The Relationship Between Corporate Governance Mechanisms and Financial Performance of Non-Financial Firms in Pakistan

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Abstract

The primary objective of this study is to investigate the relationship between corporate governance practices and the financial performance of non-financial firms listed on the Pakistan Stock Exchange (PSX). Corporate governance was assessed by utilizing Principal Component Analysis (PCA) to create a single governance score, which was based on eleven distinct indicators, each reflecting different aspects of governance structures. Financial performance was similarly measured using PCA, incorporating four key financial indicators to provide a comprehensive assessment of the firms' financial health. The research relied on secondary data obtained from the annual financial reports of non-financial firms listed on the PSX, spanning a period of twelve years, from 2013 to 2024. Panel data analysis techniques were applied for the empirical investigation. The results reveal a statistically significant and positive relationship between corporate governance and financial performance. Anchored in established corporate governance theories, the study highlights how governance frameworks can impact a firm's financial results. The findings contribute to the expanding literature on the governance-performance link and offer valuable insights for future research and policy development, especially within Pakistan's non-financial sector.

Key Words: Corporate Governance Mechanisms, Corporate Financial Performance, Principal Component Analysis.

Introduction And Background

Corporate governance refers to the system of rules, practices, and processes that guide the management and direction of a company. It ensures that businesses operate in a way that aligns with the interests of all stakeholders (Kumari & Pattanayak, 2014). Effective corporate governance is crucial for protecting investor rights, enhancing organizational performance, and creating a positive environment for investment (Braga, Alves & Shastri, 2011). The significance of corporate governance became evident following various financial scandals, which highlighted the urgent need for improved governance practices (Baydoun et al., 2013). In essence, corporate governance involves the distribution of rights and responsibilities within an organization. McGee (2009) explained that a company's financial performance may be compromised if governance mechanisms are weak. Therefore, the primary goal of governance mechanisms is to ensure the transparency of financial reporting (Kamran & Shah, 2014), while also encouraging business leaders to disclose higher levels of corporate performance (Ghabayen, 2012). Key elements of corporate governance, including the composition of the board, ownership structures, the effectiveness of the audit committee, and executive compensation systems, play a significant role in shaping a company's overall performance. A

well-structured board with independent and qualified directors can provide better oversight, reduce agency conflicts, and improve decision-making (Yahaya, 2025). Similarly, concentrated ownership can enhance control and accountability, but may also lead to entrenchment if not balanced properly (Choi, 2018). Effective audit committees help ensure transparency and reduce the likelihood of financial misstatements (Babalola et al,.2025). Studies have shown that these governance mechanisms are positively associated with financial performance indicators like Return on Assets (ROA), Return on Equity (ROE), and net profit margin. Thus, strong governance structures contribute to better financial outcomes, reduced risks, and increased investor confidence (Xuan, 2023). Although, numerous research has explored the relationship between corporate governance and business performance. Many existing studies focus on developed economies, with limited research on emerging markets where governance challenges differ significantly. Additionally, there is a lack of consensus on which governance mechanisms have the most impact, as findings often vary across industries and regions. Few studies also examine the mediating role of earnings management or innovation capacity in this relationship. Moreover, much of the existing literature relies on outdated data or does not consider recent changes in governance codes and regulatory frameworks particularly in the context of Pakistan. Therefore, by observing such gaps in the prevailing literature this study intends to quantify the effect of corporate governance mechanism on the financial performance of listed firms on the Pakistan Stock Exchange by considering the recent 12-year data from 2013 to 2024. Most interestingly, this study developed composite variables to represent corporate governance and firm performance. These composites were formed by combining several commonly used indicators from previous research. This approach provides a broader and more reliable measure of the key concepts under investigation.

Objective and Significance of the Research

The significance of this study lies in its focus on an emerging economy, where governance frameworks are evolving and often differ from those in developed markets. By using recent data and composite governance indicators, the study provides updated insights into how governance structures affect firm performance in Pakistan. The results of this study can provide valuable insights for policymakers, regulators, investors, and corporate managers to improve governance practices, thereby enhancing financial performance and fostering greater investor confidence in the market. Consequently, the primary goal of this research is to assess the impact of corporate governance on the financial performance of firms listed on the Pakistan Stock Exchange.

