Corporate Governance and Financial Sector Performance with Moderating Role of Corporate Social Responsibility: Empirical Evidence from Pakistan

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Abstract

Due to its viability in financial sector, corporate governance has become an integral component in various business organizational activities. This study examines relationship between corporate governance and banking sector performance by using the corporate social responsibility as a moderating factor for a sample of 14 listed banks over a period of 2012 – 2023. On the basis of performance, these banks are selected from Pakistan Stock Exchange. For empirical purposes, since Hausman test remained significant hence fixed effects method is utilized to estimate objectives of the study. The results reveal that in the presence of corporate social responsibility, the corporate governance has significant effect on banking sector performance. It is also evident that corporate social responsibility itself has positive and significant effect on banking sector performance.

Keywords: Corporate Social Responsibility, Corporate Governance, Firm Performance.

JEL Classification: M14, L21

Introduction

Globally, it has been considered that various financial sectors performance depends upon corporate governance. In general, corporate governance deals with the structure and procedures of different organization and generally, it controls firm’s framework, board structure and develop relationship between investors and partners. In other words, corporate governance is associated with cost of exchange due to which firm’s performance increases and the development of corporate social responsibility is essential for effectiveness of corporate governance in various organizations, which may improve multi-sectoral organizations around the world. In this regard, organizations are formulating various policies regarding corporate social responsibility and their effectiveness for their betterment in developed and developing countries.

The financial performance of a firm is a numerical measure, showing how well it is utilizing available assets to make its profit. A review of literature uncovers that the financial performance has been fundamentally estimated utilizing three approaches: market, accounting, and survey measurements (Masadeh et al., 2015). In this regard, the primary approach reflects the level of fulfillment of the investors, whereas the second focus the internal effectiveness of the firm while the performance of the last measurement approach gives an emotional estimation of firm’s financial performance. The first approach is the very important to the shareholder because it is mainly linked to how we wealthier the shareholder at the end of a period to calculate that what he/she stands at the beginning. The shareholder’s financial well-being can be determined by using various ratios which are derived from financial statements, mainly from the balance sheet and income statement, or by using stock market data (Berger & Patti, 2006).

Monetary performance is used to assess an organization's general financial position over a given period of time and can be used in a similar manner to break down of comparative companies in the same industry or to view cumulative market segments or businesses (Capon, Farley & Hoenig, 1990). Corporate performance is examined in monetary terms. Firm performance was found in terms of asset returns and return assets. In order to assess the efficiency of the company, some financial ratios were used, of which return on assets (ROA) is one of them (Khrawish, 2011). ROE implies how much profit an investor has earned from a balance of contributions. Return on equity (ROE) is meant for that what shareholders examined in venture capital. In any case, ROE can make up for many potential problems. If financial experts are not careful, it may shift ideas from the business foundation and incitement issues. The organization can turn to financial procedures to maintain good ROA for a long period of time and to take up the crisis in performance in business details. ROA indicates the ratio of wages to total assets (Khrawish, 2011). It examines the limits of a company's organization to generate a salary by leveraging the accessible associated assets. For effective management of any firm we have to measure the performance which is very critical (Demirbag, Tatoglu, Tekinus, & Zaim, 2006). The improvement in the process without measuring the outcomes are very difficult and impossible. Hence, which organizational resources impact the business performance leads to improve the organizational performance (Gadenne & Sharma, 2002).

Kanwal et al. (2013) examine that the CSR practices are used to find out the relationship between firm's performance and stakeholders through in process of investment in various corporations. In their analysis, it is evident that the stock ownership and managerial behavior are essentially important to increase firm's valuation over a period of time.

In the global scenario, the CSR has been considered for many corporations because every stakeholder is interest to know everything about the business in a true and fair manner in the presence of suitable corporate governance structure (Singh, 2014). In order to increase performance of firms over a period of time, many firms have utilized various aspects of CSR and corporate governance for their corporate philanthropy, business ethics, and corporate accountability.

