

**Research Article**

# Optimizing Accounting-Based Financial Performance: The Role of Corporate Social Responsibility and Independent Board Structures in Pakistan

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**Declaration of Interests**

The authors declare no competing financial or personal interests that could have influenced this work.

**Abstract**

This study investigates the impact of CSR and independent boards on firm performance using the theory of stewardship. The study uses panel data of the top 30 companies listed on the Stock Exchange during the period 2017-23. Data were collected yearly from the publications of the companies, such as balance sheets and other reports. The study finds a positive relationship between independent boards and companies' performance. It shows the importance of corporate governance for a limited board structure when the members are increased up to the limit the performance of the company is reduced and may be an external member who lacks expertise regarding the company's internal system. However, the relationship between CSR and company performance is negative. This study indicated in Pakistani's context that the performance of that company will be good, with a fair number of independent members. Because there are fewer rules and regulations to protect investors in Pakistan, independent members work sufficiently in the interest of investors. For companies that make CSR in the form of philanthropic donations or money, their performance is reduced Because CSR does not reach deserved people, and the company does not get any special value in the minds of the public.

**Keywords:** Independent board, CSR, stewardship theory, accounting-based performance, Pakistan.

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## 1 INTRODUCTION

Prior studies of corporate governance have focused on board structure, corporate social responsibility (CSR), and company performance. Most similar studies show different results regarding the impact of CSR on company performance. It can be evidenced by some previous studies that there is no relationship between the independent board and company's performance, this situation may exist due to lack of causal relationship between variables (Almaqtari et al., 2023; Amir et al., 2022; Bauer et al., 2021; Linck et al., 2008). Therefore, studies in developed markets show a negative relationship between an independent board and a company's performance and a positive association between CSR and company performance. Studies in emerging or developing markets show a positive relationship between an independent board and a company's performance as well as a positive association between CSR and a company's performance. However, it is possible that strong rules and regulations exist in developed markets such as the USA and the UK, where investors are protected from any influence by strong laws, which shows that the majority of members have ownership in developed markets (Adams et al., 2010b; Hadj, 2020).

Most studies in emerging markets show a positive relationship between independent boards and company performance because they do not have sufficient corporate governance laws. To protect investors' rights, a positive relationship between independent boards and a company's performance has been found (Adams & Ferreira, 2007; Klapper & Love, 2004; Lei et al., 2021; McCahery et al., 2016). Researchers find different explanations for the results in the USA or developed markets opposite to those in other countries because of differences in nature, culture, and environment. However, a direct relationship exists between company performance and CSR. The dominance of independent boards could be demonstrated by the corporate situation in the USA during the era—1991-2003. In addition, in many countries, such as India and Kuwait (Hamdan & Al-Sartawi, 2013), and even in Pakistan, there is a positive relationship between independent boards and company performance (Claessens, 2006; Kara et al., 2015). This makes it difficult to statistically prove this relationship statistically (Kapil & Rawal, 2023).

To obtain the research results and make the research scientific, the researcher organized the study in different sections as follows. The second section discusses the relevant literature that the researcher has studied to develop the hypotheses for the study. belongs to the methodology of this study. The fourth section presents descriptive studies and the relationship between variables, and the fifth section is related to the empirical study and hypotheses testing. The final section presents the results of the study, along with suggestions and limitations of this study.

## 2 LITERATURE REVIEW AND THE HYPOTHESIS DEVELOPMENT

In a previous study, different authors described the different relationships between an independent board and a company's performance and the relationship between the company's performance and CSR. A Pakistani study shows that board size has a positive influence on the company's performance, whereas the company's performance is negatively affected by outside directors. Managerial ownership, ownership concentration, and CEO duality are positively related to the company's performance in Pakistan, and that an independent board positively affects a company's performance in Pakistan (Nadeem et al., 2013; Steblianskaia et al., 2023; Stoelhorst, 2023). Another study found a negative relationship between external directors and non-innovative firms and showed the positive effect of external directors on innovative firms with high knowledge and professional backgrounds (Balsmeier et al., 2014).

In the future, the theory shows that a friendly board system will enhance company performance. Because the performance of external directors' depend on information which is come to know from company CEO and management, if information is true their expertise increase performance, if information is wrong then they are unable to give valuable advice (Adams & Ferreira, 2007), a chains' theory define the positive relationship of the independent board and company's performance, also find a strong relation in government organizations because independent directors inside self-dealing improve efficiency (Liu et al., 2015; Wu et al., 2022). Emerging markets obtain valuable benefits from independent boards because of their weak legal environment (Klapper & Love, 2004). A Pakistani study examined whether boards with outside directors have no relationship between board composition and company performance; however, family directors are more efficient in enhancing company performance of the company (Yasser et al., 2017).

