

## Impact of Corporate Governance on Firm Performance: Mediating Role of Agency Cost

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### Abstract

*The study is conducted to assess the impact of corporate governance on the firm performance and to study the mediating role of agency cost in the association between corporate governance and firm performance. 74 non-financial companies are selected as a sample for the study. The data from 2017 to 2022 is assessed in the study. Regression analysis is used to assess the direct impact of corporate governance on agency cost and firm performance. Mediation is assessed using Sobel Test. The finding of the study revealed that better corporate governance leads to better firm performance. Results also showed that stronger governance decreases agency cost which in turn leads to better firm performance. This study is unique in a way that it studied the mediating role of agency cost in the relationship between corporate governance and firm performance. The study will help the companies to recognize the importance of strong governance structure in order to increase financial performance. The study will also help to identify the role of agency cost on financial performance and to recognize that agency cost can be reduced via better corporate governance.*

**Keywords:** Corporate governance, Firm Performance, Agency Cost

Corporate governance is a topic that is expanding rapidly and investigates how the governance systems are linked to increasing shareholders' value. In such a competitive market, term corporate governance means a kind of structure that assists firms to enhance the effectiveness and efficiency of performance. The issue appears to revolve around putting in place the appropriate laws, regulations, and incentives to promote openness and accountability in the management of business entities' activities (Cadbury, 1992). Designing governance structure is one of the key and complex issues that companies face (Morri et al., 2023). According to Solomon (2007), corporate governance is the mechanism of ensuring accountability to stakeholders through checks and balances. This mechanism includes policies with effective rules and regulations as well as procedures by which a firm can be effectively operated. Corporate governance (CG) is responsible for providing a structure for the accomplishment of firm goals. The governance structure of firm comprises of these aspects: First, it states hierarchy of responsibilities for board directors, stakeholders and for the other members of the organization, second it takes corrective measures for reducing the interest conflicts and related issues among management and stockholders; third it also ensures effective control mechanism for the proper functioning of the firm. The mechanism of CG assists to safeguards the shareholders' interests and make sure that they will earn sufficient and satisfactory return from the investment they made. If the corporate governance fails to be effective it is due to the reason when there is the absence of effective control and monitoring system and this ultimately makes the management system unpleasant. Effective CG should essentially secure shareholder value by ensuring optimal resource utilization, allowing capital access, and enhancing investor confidence (Denis & McConnell, 2003). Resultantly, the term governance refers to the commitment of upper-level management, for which the board of directors is selected by stockholders or other business affiliates, and they are responsible for doing well for the stakeholders.

Proficient and sound governance can effectively focus on the problems of agency incurred in the firm. These problems occur due the clashing interests of management and shareholders (Shleifer et al., 1997). Fama (1980) advocated that clashes occur mostly when management fail to leads the welfare of stockholders. As per Wang et al., (2017) the dominant structure of governance contributes to deteriorate the influence of conflicts and be responsible for a smooth platform for effective functioning. Moreover, it helps to achieve the edge in marketplace and articulate guidelines to cope with erratic state of affairs that sooner or later are faced by the investors for making productive choices of investment (Listokin, 2008).

The study's main goal is to investigate the impact of CG on firm performance, along with the role of agency costs as a mediator between these two factors. In Pakistan, it is critical to look at

this form of interaction. Many researchers concluded that the internal corporate governance mechanisms aids to diminish the negative effects from firms and ensures long-term firm performance (Mediaty, 2013; Linden & Matolcsy, 2004; Ang et al., 2000; Kim & Purnanandam, 2009 and Chi & Lee, 2010).

Pakistan's economy is developing and is now seen as an essential part of the global economy. Many researches have focused on studying the impact of CG on firm performance (Hassan & Halbouni, 2013; Pillai & Al-Malkawi, 2017). However, only a small amount of researches have been done on agency costs as a mediating variable between CG and company performance. This study therefore is focused on exploring how good corporate governance can reduce agency cost by aligning the interest of management to that of shareholders which can further increase profitability of the firm through better managerial decisions.

### **Significance of the study**

This is the first study in Pakistan to examine the mediating role of agency costs in the association between CG and firm performance. Role of agency problem in explaining the decline in company performance has also been examined in this study which has not been done in Pakistani context previously. The research horizons for CG, FP, and agency theory will be enlarged as a result of the study and it will be illustrated that increased corporate governance may bring to increase to shareholders value.