Literature Review

The literature review explores the existing studies related to corporate governance and financial performance. It identifies key theories, findings, and gaps in the current research. This chapter helps to establish the foundation for the study and highlights the need for further investigation. The portion of literature review in this study was categorized into theoretical and empirical review. These reviews were discusses briefly as under:

Theoretical Review

There are several theories that have been developed on the corporate governance over the years. These theories help to explain the back ground of relationship between corporate governance and other variables. Below is a brief overview of some of the most influential theories. Agency theory describes the dynamic between shareholders and corporate managers, where shareholders serve as principals and managers operate as their agents. However, managers may sometimes pursue their own interests rather than those of the shareholders. To address this potential conflict, oversight mechanisms are necessary to ensure managerial accountability. Strong corporate governance systems help align managerial actions with shareholder interests, promoting transparency and trust. Stewardship theory views managers as responsible custodian

of the company. It suggests that they are motivated to act in the best interests of the business and its stakeholders. Managers are seen as trustworthy individuals who value the company's long-term success. This theory highlights the role of trust, mutual respect and cooperation. It encourages strong collaboration between managers and shareholders to achieve common goals. Resource dependence theory explains that companies rely on external resources to function. These resources include things like capital, labor, and raw materials. A firm's ability to access such resources often depends on its relationships with outside parties. These external stakeholders can influence how easily a company gets what it needs. Because of this, an effective governance system is important. Transaction cost theory focuses on the costs involved in business transactions. These include not just the direct financial costs, but also hidden costs like monitoring and negotiation. For example, working with suppliers or hiring employees may involve extra time and effort. These additional costs can affect the overall efficiency of the company. Good corporate governance helps to reduce these costs. It does so by setting clear rules and procedures for how transactions are handled. Stakeholder theory argues that companies have responsibilities beyond just their shareholders. They are also accountable to other groups such as employees, customers, suppliers and the broader community. These groups are known as stakeholders because they are affected by the company's actions. According to this theory, corporate governance stimulates managers to take all their interests into account.

Empirical Review
This part of the study presents a review of previous empirical research examining the link between corporate governance and firm performance using real-world data. It also summarizes the methodologies, variables, and key findings of studies conducted in various regions and contexts. For instance, Ali et al. (2019) examined secondary data from 18 cement companies listed on the Pakistan Stock Exchange, spanning the years 2012 to 2017. They utilized eight corporate governance indicators to represent the independent variable and applied the Capital Asset Pricing Model (CAPM) to assess the cost of equity as the dependent variable. Their analysis showed that while some corporate governance factors had a positive impact on the cost of equity, others exerted a significant negative influence. Nasr and Nitm (2018) examined the link between corporate governance mechanisms and accounting conservatism. The sample included 300 non-financial firms listed in Egypt. They measured corporate governance by using variables such as board size, board independence, CEO ownership separation, and the type of external auditor. They quantified the accounting conservatism by using the conservatism model developed by Givoly and Hayn (2000). They included firm size, profitability, leverage, and sales growth as control variables in their analysis. They applied multiple regression techniques to analyze the data. Their results showed a positive relationship between board independence and accounting conservatism. In contrast, board size and audit quality were found to have a negative association with conservatism. Additionally, no significant link was found between CEO or chairman ownership and accounting conservatism. Rehman (2021) explored the impact of sustainable corporate governance (SCG) on the internal audit (IA) function in publicly listed companies in Oman, using agency and institutional theory frameworks as the basis for the study. The study also considered how Chinese investment might shape corporate governance practices in Oman. SCG was considered the independent variable, while IA served as the dependent variable. Employing a descriptive cross-sectional survey approach, data were gathered through an online platform and analyzed using PLS-SEM and SPSS. The results revealed a significant positive association between SCG and IA. The research recommends that policymakers, regulatory bodies, and organizations strengthen corporate governance frameworks by incorporating SCG principles to safeguard foreign investors and encourage Chinese investment. Ali et al. (2021) investigated the moderating effect of corporate governance mechanisms on the relationship between accounting conservatism and corporate financial performance. By applying panel data

analysis to secondary data from firms listed in Pakistan, their study found that robust governance structures strengthen the positive relationship between accounting conservatism and financial performance. Amri et al. (2023) investigated how internal and external corporate governance elements influence tax aggressiveness, using data from 52 firms listed on the Tunis Stock Exchange. Their findings revealed that ownership structure significantly affects tax-related behavior, while strict monitoring by tax authorities helps curb aggressive tax strategies. Interestingly, board characteristics did not have a notable impact on tax aggressiveness. Bui and Krajcsák (2024) studied the relationship between corporate governance and financial performance among publicly listed firms in Vietnam during the period 2019 to 2021. Their research emphasized that robust governance practices, especially transparency in financial disclosures, positively influence firm performance. Additionally, they identified a positive correlation between governance quality and firm size. Drawing from both theoretical frameworks and empirical findings, the present study puts forward the following hypothesis.