The board of the independent director not only enhances the company's performance but also protects shareholder interests (Shaker & John A. Pearce, 1989). Many other studies show a negative relationship between the board and the company's performance when investor protection rules are strict, and An American survey finds an inverse relationship between an independent board and the company's performance (Adams et al., 2010a; Vysochan et al., 2023). On the other hand, to check the impact of CSR on the company's performance different studies give different results, some studies describe a strong relationship of CSR and company's performance, in California "*Margarita*

*Tsoutsoura*” not only describes the relationship between CSR and Company’s performance but also tell his study the CSR increase the firm productivity and company’s performance(Tsoutsoura, 2004). Another study of 1000 Taiwanese cases showed a strong positive relationship between CSR and Company’s performance in the long run. However, in the short run, CSR has no significant effect on company performance (Lin et al., 2009).

However, CSR enhances the company’s performance when customers have significant awareness of Company CSR activities, and customer awareness of company CSR increases profitability, while customers’ low awareness of company CSR has an insufficient impact on company value(Servaes & Tamayo, 2013). In Italian theory, CSR has no effect on Italian listed companies because Italian investors are short-term ordinates, while CSR mostly affects the medium- and long-term. Future CSR is a new issue in Italian business; people do not have sufficient knowledge about CSR, so this theory shows a negative result for CSR and firm performance (Alola et al., 2022; Fiori et al., 2007). The USA theory shows that the effect of CSR on Company’s performance varies from industry to industry (Kang et al., 2010), so it depends on the nature of the industry and people’s awareness. On outgoing debate different studies find the positive relationship of independent board and performance in emerging markets and negative relationship in developed markets, CSR also positively affects performance, on the basis of previous literature the following hypothesis developed to find the combined relationship of CSR and Independent board on performance.

H<sub>1</sub> = An independent board has a positive and significant effect on company performance.

H<sub>2</sub> = CSR has a positive and significant effect on company performance

### 3 METHODOLOGY

This study used panel data of companies listed on the Pakistan stock exchange for a period of two years from 2017 to 2023. The sample includes 30 companies of Pakistan stock exchange 30 index. This study examines the impact of CSR, and an independent board listed on the PSX on Pakistani companies’ performance. This study draws on a model of study variables. This helps measure the performance of firms, a set of independent variables that are used to measure CSR in terms of the philanthropic and independent board, ROA as a dependent variable to measure firm performance, and a set of control variables that show the characteristics of firms.

#### 3.1 Accounting based measure of company’s performance

In this study to measure the performance of the firms an accounting ratio is used which known as “return on assets,” ROA is calculated as to divide net earnings before Tax on total equity/assets (Liu et al., 2015). Performance measures have been used as a method for confirmation, as past investigations have demonstrated variations after the effects of a particular technique used to quantify performance(Mousa & Saeed, 2017).

#### 3.2 Measurement of independent board and CSR

##### 3.2.1 Independent board

An independent board has more than one non-executive director as compared to executive directors, and they have no or minimal relationship with business dealing to secure shareholders’ interests. In this study, some conditions are also applied to the independent board described in the study of Mousa and Saeed (2017): a member is not directly or indirectly related to the firms, in the past having no managerial position in the firms, and also not having 10% or more shares of the company. Finally, a member should not have any contractual relationship with firms and should not provide any legal, consulting, or financial services to firms.

##### 3.2.2 Corporate social responsibilities

CSR is also introduced in this paper as an independent variable which means that “Movement aimed at encouraging companies to be more aware of the impact of their business on the rest of society, including their own stakeholders and the environment. (Barned 1938)” in this study, CSR is considered with respect to philanthropic responsibilities. Philanthropic responsibilities are activities in which a company benefits society by giving donations and money is a charitable thing.

##### 3.2.3 Control variables

Two types of control variables were used in this research: one related to a company’s monetary cost, and the other related to the company’s environment and characteristics (Mousa & Saeed, 2017).

**Monitoring costs:** In this study, the monitoring cost was introduced as a controlled cost, which was measured using two control variables. One is the asset turnover ratio, which is calculated by dividing total net sales by average assets. The second is financial leverage, calculated by dividing debt by total assets.

**Board and company's characteristics:** Other control variables are associated with the board and company characteristics. Among these control variables, first one is firm size is measured by taking the natural log of a company's total assets, firm age in respect of years from the day of incorporation, and board size is the total number of board members. Duality: the duality between the CEO and the board chairman if he has two posts assigned 0 otherwise 1.