Research gap and Problem Statement

It is evident that firm's performance augment over a period of time in the presence of corporate governance and corporate social responsibilities (Tsoutsoura, 2004). Corporate social responsibility starts when businesses exist. From there existence, as a responsible member of the society the firm behave ethically and perform its social duties in a good way. The companies which are socially responsible have a comprehensive set of programs and policies relating to companies responsibility towards the society which they incorporate in decision-making processes and business operations. Continuous improvements in this area is another EU's decision to announce mandatory corporate social responsibility for large organizations in 2014, and further strengthen the organization's participation in socially sound activities. The corporate social responsibility can increase the goodwill of the business. Holme and Watts (2007) describes that corporate social responsibility is considered as long term promise to act as economic development and to improve the living standards of the societies. The corporate social responsibility is about understanding and organizing the connection between trading operations and the financial system, situation and communities within which it is operated.

In fact, Pakistan is seen as a country with negligible corporate social responsibility practices. Similarly, investor enthusiasm for social and natural issues is evolving, and when they recognize the importance of corporate social responsibility, this will have a greater impact on their risk choices. This is also true for Pakistani investors, as more customers currently require social and ecological thinking in risk choices. (Awais, Saboor, Khan, & Mohd Thas Thaker, 2022; Awais, Ullah, Sulehri, Thas Thaker, & Mohsin, 2022). The literature is evident that the concept of corporate social responsibility related to the micro foundation has gained the persistent attention of researchers and practitioners during the last decade (Rupp & Mallory, 2015). Corporate social responsibility is an important aspect and unfortunately in Pakistan Government has no concrete plan to set and fix social responsibilities on corporate sectors. Government must provide ease of doing business and earns money at the same time it sets some responsibilities on corporate like health and safety, environment, cleanliness drives, apprenticeship and internship program, etc. This important aspect is identified and cascaded as a moderator between corporate governance and firm performance.

Objective of Study

The main objective of this study is to analyze the relationship between corporate governance and firm performance with the moderating effect of corporate social responsibility in financial sector of Pakistan. In this study, the novelty claimed to construct a new study taking the corporate social responsibility as a moderating factor between corporate governance and firm performance. Since that in literature, it is evident that corporate social responsibility being a moderator factor positively and significantly moderates between firm corporate governance and firm performance. The study is organized as follows: after introduction in section I, the section II describes the relevant review of literature. Methodology and data description is discussed in section III. Results are discussed in section IV. Final section concludes the study with relevant policy recommendations.