## **Literature Review and Hypothesis Development**

### ***Corporate Governance and Firm Performance***

Mollah et. al. (2012) conducted the study to explore association among characteristics of board and corporate financial results and concluded that better corporate governance mean better decisions which results in better financial performance. Hassan and Halbouni (2013) collected data of year 2008 from 95 UAE financial and non-financial registered firms and the results showed significant linkage exists between CG and UAE firms' financial performance. The outcome of the study documented dual functionality of CEOs, volunteer disclosure, and number of directors in board significantly affect profitability. Moreover, Darko et al. (2016) in his study focused on cross-sectional and longitudinal data of twenty Ghanaian Stock Exchange registered companies from 2008 to 2012. The regression results show that female representation and ownership concentration on board have a positive effect on firm performance. Whereas, size of board and size of audit committee indicated no association with firm profitability, but independent directors and frequency of audit committee unfavorably affect firm performance. Malik and Makhdoom (2016) conducted a study to explore the impact of governance practices of Fortune 500 Global Companies on their performance. The analysis found that smaller board size gives better performance whereas CEO compensation and board meetings frequency are inversely related to performance. The study further stated that board independence is a key to enhance decision-making process which in turn improves firm performance and agency problems can be solved. Pillai and Al-Malkawi (2017) inspected the association of CG and firm performance. Findings revealed that CG has a considerable effect on firm performance in Gulf countries. The findings also revealed that the board of directors, as a component of CG, is a critical component of financial performance. On the basis of above arguments, following hypothesis is proposed:

H<sub>1</sub>: Corporate Governance has a positive impact on firm performance.

### ***Corporate Governance and Agency Cost***

Agency costs refer to expenditures and additional costs linked with agency issues. Meanwhile when an agent and a principal do not have common personal interests, the firm affiliation eventually give birth to agency problems. Monitoring costs are the expenses sustained by stockholders to observe the activities of managers (Jensen & Meckling, 1976). Eisenhardt (1989) found in his research that effective CG can discourage the agency conflicts. He suggested that there can be two ways to eradicate the agency problems, firstly, the companies can have an outcome-based contract, where the agents' activities can be monitored and other is the principal requires to build a durable information system, so the principal remains responsive to all the information related to the agents' action it ensures to avoid the misrepresentation done by agents. According to Júnior (2022), CG mechanism is one of the vital factors that affect the agency cost in an organization. Pearce and Zahra (1991) examined that authoritative and massive boards as a part of governance mechanism, are useful. There are multiple aspects of CG available that can be used to mitigate the agency issues. The agency issues become apparent due to opposing interests and give

birth to the conflicts, this happens because principal gave some decision-making powers to the agent and they use it for self-interest motive. Agency theorists have an opinion that sound corporate governance can assist to elevate the agency conflicts. The above given literature is enough to support the hypothesis:

H<sub>2</sub>: Corporate Governance negatively impact agency cost of a firm.

**Agency Cost and Firm Performance**

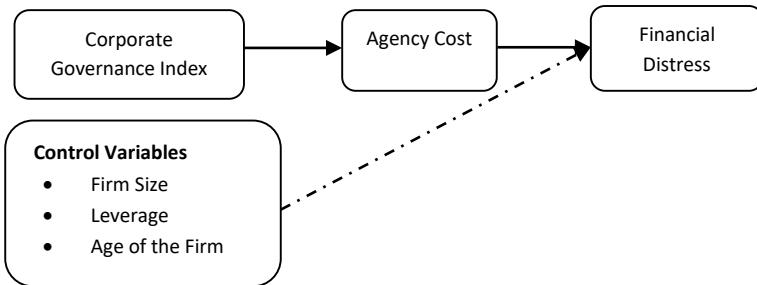
As per agency theory, agents are often risk averse. Because of this risk discrepancy, managers don't capitalize in proffering options that disappoints the governance. If director's intentions are not according to the owners' goals, agency cost will arise. Managers mostly prefer to be responsible for excessive perks and make self-interest choices rather than working to enhance shareholder value (Ang et al., 2000). Agency theory contends that corporate value can be maximized if agency issues can be managed well. The primary interest of shareholders is maximization of wealth. In agency theory, corporate governance has a vital part to make sure the alliance of the agent interests with the principal, therefore elevating the firm's competency to increase company's value. In short, it proposes that as there is a split-up in the ownership and controls of corporate setups, agents are less probable to constantly put efforts that are for the benefits of the shareholders. To diminish this deviation of interests, shareholders use internal CG to observe managers and accordingly encourage managers to adopt behaviors of maximizing the value of shareholders and enhancing firm performance. Furthermore, agency cost is supposed to be act as mediating variable to create a linkage among CG and firm performance (Piron & Smith, 1995). Therefore, the proposed hypothesis is:

H<sub>3</sub>: Agency cost mediates the relationship among corporate governance and firm performance.

**Conceptual Framework**

**Figure 1.**

*Model of the study*



**Research Methodology**

The capital structure of the financial sector differs significantly from that of the non-financial sector; that is why this research solely studies non-financial firms. The 74 non-financial companies listed at PSX are chosen as the sample. This study's sample includes 370 observations from 74 non-financial companies. The recent years are employed in order to generate current results for businesses and policymakers. In this study, data from year 2017 to 2022 is used for analysis. Annual reports of all companies from 2017 to 2022 are used for data collection. Market value of the share is obtained through different financial data websites e.g. Business recorder.

**Measures of variables**

Tobin's Q is used as a proxy for firm performance in the current study. Tobin's Q is derived by dividing the sum of the market value of ordinary shares and the book value of long-term debt by the book value of the company's entire assets (Pillai & Al-Malkawi, 2017).

The study took CG index as measure of corporate governance. The index covers 7 objects, all of which is scored out of 10, which marks an entire score of 70. Hence maximum score is 70. The 7 objects of the index are (1) Proportion of outside director (2) Size of the board (3) CEO/

Chairman Duality (4) Audit Committee Independence (5) Auditor Remuneration (6) Female Directors in Board (7) Number of Board Meeting. In Pakistan, code of corporate governance requires a split of position of Chairman and CEO. Hence, in this factor, most companies obtained a full score out of 10 as per the criteria of the CGI.

Agency cost is measured using the asset utilization ratio. Asset utilization ratio is the ratio of total revenue to total assets. Firm size is measured using logarithm of total assets. Leverage is measured as:

$$\text{Leverage} = \frac{\text{Total Debts}}{\text{Assets (Total)}}$$

The term "firm age" has been used in a numerous studies to refer to the no. of years since the company is incorporated (Berger & Udell, 1998; Boone et al., 2007; Borghesi et al., 2007). Measure is given as follows:

$$\text{Age} = \text{Years since firm was incorporated}$$

Measurement of the table is given in the Table 1 as follows:

**Table 1**

*Measurements of the Variables*

Variable	Measurement
Corporate Governance (CG)	Corporate Governance Index comprising of seven items
Agency Cost (AC)	$\frac{\text{Total Revenue}}{\text{Total Assets}}$
Firm Performance (FP)	$\frac{\text{Market Value of Equity} + \text{Book Value of Debt}}{\text{Book Value of Total Assets}}$
Firm Size	Natural log of total Assets
Leverage	$\frac{\text{Total Debts}}{\text{Total Assets}}$
Firm Age	No. of Years since Incorporation

**Econometric Model**

Following model is developed for present research work:

In first step, direct influence of CG on Agency cost.

**Equation 1:**

$$(AC)_{it} = \beta_0 + \beta_1(CGI)_{i,t-1} + \beta_2(\text{Firm Size})_{i,t-1} + \beta_3(\text{Leverage})_{i,t-1} + \beta_4(\text{Age})_{i,t-1} + \varepsilon_{it}$$

Here AC is agency cost. CGI is used for governance variables.

In second step, corporate governance index effect on firm performance.

**Equation 2:**

$$(FP)_{it} = \beta_0 + \beta_1(CGI)_{i,t-1} + \beta_2(\text{Firm Size})_{i,t-1} + \beta_3(\text{Leverage})_{i,t-1} + \beta_4(\text{Age})_{i,t-1} + \varepsilon_{it}$$

Here FP is a vector for the measures of firm performance and other things are same as discussed above.

In third step, the impact of Agency cost on FP is measured as.