Based on variable measurements, the study model combines the following variables:

$$\begin{aligned} Performance_{i,t} = & \beta_0 + \beta_1 \%Ind_{i,t} + \beta_2 ind_{1,i,t} + \beta_3 Ind_{2,i,t} + \beta_4 Ind_{3,i,t} + \beta_5 Ind_{4,i,t} + \beta_6 Ind_{5,i,t} + \\ & \beta_7 CSR_{P,i,t} + \beta_8 turnover_{i,t} + \beta_9 FirmSize_{i,t} + \beta_{10} FirmAge_{i,t} + \beta_{11} Leverage_{i,t} + \\ & \beta_{12} BoardSize_{i,t} + \beta_{13} Duality_{i,t} + \varepsilon_{i,t} \end{aligned}$$

Performance is measured by the return on assets ratio,  $\beta_0$  is the constant, which indicates the performance of the firms without any effect of CSR, BI and control variables, and other remaining variables  $\beta_{1-13}$  the slop of the model,  $\%\_Ind$  is the percentage of independent director in the board,  $\beta_2$  is the dummy variable if a firms having one independent director it assigned 1 if not than 0, if a firm having two independent member  $\beta_3$  is assigned 1 if not than 0, if firms having three independent member  $\beta_4$  is assigned 1 if not then 0, if a firm having four independent member  $\beta_5$  is assigned 1 if not then 0, if a firm having five or more than five independent members than  $\beta_6$  is assigned 1 if not than 0,  $\beta_7$  is related with CSR it is also a dummy variable if a firm contributes to philanthropic CSR it assigned 1 if not then 0,  $\beta_8$  is a control variable related to assets turnover,  $\beta_9$  is Company's size natural log of company's total assets,  $\beta_{10}$  is the Company's age in years,  $\beta_{11}$  is the Leverage,  $\beta_{12}$  is the board size in respect of total members of the company's board,  $\beta_{13}$  is the duality of the CEO and chairman post which is dummy variable so if he has two posts assigned 0 if not then 1, and  $\epsilon$  the error term.

#### 4 STUDY RESULTS

The table I shows the result of descriptive analysis of study variables, where the member of the independent board in firms of Pakistani stock exchange have 25.7 percent and the maximum 75 percent of the total board in Pakistani firms, while the CSR is only 0.62 percent of these companies in terms of philanthropic. Table 2 where 42-percent firms in Pakistan have one independent member on the independent board, and 18.8-percent of Pakistani firms have five or more independent members on the board. And the 0.82-percent firms have a duality between the board chairman and the CEO. The control variable also shows the different characteristics of Pakistani firms, as board size has maximum 21 members of a board, and the highest firm size 29. For monitoring costs, the highest leverage and turnover were 234 and 4, respectively.

Table 1. Descriptive Statistics

Variables	Minimum	Maximum	Mean	S. D
ROA	-13.000	30.000	9.470	8.216
$\%\_Ind.$	0.000	75.000	25.720	18.146
Ind._1	0.000	1.000	0.480	0.504
Ind._2	0.000	1.000	0.230	0.427
Ind._3	0.000	11.000	0.380	1.451
Ind._4	0.000	1.000	0.180	0.390
Ind._5	0.000	1.000	0.220	0.415
Philanthropic	0.000	1.000	0.620	0.490
Turnover	0.000	4.000	1.280	0.922
Leverage	1.000	234.000	9.570	31.819
Firm Size	19.000	29.000	24.670	1.954
Firm Age	6.000	103.000	43.070	23.097
Board Size	4.000	21.000	9.430	2.999
Duality	0.000	1.000	0.820	0.390

Table 2. Descriptive Study of Dummy Variables

The level of CSR and independent board	Frequency (1s)		Frequency (0s)	
	Frequency	Percent	Frequency	percent
Ind_d1	29	42.0	31	44.9
Ind_d2	14	20.3	46	66.7
Ind_d3	12	17.4	47	68.1
Ind_d4	11	15.9	49	71.0
Ind_d5	13	18.8	47	68.1
Philanthropic	37	53.6	23	33.3

Table 2 shows the percentage and frequency of the dummy variables related to the measurement of independent boards and CSR in Pakistani companies., PakistanThe 42 percent of companies have one independent member on an independent board, 20.3 percent companies have two independent members on the board, and 53.6% are interested in CSR.

Empirical studies have faced different measurement problems to check the relationship between internal variable problems related to the casual error of the regression model. Most corporate finance studies face the challenge of endogeneity. To overcome these problems, this study uses the fixed affect approach in the regression model because when cross-sectional and time-series data merge, we obtain more disparity and fewer internal co-relations between variables.

#### 4.1 Regression model with fixed effect approach

A regression model with panel data is divided into two approaches: the fixed effects (FE) and random effects (RE) approaches. This depends on the assumptions of the regression when the data are cross-sectional and time series; if there is no correlation between the error term and independent variables, then the RE approach is the best. Otherwise, if there is correlation between error term and independence of control variable then FE approach is best, so our data having a correlation between error term and independent variable due to this we use FE approach.

Table 3: Effect of IB and CSR on company's performance.

