



Impact of Board Characteristics, Firm Level Factors and Political Connections on Cost of Capital: Evidence from Pakistan

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ABSTRACT

The purpose of the study is to analyze the impact of board characteristics, firm level factors and political connections on cost of capital. The sample of study comprises of 175 non-financial companies listed on Pakistan Stock Exchange from 2008 to 2021. Fixed effect model is used for analysis of data. The findings revealed that Increasing board independence and leverage has a negative influence on the cost of capital. Whereas, Board size, Audit committee size impact the cost of capital positively. The study resolute that the cost of capital is not influenced by political connections, firm size, or institutional ownership. The research identified that there was a decline in the cost of capital, along with an increase in board independence and leverage. In addition, the cost of capital is unaffected by political connections, the size of firms and institutional shareholdings. In contrast, the cost of capital grew due to an increase in the size of the Board and the Audit Committee. The study suggests that In Pakistan non-financial firm's maximum family own business and very low focus on management and foreign owners. Alternative prospective of managerial and foreign ownership firms should minimized the agency problems as family ownership. And for the best improvement of corporate governance board of directors should bring a transparency, accountability and fairness financial reporting.



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1. Introduction

Researchers all over the world have been interested in corporate governance for a number of years, especially the effects of financial scandals like Enron, WorldCom, and Parmalat, which caused a lot of people to lose a lot of money. Most of these scandals showed that there were problems with the way things were run. It was important to restore investor confidence, which required good governance to lower investment risk. In addition to this, CG sends signals to the market on the good management and performance of a business, as well as the successful alignment of the interests of management with those of other stakeholders (Rustam & Narsa, 2021).

However, the reasons listed above are some of the most fundamental explanations why corporate governance (CG) has risen to the top of the list of concerns for

comprehensive supportable evolution (Becht, Bolton, & Roell, 2003). In order to improve the performance of a corporation while also protecting the rights of shareholders and creating an environment conducive to investment and economic growth, good governance is essential (Braga-Alves & Shastri, 2011). The failures of corporations as a result of a weak governance system necessitate the development and reform of corporate governance systems. The failure to prevent accounting frauds is a source of concern when it comes to the governance procedures and principles (Sun, Stewart, & Pollard, 2011). The problem with the agency is that the directors are not as concerned about other people's resources as they are about their own (Letza, Sun, & Kirkbride, 2004). Moreover, giving to agency theory, the important goal of corporate governance is to provide principals with the assurance that managers (agents) are acting in their best interests as opposed to their own. It is also asserted that the observing role played by large numbers of investors and independent managers might be able to improve managing's self-serving behavior and rise the value of the company in question (Jensen & Meckling, 1976). Despite the fact that corporate governance systems differ from country to country, stakeholders believe that a mechanism should be in place to minimize agency issues. Consequently, corporate governance is continued for the purpose of controlling management and communicating necessary information to shareholders in order to grasp organization accountable for the wealth of the shareholders because his actions will have a direct impact on their wealth (Al-Malkawi, Arabia, Pillai, & Dhabi, 2012). Along with these statements, stewardship theory asserts that there is a strong relationship among an establishment's success and the approval of its shareholders. A steward protects and maximizes the wealth of the shareholders since his worth remains increased as a result of doing so.

Apart from the above discussion, the static trade-off theory of capital structure states that a firm should opt the best composition of debt to get the advantage of the interest-tax shield. The reason behind this is that it leads to agency problems and ultimately will affect firm performance and riskiness. Agency theory claims that agency cost is a factor of capital structure and agency cost can be reduced by effective corporate governance system (Jensen & Meckling, 1976). Consequently, CG quality plays an essential part in a company's financing decision as these choices are made by the managers.

The present research estimates the selections of cost of capital in Pakistan non-financial industries are effected by the corporate governance determinants, many types of corporate governance determinants that effect the judgments of management while release ownership and control. The cost of capital decisions has a significant one subsequently the profit of a firm is openly influenced through which the decisions by Achchuthan, Rajendran, and Nadarajah (2013).

Interpreting to the previous explanation the initial determination of corporate governance is to safe attention of investors and owners of the firm. In present research work the significance of the internal corporate governance is emphasized, when the concern of shareholders is protected, then it will provide a positive or effective variation in the profitability of the company. Various empirical investigations have been conducted, all the proven the presence of an association among corporate governance and firms financial position. When the discussion of developing and developed market, the explanation of corporate governance is examining that this is different for different countries. According to the very important area of huge corporations like corporate governance sector in developing countries like Pakistan is a better implementation for the progress of good corporate culture, but in the developed countries not new thing. However, several investigations conducted on corporate governance being a comparative research. Main contribution in this attention given by Ali (2018) he directed the study on the comparative investigation among developing country like Pakistan and developed country like United State. The important aspect in reducing knowledge asymmetry is corporate governance; the major elements that are the purposes of corporate governance like as internal management, supervision of strategic polices. The one element is to be established in the presentation of financial statements that deliver final knowledge so, that among administration and others the same relative knowledge quality. As a consequence, that the financial statements such as list of the manager's performance created by the management then the pattern of provision is exposed to minimize struggle of interest.