**Equation 3:**

$$(FP)_{it} = \beta_0 + \beta_1(AC)_{i,t-1} + \beta_2(\text{Firm Size})_{i,t-1} + \beta_3(\text{Leverage})_{i,t-1} + \beta_4(\text{Age})_{i,t-1} + \varepsilon_{it}$$

In last step, the mediation effect when including firm performance as Y variable (Dependent) and both CGI and Agency cost as X variables (Independent).

**Equation 4:**

$$(FP)_{it} = \beta_0 + \beta_1(CGI)_{i,t-1} + \beta_2(AC)_{i,t-1} + \beta_3(\text{Firm Size})_{i,t-1} + \beta_4(\text{Leverage})_{i,t-1} + \beta_5(\text{Age})_{i,t-1} + \varepsilon_{it}$$

## Data Analysis and Results

### Descriptive Statistics

**Table 2**

*Descriptive Statistics*

	N	Min	Max	Avg.	Dev.	Skewness	Kurtosis
<b>CGI</b>	370	30	70	5.57	0.77	-0.12	0.59
<b>AC</b>	370	0.3	6	1.04	0.99	1.79	2.53
<b>FP</b>	370	0.2	4	1.31	0.95	0.56	-0.97
<b>Firm Size</b>	370	1	6	3.79	0.93	-1	1.57
<b>Leverage</b>	370	0.2	0.9	0.51	2.36	0.78	1.77
<b>Age</b>	370	13	86	41.93	16.75	0.39	-0.91

*CGI = Corporate Governance Index; AC = Agency Cost; FP = Firm Performance*

In this table the corporate governance observations taken are 370 having mean value of the corporate governance is 5.57 and standard deviation is 0.77. The maximum value of CGI is 70 and minimum value of CGI is 30. The average value of the agency cost is 1.04 and its standard deviation is .99. The maximum value of agency cost is 6 and minimum value of agency cost is 0.3. There are 370 observations of FP, and the mean value of firm performance is 1.31, with an SD of .95. FP has a maximum value of 4 and a minimum value of 0.2. In this study, firm size, leverage, and age serve as control variables; the average firm size is 3.79, and the standard deviation is .93. Firm size has a minimum and maximum value of 1 and 6. Leverage has a mean value of 0.51. Leverage has a minimum and maximum value of 0.2 and 0.9, respectively. Another control variable is age, which has a mean and standard deviation of 41.93 and 16.75 respectively. Age has a minimum and maximum value of 13 and 86 accordingly.

### Correlation Matrix

The Pearson's co-efficient is used to determine whether or not there is multicollinearity among the regressors, as shown in Table 3. The correlation matrix was used to detect multicollinearity between variables. Multicollinearity is defined as a series of severe correlations between variables, but numerous authors disagreed on when a correlation becomes a high correlation.

**Table 3**

*Correlation Matrix*

Variable	CGI	AC	FP	Firm size	Leverage	Age
<b>CGI</b>	1					
<b>AC</b>	-0.148**	1				
<b>FP</b>	0.144**	-0.138**	1			
<b>Firm Size</b>	0.264*	0.212**	0.016**	1		
<b>Leverage</b>	-0.053**	-0.096*	0.156**	0.053	1	
<b>Age</b>	-0.165	-0.009	-0.066**	-0.085*	0.03	1

\*\*\* Significant at 1%, \*\* Significant at 5%, Significant at 10%

Correlation is considered high when its value exceeds 0.90 (Hair et al., 2010). Similarly, High correlation between two independent variables can be a sign of multicollinearity (Brayman and Cramer, 2001). Using Pearson's co-efficient, the data in table 4.2 is utilized to find correlations between explanatory factors. Independent variables, on the other hand, showed no significant association.

Table 4.2 illustrates that corporate governance and agency cost are inversely associated, meaning that as corporate governance improves, agency cost drops and vice versa. Their negative and significant relationship shows that good CG mechanism can reduce the effect of agency cost.

Table shows that CG and FP has positive and significant relationship which implies that when corporate governance increases then FP also increases. Agency cost show negative and significant relationship with FP which indicate that when agency cost increase then firm performance decrease and when agency cost decrease then firm performance increase.

### Regression Results

The tests include finding direct effect of CG on AC, AC on FP and testing mediating effect of AC in the link between CG and FP.