Literature Review

It is evident that corporate social responsibility is essential for improvement of firm performance over a period of time. Islam et al. (2012) conduct a study of the Bank of Bangladesh's corporate social responsibility firm performance linkages and found that banks that emphasize corporate social responsibility practices have more on returns on asset than those that did not focus on this training. Iqbal et al. (2012) examine the relationship between corporate social responsibility, firm performance, quotation and financial leverage. Overall, results conclude that corporate social responsibility did not have any impact on firm performance. It can be clearly seen from the results that corporate social responsibility has a negative impact on the available quote estimates, but had no significant relationship with the company behavior. Gupta and Sharma (2014) examine the impact of corporate governance variables on Indian and Korean companies regarding firm performance and conclude that corporate governance has limited impact on the organization's quoting costs and firm performance. Danoshana and Ravivathani (2014) investigate the impact of corporate governance on the performance of 25 record financial institutions in Sri Lanka. Return on equity and return on assets has been used to examine subject matter. The analysis reveals that the corporate governance variables has significant impact on business performance, and the size of the board of directors and the size of the audit committee have a positive impact on business performance. In addition, meeting reproduction is inversely related to business performance. Kiran et al. (2015) examine the firm performance and the impact of corporate social responsibility of 10 oil and gas organizations recorded during the 2006-13 period on the Karachi Stock Exchange and reveals that a positive link between corporate social responsibility and net income and net total income; a negative link between corporate social responsibility and absolute assets and a negligible link between the productivity of the organization. Afsheen (2015) examines the impact of corporate social responsibility on company performance through employee performance impact and expanded consumer loyalty. The study was quantitative in nature and find out a positive impact of corporate social responsibility on firm performance. Ahmed and Hamdan (2015) examine the impact of corporate governance quality on the company's performance on the Bahrain Stock Exchange. Past evidences reveal and found that corporate governance practices are effective in improving the company's firm performance. Furthermore, that performance measures such as return on assets and return on equity are significantly related to Bahrain's corporate governance. More importantly, earnings per share performance indicators did not show any significant impact on corporate governance. Overall, findings show that the corporate governance has a positive impact on the performance of the entire Bahrain Stock Exchange. Johl et al. (2015) examine the role of corporate governance and analyzed the impact of board characteristics and its impact on firm performance for 700 financial companies during 2009 and results reveal that there is no relationship between the independence of the board of directors and the company's performance. The statistical capacity of the size of the board of directors and board of directors had a great relationship with the company's performance. In order to conduct relationship of corporate governance and firm’s performance. Javaid et al. (2016) examine the impact of on corporate financial performance between the US and Pakistan by using various factors such as board ownership, effectiveness, size and structure, independence, CEO duality, and board education and experience, while the company's firm performance was measured by return on assets and return on equity. A sample of 100 companies from the Karachi Stock Exchange of Pakistan and the New York Stock Exchange of the United States had been investigated to examine the firm performance of its similar companies in corporate governance from January 1, 2010, to December 31, 2015. They conduct their analysis by collecting data through online questionnaires in Pakistan and the United States. The internal and external performance of the two companies estimates external performance by using return on assets (ROA) and return on equity (ROE) as internal performance and concludes that two countries follow the corporate governance (CG) rules. In Pakistan, there are some conflicts between the SECP-drawn CG code and the officially set strategy that it effectively draws, as most home-owned businesses were in the process, although strict CG codes were being pursued in the United States. There is positive correlation between, board education, experience and board ownership, survivability and company performance and also CEO duality, but negatively correlated board size. Yilmaz and Buyuklu (2016) investigate the relationship between corporate governance and the firm performance in Turkey. The association between ownership structure, board structure and financial results has been found and conclude that the corporate governance, board size, proportion of independent board members, foreign investors, the impact of the company's leverage index. Return on assets is used for companies listed on the BIS 100 stock exchange in Turkey. The shares of independent members of the board and leverage have a negative impact, while foreign ownership has a positive impact on the company's financial performance.

Methodology and Data Description

The previous literatures reveal that relationship between corporate governance and firm performance can be examined through panel data analysis. Since panel data gives more consistent results than time series and cross sectional data and more number of observations. So depending upon relationship between dependent and independent variable for various cross sectional units *"i"* and time period *"t"*, equation (1) can be written as:

$$ROA_{it} = \beta_o + \beta_1 ED_{it} + \beta_2 TS_{it} + \beta_3 MNG_{it} + \beta_4 CSR_{it} + \mu_{it} \quad (1)$$

In the above equation, ROA shows return on asset, ED shows proportion of executive board, TS shows proportion of top twenty stakeholders, MNG shows proportion of managerial ownership, CSR stands for corporate social responsibility and µ indicates error term. Further, effectiveness of regressors on regressand can be examined by respective estimated parameters.

Besides, return on asset, past evidence reveals that performance also depends upon return on equity (ROE) for financial sector performance. Therefore, another equation can be written as:

$$ROE_{it} = \beta_o + \beta_1 ED_{it} + \beta_2 TS_{it} + \beta_3 MNG_{it} + \beta_4 CSR_{it} + \mu_{it} \qquad (2)$$

In this study, panel data analysis technique is utilized. During panel data analysis, we use fixed effects method and random effects method. Both these methods are distinguished by using Hausman test. During analysis, if Hausman statistic is statistically significant, we use fixed effects method otherwise random effects method.