Variable	Coefficient	t-Statistic
<i>Panel A: Independent Variables</i>		
%_IND	0.134165	2.133669
IND_1	0.182830	2.585454
IND_2	0.113174	1.998810
IND_3	0.584637	0.535390
IND_4	-0.584486	-0.104642
IND_5	-0.429550	-4.448498
Philanthropic	-0.236943	-3.439807
<i>Panel B: control variables</i>		
Leverage	-0.005817	-0.248515
Turnover	0.658010	2.759587
Firm size	-0.871707	-1.367184
Firm age	0.580576	3.485994
Board size	-0.658149	-0.478290
Duality	-0.671548	-2.130748
R-squared	0.727359	
Adjusted R-squared	0.697303	
S.E. of regression	3.532522	
F-statistic	14.24284	
P-value	0.000029	
Durbin-Watson stat	2.270968	

Based on the FE approach, an independent board and company performance have a significant and positive effect, but four or more members of the independent board have a negative relationship with the company's performance. Our results differ from those of previous studies (Mousa & Saeed, 2017)

Conducting research in Saudi Arabia and Bahrain, there is a negative relationship between independent boards and company performance; however, our result is linked with (Liu et al., 2015), who found a positive effect of independent boards on performance. Therefore, independent boards have a progressive effect on performance in emerging markets. Philanthropic CSR is negatively related to company performance. There may be some reasons related to the characteristics and environment of companies as well as the country.

## 4.2 Control Variable Results

The FE approach shows the additional results of the control variables, which show the negative and insignificant relations of firm size and leverage; however, the positive and insignificant results of turnover and firm age, board size, and duality are also negatively related to the company's performance; these results are different from those (Dittmann et al., 2009; Nguyen & Nielsen, 2010) where positive effects are observed, while some studies show negative relationships. These different results require further study to verify their relationship with performance.

## 4.3 Discussion on the Hypotheses

In emerging markets, there is a direct and significant effect of an independent board on a company's performance. Therefore, in this research, we reject  $H_0$  because, in Pakistan, the effect of an independent board on a company's performance is positive; therefore,  $H_1$ . Our results differ from those (Mousa & Saeed, 2017). However, it should be noted that the effect of an independent board on performance is positive for up to three members. For the above three members, the result goes in the negative direction; thus, we have to accept  $H_0$ . However, in the case of CSR, we do not reject  $H_0$ , the result of CSR on company performance shows a negative relation between CSR and performance, and our results match those of (Nigro et al., 2015) and differ from those (Giannarakis et al., 2016) so it depends on marketing conditions and people's attitudes.

## 5 CONCLUSION

This study provides a structure for the relationship between a company's performance and independent boards as well as CSR. This study is based on the stewardship theory, and a company's performance is measured by accounting-based ratios, which are return on assets. To test this hypothesis, panel data were collected from 30 companies in Pakistan from 2017 to 2023. Descriptive and empirical results show positive and significant results for independent boards and company performance, but more than four members of the independent board show negative results, which may be due to a lack of internal knowledge of the company or any other factor (Mousa & Saeed, 2017). However, the negative relationship between CSR and a company's performance, such as (McWilliams & Siegel, 2001) shows a neutral effect of CSR on firm performance, there is also a study (Aupperle et al., 1985) found no relationship between CSR and firm performance.

This study shows that negative and insignificant results regarding CSR and performance may be problematic in the data, which may be because companies did not provide real published information about CSR. Undoubtedly, "there are many benefits of the independent board, but it is depending on business characteristics and the nature of the business." Therefore, the most significant recommendation of more than four members decreases performance, because external members lack knowledge and experience. Here, internal members are more efficient (Adams & Ferreira, 2007; Mousa & Saeed, 2017) and limited philanthropic CSR is beneficial for company performance.

This study uses econometric techniques to reach the results by overcome the different problems because of endogeneity problems in the variables of the model. To provide the results about the independent board and CSR relations with company performance, this study used a limited sample, and the researcher took only one variable to measure performance. However, to obtain clear performance results, the sample size must be increased to apply to all Pakistani firms and measure performance with more scales such as ROE and earnings quality, so that it can contribute to understanding the best board structure.

**Practical implications:** This article provides helpful information to those affiliated with management authorities when they design the structure of the company's board, so they need to combine independent and dependent directors, which could increase the company's performance. A company's performance will improve when appropriate dependent members are hired to handle the company's internal issues. A suitable Independent Member can maintain checks and balances on Dependent Members and other subjects.

**Social implications:** This study states that, in Pakistan's context, the performance of that company will be good, which will have a fair number of independent members. Because there are few rules and regulations to protect investors in Pakistan, independent members work sufficiently in the interest of investors. For companies that make CSR in the form of philanthropic donations or money, their performance is reduced Because CSR does not reach deserved people and the company does not get any special value in the minds of the general public.

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