H $_1$: There is a positive impact of corporate governance mechanism on the performance of non-financial firms listed in Pakistan.

Corporate Financial Performance

In this research, corporate financial performance was assessed through a composite score derived from four financial metrics. Principal Component Analysis (PCA) was employed to determine the appropriate weight for each metric, following the approach of El-Habashy (2019). The first metric, Return on Assets (ROA), was calculated by dividing net income by total assets. The second metric, Return on Equity (ROE), was determined by dividing net income by shareholders' equity. The third measure, Earnings Per Share (EPS), was derived by dividing net income by the total number of outstanding shares. Finally, the Net Profit Margin was obtained by dividing net profit by total sales. These indicators were collectively synthesized into a single index using PCA, providing an overall measure of financial performance.

Performance=$\Sigma[W_1ROA+W_2ROE+W_3NPM+W_4EPS]$

Corporate Governance Mechanisms

The study treated the governance mechanism as the independent variable, represented through a composite index formed from eleven governance-related attributes. Principal Component Analysis (PCA) was utilized to assign appropriate weights to each attribute. The factors considered included managerial ownership, ownership concentration, institutional ownership, board size, the frequency of board meetings, board independence, audit committee size, the frequency of audit committee meetings, audit committee independence, CEO duality, and audit quality. These elements were integrated into a single governance score using PCA. A higher score indicated robust governance structures, whereas a lower score pointed to weaker governance practices, as outlined by Saeed et al. (2018).

GM = Σ [w_1MO+
W_2OC+w_3IO+w_4BS+w_5BM+w_6BI+w_7ACS+w_8ACM+w_9ACI+w_{10}CEOD+w_{11}AQ]

Control Variables

This study included five control variables to improve the analysis of the relationship between corporate governance mechanisms and financial performance in non-financial firms listed on the Pakistan Stock Exchange. These variables were firm size (FS), prudence in accounting practices, financial leverage (FL), capital adequacy (CA), and firm age (FA). The inclusion of these variables aimed to minimize the impact of omitted variable bias and ensure more reliable results, in line with the approach of El-Habashy (2019).

Conceptual Framework

This study's conceptual framework explains how corporate governance affects financial performance. The framework is built on earlier research and the theories mentioned above. It shows a direct link between governance mechanism and the financial outcomes of firms.
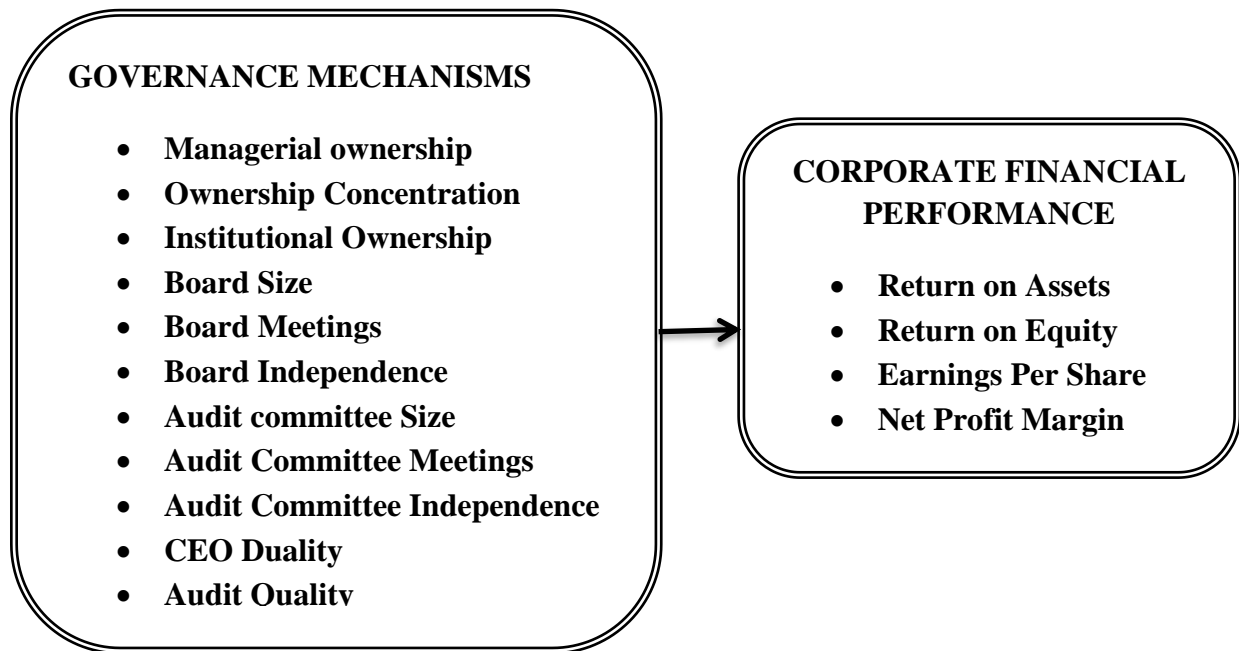
GOVERNANCE MECHANISMS