According to Rehman (2006), the involvement of politicians in Pakistani local businesses has existed for a long time. Further, since the partition of the subcontinent and the establishment of Pakistan, many of the politicians in Pakistan have their business organizations in both financial institutions (e.g. Banks) and non-financial institutions. Moreover, politicians also have connections with firms by taking the membership of the board of directors or through informal relationships (friendships) with the higher management of firms. Irrespective of the nature of relationships or connections, the participation of politicians in governance generates opportunities for firms to obtain a low cost of capital. According to Khwaja and Mian (2005), politically connected firms obtain financing at a low rate and with soft terms. Politically connected firms have easy access to credit from government-owned banks (Ashraf & Ghani, 2005). In Pakistan, politicians contested general elections held in 2002, 2008, 2013, and 2018 with the support of different businesses. Phan, Tee, and Tran (2020) and Wong and Hooy (2018) indicate that the types of corporate political strategies also matter. From existing literature, we find a lack of evidence linking to the effects of board characteristics and firm level factors on the cost of capital in Pakistan.

Due to globalization many challenges and issues are facing to small size and large size firms in the modern world. After the establishment of new government in Pakistan 2018, there are many issues raised by the government according to economic growth and debt burden of Pakistan, every political party has own policies and procedures, and if they become in government they will apply new rule and regulations on the firms listed in SECP and Stock Exchange. So, according to new policies regarding interest rate and tax rates however, the company's corporate governance bodies like board of director's members and audit committee members handle these specific challenges and its outcome on cost of capital of the company in Pakistan such as developing country.

2. Literature Review

2.1. Board Size and Cost of Capital

Board size means overall members of the board. Prior studies show mixed results that both board size affect cost of capital or not and what will be the appropriate size of the board. Resource dependency theory suggests that the bigger size of board improves cost of capital due to different information, abilities and expertise. Prior studies show mixed results regarding the relationship. Berger, Ofek, and Yermack (1997) show a negative influence while Jensen (1986) shows a positive affiliation amongst board size and cost of capital. It is considered that firms with large board size perform superior than others. The larger number of directors on board seems to have a negative relation with the firms cost of capital and cost of equity. A larger board size may involve diversity of managerial ability & know-how with respect to decision making. This may result in moderately better performance by the firm, which may increase the investor's opinions, trusting them about the safety of their capital invested.

H₁: Board size has positive effect on Cost of Capital.

2.2. Board Independence and Cost of Capital

A rise in board independence (Board Ind) is accompanying with an increase in cost of capital, both WACC and K_e both show that a rise in board independence (Board Ind) is related with an increase in a company's cost of capital. The outcome for K_d , on the other hand, is as expected, with the cost of debt being inversely linked to the (Board Ind), indicating that a higher number of independent members on the board serves as a measure of safety for debt lenders.

H₂: The board Independence has negative impact on Cost of Capital.

2.3. Leverage and Cost of Capital

In research studies, ratio has been measured regarding to the total debt to total assets in the past study of (Rad, 2014). Leverage is negatively related to the cost of capital (Bozec & Bozec, 2010). Leverage as a total liabilities/total asset has a negatively/significantly effect on cost of capital, highlighting the companies that are capable

to adopted more borrowings to get benefit of the debt financing tax pattern and minimize their cost of capital (Pham, Suchard, & Zein, 2011). In recent research investigations examining the role of domestic level elements as dimensions of company leverage by Antoniou, Guney, and Paudyal (2008); Beck, Demirgüç-Kunt, and Maksimovic (2008); Rajan and Zingales (1995), in any country across the limitations, high rate of interest and more complicated financial leverage policy have negatively influence the company major profitably by Astawa, Sudika, and Yuliarmi (2015). The regulatory bodies of Pakistan have described an significant role in differentiate the financial leverage rules and solve the economic leverage difficulties by affords low interest rate however, not even numerous firms get benefit of its opportunities but also slight and meddle business can make grow quickly. The present declaration that profitability relies on the ratio of debt financing. The firms leverage brings shortest relation with its cost of capital (WACC, K_e , K_d). It suggests that higher the financial risk invested by the firm, higher shall be its cost of capital. The beta coefficient for Leverage is not very high, which supports the result with the theory that higher debt component (after a certain level) may make safety concerns within equity investors as well as lenders, thus influence them to demand a more return for their investments.

H₃: Leverage negatively affect the Cost of Capital.