### Direct Effects

*Effect of CG on Firm Performance:*

**Table 4**

*Regression Results*

	<b>B</b>	<b>Standard</b>	<b>t-test</b>	<b>Sig.</b>
<b>Constant</b>	0.403	0.42	0.962	0.337
<b>CGI</b>	0.194	0.067	2.901	0.004
<b>Firm Size</b>	-0.039	0.054	-0.725	0.469
<b>Age</b>	-0.003	0.003	-0.933	0.351
<b>Leverage</b>	0.059	0.018	3.283	0.001

### Dependent Variable: Firm Performance

Table 4 shows that CGI has a positive effect on FP at the 4% significant level (p-value =.004), with a t-statistics value of 2.901, (R= 0.564), and R-square of 31.79 percent. The CG coefficient is extremely significant and positive, implying that improved corporate governance leads to better results. The N is 370. The intercept value is 0.403, residual is 0.420, t-test value is .962, and p value is 0.337, is indicated in the table constant (C).

Several studies have attempted to show a link between CG and firm success in the past. The results, however, were inconclusive and inconsistent. CG is a structure of administration and management that impacts the achievement of any organization's purposes and goals. Many researchers found that there exist a positive link between CG and profitability (Bhagat and Black, 1999; Beiner et. al., 2006; Claessens, 2006) but few researchers also found negative association (e.g. Eisenberg et. al., 1998; Brown and Caylor, 2006) discovered a negative relationship. Few studies have also concluded mixed results when testing the same relationship (e.g. Connelly et al., 2012). Better governance leads to higher corporate value (La Porta et. al., 2002).

The control variables show different effects on firm performance. Firm size shows negative and insignificant relationship with FP as shown in the Table 4.3, the value of B is -0.039 with p value is 0.469. As shown in Table 4.3, age has an insignificant relationship with firm performance ( $\beta = -0.03$  and a p-value of 0.351), whereas leverage affects firm performance positively ( $\beta = 0.059$  and a p value of 0.001) suggest that inclusion of debt in the capital structure increased profitability.

### Effect of CG on Agency cost:

The findings with agency cost as the dependent variable, are shown in Table 4.4. The agency cost was calculated using the total asset turnover rate (TAT); the higher the TAT, the lower the agency cost.

**Table 5**

*Regression Results: CG and AC*

	<b>Coefficient</b>	<b>Std.</b>	<b>t-Statistic</b>	<b>Prob.</b>
<b>Constant</b>	-0.438	0.433	-1.011	0.313
<b>CGI</b>	-0.124	0.069	-1.804	0.042
<b>Firm Size</b>	0.207	0.056	3.686	0
<b>Age</b>	0.002	0.003	0.519	0.604
<b>Leverage</b>	-0.038	0.019	-2.017	0.044

Table 5 shows the direct influence of CG on agency expenses. The table demonstrates a positive significant association between CG and agency cost (coefficient = -0.124, t-value = -1.804). When it comes to corporate governance factors, the vast majority have a significant impact on asset utilization ratio. Our findings are similar to that of Ibrahim and Samad (2006), who found that smaller boards have a significant impact on agency costs. Singh and Davidson (2003) find no significant influence on agency cost when looking at the discretionary spending ratio and asset utilizations ratio. From the results, it is concluded that agency cost is inextricably linked to CG.

Firm size's effect on the agency cost is statistically significant. The firm size coefficient is 0.207, the standard deviation is 0.056, the t-test is 3.68, and the p value is 0.00. Age has a statistically small impact on agency costs, although it does have a favorable link with agency costs. The age coefficient is 0.002, the standard deviation is 0.003, the t-test is 0.519, and the p value is 0.604. The leverage has a statistically significant impact on AC, as well as a negative association with them. The leverage coefficient is -0.038, the standard deviation is 0.019, the t-test is -2.017, and the p-value is 0.04.

**Effect of Agency cost (AC) on Firm Performance:**

The impact of agency expenses on business performance has been the focus of our work thus far. It is discovered that agency expenses had a negative influence on the performance of businesses.