- **Managerial ownership**
- **Ownership Concentration**
- **Institutional Ownership**
- **Board Size**
- **Board Meetings**
- **Board Independence**
- **Audit committee Size**
- **Audit Committee Meetings**
- **Audit Committee Independence**
- **CEO Duality**
- **Audit Quality**

CORPORATE FINANCIAL PERFORMANCE

- **Return on Assets**
- **Return on Equity**
- **Earnings Per Share**
- **Net Profit Margin**

Figure: 1 Conceptual Framework

Research Methodology

This study explores the link between corporate governance and financial performance using a systematic data analysis approach. The methodology involves performing pre-estimation tests, generating descriptive statistics, and conducting panel data analysis. These procedures are employed to uncover and interpret the associations among the selected variables.

Model of the Study

The following models were analyzed to examine the relationship among variables.

$$\textbf{PERF}_{it} = \beta_0 + \beta_1 CGM_{it} + \beta_2 PA + \beta_3 FS_{it} + \beta_4 LEV_{it} + \beta_5 CA_{it} + \beta_6\ GRP_{it} + \beta_7\ FA_{it} + \varepsilon_{it}$$
$$1(A)$$

The above model indicated the mode of present study. It includes $PERF_{it}$; performance of the firms, CGM_{it} corporate governance mechanisms, PA prudence accounting, FS_{it} Firms size; LEV_{it} ; Financial leverage, CA_{it} ; capital adequacy; GRP_{it}; Growth perspective, FA_{it} Firms age.

Result and Discussion

The present study began with descriptive analysis to summarize the main features of the data. It then used a correlation matrix to explore the strength and direction of relationships between variables. Pre-estimation tests were carried out to ensure the data met the necessary assumptions for analysis. Afterward, the fixed effects model was applied to examine the impact of corporate governance on financial performance. The results from each stage of the analysis are presented in sequence below.

Descriptive Statistics for All Variables

Variable	Obser	Mean	Std. Deviation	Minimum	maximum
Governance Mechanism	2664	-1.02	1.00	-1.27	1.69
Prudence Accounting	2664	-.0041	0.122	--0.32	0.2
Financial Performance	2664	-0.039	0.61	-0.69	1.90
Firm Size(log ta)	2664	6.58	0.60	4.25	8.31
Financial Leverage	2664	2.51	8.71	-115.79	63.56
Growth Perspective	2664	6.11	34.50	-88.075	66.13
Capital Adequacy	2664	0.40	1.56	-14.03	16.29
Firm Age	2664	35.9	15.13	12	63