Data Description

On the basis of performance, a sample of 14 listed banks from Pakistan Stock Exchange has been selected to examine the objectives of study over a period of 2012 – 2023. The use of variables is as follows:

Variable Description

As is evident that the corporate governance is treated as an independent variable, which consists of further three factors and firm performance is taken as dependent variable consisting the two factors. Nishanthini and Nimalathasan (2014) state that profitability is the major measure of the overall success of enterprise. Similarly, Achim (2010) suggests that profitability will provide more exact view of the firm's performance. It is the major measure of the overall success of enterprise. Therefore, for measuring performance, returns on asset and returns on equity have been utilized as dependent variable.

Dependent Variables

Return on Asset (ROA)

It is the indicator of firm's profitability relative to firm's total assets. It provides with framework to manage the efficiency by utilizing the minimum assets to generate maximum output and making use of scare firm's resources into maximum productive and profitable endings. It can be calculated mathematically by division of company's earnings in a period of year by its amount of total assets at that time. ROA is measured in various studies, such as (Prado et al., 2008):

Return on Assets = Net Income / Total Asset

Return on Equity (ROE)

Return on Equity is the net income amount yields as equity to shareholders in percentage of his/her investment in a particular firm. It can be measured through company's amount of profitability to amount of investment made by a particular shareholder. It measures the company's gain or loss among the entire shareholder's according to their share percentage. ROE can be estimated as follows, which already is measured by (Prado et al., 2008):

Return on Equity = Net Income / Shareholder's Equity

Independent Variables

Proportion of Executive Directors**:** It represents the number of executive directors or board size in the firms.

Proportion of Top Twenty Stakeholders: It represents the total share or amount to invest by top twenty stakeholders in the firms.

Proportion of Managerial Ownership: It represents the total share or amount invests by top managerial ownership in the firm.

Corporate Social Responsibilities: It is measured in various studies namely (Nieto et al., 2012; Reverte, 2009, 2011) and here we will use donations as a proxy for CSR.

Results and Discussion

In this study, we want to empirically examine the effectiveness of various factors of corporate governance on performance of financial sector, being measured in terms of returns of asset and returns on equity with and without mediating role of corporate social responsibility. Table 1 shows empirical result regarding relationship between return on asset and various factors of corporate governance. Analysis shows that value of Hausman statistic is statistically significant, therefore, we will use fixed effects method.

Table 1: ROA and Corporate Governance

Dependent Variable: ROA		
Variable	**With Moderator**	**Without Moderator**
Constant	-4.71 (-20.40)**	- 3.12 (13.01)**
ED	- 0.51 (-0.63)	- 0.05 (- 0.32)
TS	0.24 (1.42)	0.14 (1.98)**
MNG	0.32 (2.14)**	0.09 (2.54)**
CSR	0.04 (2.04)**	--
	R Square: 0.82	R Square: 0.83
	F-Statistic: 14.36 (0.00)	F-Statistic: 14.27 (0.00)
	Hausman Stat: 8.12 (0.00)	Hausman Stat: 9.10 (0.00)
** Show 5 per cent level of significance.		

The result shows that under this scenario, except for executive board, all other factors are positively affecting return on asset. Further, also evident that effect of managerial ownership and corporate social responsibility remain statistically significant at 5 per cent level of significance. On the other hand, without moderator, result reveals that only stakeholders and managerial ownership are positively and significantly affecting the return on asset over a given period of time. It concludes that effectiveness of corporate governance on return on asset remain statistically significant at conventional standard in the presence of corporate social responsibility for selected firms over a given period of time. It also reveals that over a period of time, corporate social responsibility is positively affecting the return on asset for selected financial firms. To some extent, similar findings have also been concluded by Javaid et. al. (2016) and Iqbal et. al. (2012).