**Table 6**

*Regression Results: AC and FP*

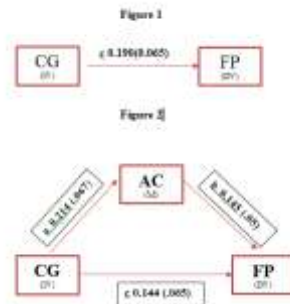
Variable	Coefficient	Std.	t-Statistic	Prob.
C	1.356	0.247	5.48	0.000
AC	-0.155	0.05	-2.87	0.002
Firm Size	-0.035	0.054	-0.651	0.516
Age	-0.004	0.003	-1.417	0.157
Leverage	0.062	0.018	3.427	0.001

The statistical results in Table 6 show a negative association between AC and FP (coefficient = -.155, t-value = -2.870). Yao and Wu's (2014) study was arguably the only important publication that empirically showed impact of agency costs on company performance, but their study was limited to insurance industry of China only.

The firm size has a statistically insignificant impact on AC. The firm size coefficient value is -0.035, the stander value is 0.054, the t-test is -0.651, and the p is 0.516. The age also has a statistically insignificant impact on agency costs. The leverage has a statistically significant impact on agency cost. The leverage coefficient value is 0.062, the stander value is 0.018, the t-test is 3.427, and the p is 0.001.

**Agency cost as mediator**

The Sobel test, which is mathematically stated, is used to establish if the agency cost acts as a mediator between CG and FP. The Sobel Test is performed first. The dependent variable is then regressed against the independent components in the second step. Finally, both the independent factors and the mediator are regressed on the dependent variable. Because there is only one mediating variable, the research employed a basic mediation approach to investigate if the agency cost has a substantial mediating influence on the link between FP and CG.



Where **a** is the effect of CG on AC, **b** is the effect of AC on FP, **c** is the direct effect of CG on FP, and **a\*b** is the indirect effect of CG on FP, and **c** is the effect of CG on Agency cost then on FP.

The Sobel test elucidates the mediating effect of AC on CG and business performance. Using the values of **a** and **b** from the figure, the following is the result of the Sobel test;

**Table 7**  
*Sobel Test*

	Test statistic	Std. Error	p-value
<b>Sobel Test</b>	2.14705153	0.01445238	0.03178918

Because the Sobel test has a statistically significant value, it implies that agency costs act as a mediator between corporate governance and business performance. Partial mediation is shown by the fact that both the direct and indirect effects are significant. Partial mediation is utilized when both the direct and indirect effects are statistically significant and the point (beta) of both effects is in the same direction (positive or negative). According to the findings of this study, agency cost mediates a portion of the influence of CG on FP, but CG still explains a piece of firm performance that is unaffected by agency cost.

### Discussion and Implications

The effect of corporate governance on firm performance is investigated in this study. To observe the influence of CG on firm's performance, mediating role of agency cost has also been examined in this study. According to the findings, CG has a considerable impact on FP. A random sample of 74 non-financial enterprises registered on the PSX was chosen. This study relies on 370 observations and uses the multivariate regression approach. The mediation effect is investigated using the Sobel test. The overall result of the regression demonstrates that CG has a considerable impact on FP and agency costs, implying that CG and company performance are mediated. The results of the study are consistent to that of Jamal and Shah (2017).

This is in line with our study's assumptions. The results revealed that lowering agency expenses is a key approach for companies' corporate governance to improve performance. Shareholders expect manager to run company in the interest of the owners. However, sometimes personal interests supersede organizational interest when it comes to the decisions taken by the managers (Bui & Krajcsák, 2023). Hence, good corporate governance practices could be of prime importance to reduce the agency cost and ultimately increase the profitability of a company.

### Implications of the study

The implications for regulators in established and developing economies to enhance corporate governance frameworks and engage with management to promote a high-quality disclosure environment in order to improve firm performance. The Securities and Exchange Commission of Pakistan (SECP) produced a comprehensive set of CG principles with the purpose of ensuring an effective work environment, accountability, and transparency. The fact that management refused to follow codes in the direct path findings implies that governance system effectiveness should be continuously checked.

On the other hand, the findings have implications for regulators in terms of improving corporate governance monitoring processes in order to reduce management-shareholder conflicts.

### Future Research Directions

Future recommendations for the future prospective are as follows: it is recommended to investigate the relationship between all aspects of CG, such as managerial and institutional ownership, audit and board independence, board size, and so on, in depth. It's also necessary to draw a line between family and non-family ownership. Scholars must embrace more recent and previous years to broaden the scope of the study and include more control variables to investigate their role. Those interested in researching the impact of CG traits in the future should also include financial factors.



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