The above Table indicates the average score of governance mechanism -1.02, suggesting generally poor governance. There is moderate variability in governance practices across firms (standard deviation of 1.00). The average prudence in accounting is close to zero, with low variability across firms (standard deviation of 0.122). Values range from slightly negative to positive, indicating a generally conservative approach to accounting. The average financial performance is slightly negative. There is significant variability across firms, with a standard deviation of 0.61. The performance range spans from poor to very strong. This reflects diverse financial outcomes across the firms. The average firm size, measured as the log of total assets, is 6.58, with moderate variability (standard deviation of 0.60). Firm sizes range from 4.25 to 8.31, reflecting significant variation from small to large firms. The average financial leverage is 2.51, with significant variation across firms (standard deviation of 8.71). Leverage ranges from highly negative to positive values, showing a wide disparity in debt financing strategies. The average growth perspective is 6.11, with substantial variation across firms (standard deviation of 34.50). The range from -88.075 to 66.13 reflects diverse growth expectations, from negative to strong prospects. The average growth perspective is 6.11, with high variability (standard deviation of 34.50), reflecting a wide range of growth expectations from negative to strong. The average capital adequacy ratio is 0.40, with significant variation (standard deviation of 1.56), indicating a broad range from low to high capital buffers. Firm age averages 35.9 years, with some firms much older or younger, spanning from 12 to 63 years, indicating diverse firm lifespans.

Pearson and Spearman Correlation Matrix for all Variables

Variable	CGM	PA	FP	FS	FL	GP	CA	FA
CGM	1							
PA	0.032^{**}	1						
FP	0.025	0.363^{*}	1					
FS	0.25^{*}	0.21^{*}	0.251^{*}	1				
FL	-0.05^{*}	-0.025	0.011	-0.047^{*}	1			
GP	-0.03	0.74^{*}	0.14^{*}	0.169^{*}	0.032^{**}	1		
CA	-0.15^{*}	0.055^{*}	0.137^{*}	0.025	-0.078^{*}	-0.254^{*}	1	
FA	0.02	0.034^{**}	0.030	-0.017	-0.016	0.023	0.023	1

The correlation matrix shows the relationships between the variables in the dataset. The governance mechanism (CGM) has weak positive correlations with financial performance (FP) and prudence accounting (PA), but no strong associations with the other variables. Prudence Accounting (PA) shows significant positive correlations with financial performance (FP), growth perspective (GP), and capital adequacy (CA), indicating that firms with more prudent accounting tend to perform better and have higher growth perspectives. Firm size (FS) is positively correlated with most variables, especially PA, FP, and GP, suggesting that larger

firms tend to have better performance, more prudent accounting, and stronger growth perspectives. Financial leverage (FL) exhibits negative correlations with some variables like FS, CA, and GP, implying that higher leverage is associated with smaller firm size and weaker capital adequacy. Growth perspective (GP) has significant positive correlations with PA and FP, but a negative relationship with capital adequacy (CA), suggesting firms with more optimistic growth prospects may have lower capital buffers. Capital adequacy (CA) itself shows weak negative correlations with most variables, indicating that firms with better capital adequacy tend to have lower growth perspectives and smaller firm sizes. Firm Age (FA) shows weak correlations across the board, indicating little relationship with other variables.

Results of Pre-Estimation Tests

Before analyzing the link between corporate governance mechanism and financial performance, this study performed several preliminary tests. These initial checks were important to confirm that the data was suitable for panel analysis. They helped to assess the reliability and consistency of the variables used. The tests also verified the stability of the model and reduced the risk of biased results.

Normality Test

The Jarque-Bera test showed that the data slightly deviated from a normal distribution. However, this issue is considered minimal due to the large sample size, which helps reduce the effects of non-normality. According to established guidelines, small departures from normality are unlikely to impact the results significantly. To further improve data quality, this study applied winsorization by trimming 5% of extreme values. This step was taken to reduce the influence of outliers and ensure the results remain dependable.

Multicollinearity

Collinearity Statistics

variable	VIF	1/VIF
Corporate Governance Mechanism	1.09	0.9158
Prudence Accounting	1.08	0.8499
Firm size	1.18	0.8499
Financial leverage	1.03	0.9692
Growth perspective	1.03	0.9708
Capital adequacy	1.07	0.9365
Firm Age	1.01	0.9857
Mean VIF	1.07	

Multicollinearity occurs when independent variables are highly correlated, typically above a threshold of 0.7. To detect this issue, the Variance Inflation Factor (VIF) is commonly used as a diagnostic tool. A VIF value greater than 10 usually signals a potential multicollinearity problem.

In this study, all variables showed VIF values well below 10, indicating no serious multicollinearity concerns. This confirms that the independent variables are distinct and suitable for regression analysis.

