theoretical demonstration that the role of financial slack differs under different corporate governance settings (Lee, 2011, 2012). The study also addresses the role of CEO duality and the role of the board of directors as a firms' resource. A good board of directors act as a resource for the firm (Ashwin et al., 2016; Boyd, 1995). The study divulges that financial slack, for instance, potential slack measured by debt to equity ratio partially mediates the relationship between overall corporate governance and firm financial performance in a developing country context where there is a weak corporate regulation, absence of whistleblower protection laws and concentrated ownership. Additionally, further investigations can also be made in the light of resource dependency theory. This research is beneficial for investors, particularly, foreign investors to invest in an emerging financial market of Pakistan. Furthermore, policymakers can be cautioned to ponder on the competing theoretical views regarding the financial slack resource.

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