Table 2: ROE and Corporate Governance

Dependent Variable: ROE		
Variable	**With Moderator**	**Without Moderator**
Constant	0.24 (9.50)**	0.25 (11.45)**
ED	- 0.16 (- 1.30)	- 0.08 (- 1.23)
TS	0.001 (0.13)	0.21 (1.02)
MNG	0.16 (4.20)**	0.14 (2.09)**
CSR	0.015 (2.84)**	--
	R Square: 0.93	R Square: 0.85
	F-Statistic: 45.34 (0.00)	F-Statistic: 21.97 (0.00)
	Hausman Stat: 9.15 (0.00)	Hausman Stat: 10.90 (0.00)
** Show 5 per cent level of significance.		

In this situation, analysis reveals that Hausman statistic is statistically significant therefore, fixed effect method will be appropriate in order to find out relationship between return on equity and corporate governance. Table 2 shows empirical relationship between return on equity and various factors of corporate governance. The result reveals that with and without moderator, managerial leadership has positively and significantly affecting the return on equity over a given period of time for selected sample of firms. Whereas other factors such as directors and stakeholders are not significantly affecting the return on equity. Similar outcome has also been found regarding the effectiveness of directors and stakeholders on return on asset by Kiran et. al. (2015) and Iqbal et. al. (2012). It concludes that in the presence of moderator, managerial ownership is significantly affecting both return on asset and return on equity for selected financial sector over a given period of time. But without moderator, it is evident that stakeholders and managerial ownership both are significantly affecting the return on asset. Contrary to this, it is evident that return on equity is significantly affected by managerial ownership in the absence of moderator. It also concludes that corporate social responsibility has positive and significant effect on return on equity.

Conclusion and Recommendations

Corporate governance deals with the structure and procedures of different organization and generally, it controls firm's framework, board structure and develop relationship between investors and partners. In other words, corporate governance deals with cost of exchange due to which firm's performance increases. The endogenous relationship between corporate governance and firm performance reveal that both are positively related with each other. In general, development of corporate social responsibility is essential for effectiveness of corporate governance in various organizations. It is also believed that people's enthusiasm for corporate social responsibility is particularly developed in multi-sectoral organizations around the world, which target their different business standards and benchmarks, regulatory frameworks and partners' interest in corporate social responsibility. The study empirically examines the effectiveness of corporate governance on financial sector performance both in the presence and absence of corporate social responsibility. In this regard, 14 banks from Pakistan Stock Exchange have been selected on the basis of their returns on assists and equities over a period of 2012 – 2023. In this analysis, various factors of corporate governance such as, executive directors, stakeholders and managerial ownership have been utilized to examine their effectiveness on performance indicators, namely return on asset and return on equity.

The results show that on the whole, corporate social responsibility and corporate governance positively are significantly affecting the firm's performance. Moreover, effectiveness of corporate social responsibility also remains positive and significant on firm's performance over a period of time. It is also evident that role of managerial decision is quite important in business decisions. Besides, it is also evident that effectiveness of leadership and various stakeholders does not remain meaningful for the effectiveness of corporate governance on the selected firm's performance. The analysis reveals that focus of policies must be to improve firm's performance by utilizing appropriate factors of corporate governance, which must be based on nature and functions of selected sector under analysis. Since this analysis shows to measure the effectiveness of the firm the corporate social responsibility remains an effective part. Therefore, it is recommending that corporate governance on firm's performance, corporate social responsibility must be included as a key component of financial sector while formulating appropriate policies.

Limitation and Future Recommendations

This study is utilizing panel data methodology and controlling both effects of individual and temporal homogeneity over a period of time. However, it suffers from a limitation which may be addressed in future research by taking any other proxy of CSR to examine firm's performance. Moreover, some other control variables may be added like R&D to examine same relationship, as this variable is using in many developed countries to estimate the performance related objectives of firms by taking different sample size.

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