White's Test for Heteroskedasticity

Homoskedasticity means that the variance of the dependent variable stays constant across all levels of the independent variables. In contrast, heteroskedasticity occurs when this variance changes, which can lead to biased standard errors and less reliable results. Although regression coefficients can still be estimated in the presence of heteroskedasticity, the accuracy of inferences may be compromised. To test for this issue, the study applied the White test, a commonly used method for detecting unequal variances. The results showed p-values greater

than 0.05, confirming that the data does not suffer from heteroskedasticity and is homoskedastic.

Ho: Homoskedasticity
Ha: Unrestricted heteroskedasticity

Chi square	**42.67.77**
Prob	0.1223

Hausman Test

The Hausman test helps to decide whether to use a Fixed Effects (FE) or Random Effects (RE) model in panel data analysis. It checks whether individual specific effects are correlated with the explanatory variables in the model. A p-value less than 0.05 indicate this correlation exists, supporting the use of the FE model for more accurate results. On the other hand, if the p-value is greater than 0.05, the RE model is considered more suitable since the effects are assumed uncorrelated. In this way, the test ensures the most appropriate model is selected for reliable estimation (Baltagi, 2024). The Hausman test reported a p-value of 0.00. It indicated a significant result below the 0.05 threshold. Therefore, the Fixed Effects model was chosen as the appropriate method for analysis.

Fixed Affect Model

The Fixed Effects Model (FEM) is commonly used in panel data analysis to control for unobserved factors that are unique to each individual or entity. It helps to produce accurate estimates by accounting for characteristics that do not change over time. FEM assumes that these individual specific effects are constant throughout the study period. By assigning a separate intercept for each unit, the model controls for potential omitted variable bias. This makes FEM a reliable method when analyzing the true relationship between explanatory and outcome variables (Baltagi, 2024).

Fixed Affect Model: Using Financial Performance As Dependent Variable

Variable	Coefficients	t-statistics	p-value
Corporate Governance mechanism	3.174	2.90	0.004
Prudence Accounting	0.9361	12.81	0.000
Firm size	0.1312	2.83	0.005
Financial leverage	-0.2104	-2.95	0.003
Capital adequacy	0.8179	10.38	0.000
Growth perspective	0.2079	7.79	0.000
Firm age	0.2547	1.96	0.048
Constant	-1.5693	-4.74	0.000
R- Square	20.20		
Prob	0.000		
F-Statistic	86.02		
N	2664		

The fixed effects model analysis provides valuable insights into the factors influencing financial performance, with independent and several control variables showing significant relationships. The coefficients for corporate governance mechanism (3.174), prudence accounting (0.9361), firm size (0.1312), capital adequacy (0.8179), growth perspective (0.2079), and firm age (0.2547) are all positive and statistically significant, indicating that these factors have a positive impact on financial performance. This suggests that firms with stronger governance practices, help to optimize resource allocation and strategic direction, leading to improved financial outcomes. Moreover, results indicates that more prudent accounting, larger

sizes, better capital buffers, more optimistic growth perspectives, and greater age tend to perform better financially. On the other hand, financial leverage (-0.2104) exhibits a negative and significant effect on financial performance, implying that higher leverage tends to reduce a firm's financial outcomes, possibly due to increased debt burden or financial risk. The model's R-squared value of 20.20% indicates that these variables explain just over 20% of the variation in financial performance, suggesting that other factors not included in the model may also contribute to performance. The F-statistic of 86.02, with a p-value of 0.000, confirms the overall statistical significance of the model. The negative constant term (-1.5693) further emphasizes that financial performance starts at a negative baseline before accounting for the included variables. The model's strength, with 2,664 observations, enhances the reliability of these findings.

Limitation of the Study

This research explored how corporate governance influence the financial outcomes of firms. The analysis focused solely on companies within Pakistan's non-financial firms. As a result, the findings may not directly translate to financial firms. This industry-specific scope presents both strength in focus and a limitation in broader applicability.

Future Research Direction

Future studies should investigate a wider range of variables that may influence financial performance in the financial industry, going beyond just governance mechanisms. Examining elements such as market dynamics, regulatory frameworks, or operational efficiency could offer deeper insights. To broaden the relevance of the findings, researchers are encouraged to include companies from various sectors. Analyzing data across multiple industries listed on the Pakistan Stock Exchange would support more comprehensive conclusions. This expanded scope can help to validate whether the observed relationships hold true in different business contexts.

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