2.4. Audit Committee Size and Cost of Capital

In order to ensure that governance is effective, the Audit Committee is an essential component. In a public sector company, the members of the audit committee should have a good understanding of finances, and most people believe that the chairman and most of the other members should be independent non-executive directors. The chairperson of the Board and the Chief Executive Officer should not serve on the audit committee in order to maintain the committee's status as an independent body. However, in the event that the chief internal auditor is not present, the audit committee is required to hold at least one meeting per year with the external auditors. This is to make sure that the external auditors and the audit committee can talk to each other without interference. Additionally, the meeting of the audit committee with the chief internal auditor and other members of the internal audit function must take place at least once annually when the chief financial officer is absent from the room. Internal corporate governance like audit committee significantly /positively effect on cost of capital. A rises in the audit committee size were extend the people self –assurance over the company finance related conversations and responsibility of audit committee participants by Abbott and Parker (2000). According to Alsaeed (2006)), audit committee size revealed significantly/negatively effect on financial position of the companies.

H₄: Audit committee size has a positive influence on Cost of Capital.

2.5. Political Connection and Cost of Capital

The idea is a relatively new one in management literature, having just appeared in the last several years. As a result of the lack of a universally applicable definition for the notion, it may be connected with either explicit (direct) connections or implicit (indirect) relationships. When this happens, it may result in several definitions for the same idea being raised to suitable in with the author's research and theoretical frameworks. In the literature, for example, conventional definitions of political ties refer to the political contributions of investors, senior executives and management officials (official). Others connect it with donations to political drives or toward political gatherings, which they believe is incorrect.

A part from this, political connections can be made either directly, as in the case of relationships among politicians who are involved in current or past political activities, or indirectly, as in the case of contributions to political campaigns and lobbying activities. Both types of connections can be considered to be political connections. Equity funding may also be beneficial to boards of directors that have a political connection. In spite of the fact that the matter has garnered the attention of a diverse group of stakeholders, such as managers, regulators, and researchers, there is currently very little experiential evidence to

demonstrate how political connections affect the cost of equity (Boubakri, Guedhami, Mishra, & Saffar, 2012). Based on data they demonstrate a negative relationship among political linkage and the cost of capital. This specifies that companies with political ties are favorably assumed by investors, as opposed to the opposite. Furthermore, according to Boubakri et al. (2012), the influence of political ties is greater in nations with less clearness, bigger and older businesses, and a restricted stock market growth.

According to the opposite view, companies with strong political ties may have poor corporate governance instruments and high agency costs, which may result in a reduction in overall company value via rent-seeking conduct. In nations with a dual board structure, however, there is a lack of confirmation on the cost of capital as well as on corporate governance with political ties, which is a concern. Organizational behavior is influenced by political connections, which are outside aspects of corporate governance mechanisms. This kind of governance may have a significant impact on organizational behavior in a variety of ways, including how a company calculates its profitability, how it increases money, who has control of the organization, and how financial statements are produced (Roe, 2006). There are two contradictory views on the implications of political connections that may be seen through the lens of the agency theory. Several reasons have been advanced, including the possibility that the political connections would lead to bad corporate governance and an increase in agency costs owing to rent-seeking (Chen, Li, Luo, & Zhang, 2017). Aside from that, linked businesses may profit politically by taking company resources at the cost of other parties (Qian, Pan, & Yeung, 2011). Political connection takes as a simulated variable. One variable is assigned if one or more major owners of the company, or if one or more members of the political families, past or current ministers and members of the country's cabinet in general, representatives or members of the country's parliament, are present; otherwise zero is assigned.

H₅: The political connections has a positive impact on Cost of Capital.

2.6. Firms Size and Cost of Capital

Specifically, it will be restrained as the natural logarithm of the company's total assets. As a result, growth will be included as an independent variable in the research. In order to assess growth, the percentage age change in sales from one year to the next will be used as a measure. Small businesses and big companies are more differentiated from one another, which lowers the firm's possible hazard then capital expenses (Botosan & Plumlee, 2005).

H₆: The Firm size has a positive impact on Cost of Capital.

2.7. Institutional Shareholding and Cost of Capital

Institutional shareholdings will be calculated as the percentage of institutional ownership. Pillai and Al-Malkawi (2018) used institutional shareholdings as a degree of corporate governance. Both the scholars indicate negative but first show in-significant. It also has a significant consequence on capital costs. According to Jensen and Meckling (1976), Investor and board conflicts can be minimized by regular monitoring.

H₇: Institutional shareholding has a positive association with Cost of Capital.

3. Theoretical Frame Work

3.1. Trade-Off Theory

Under the trade-off theory as proposed by Miller (1977), companies strive to reduce their total costs of capital by balancing the tax advantages of larger debt with a greater likelihood that they would be forced into financial hardship. Alternately, it can be stated that a firm is required to select loans until the marginal benefits of using more loans equal or exceed the marginal cost of consuming more loans (the cost of financial distress) and that thus the optimum capital structure is located at the point at which the net benefits of using more loans equal or exceed zero (Hovakimian, Opler, & Titman, 2001).

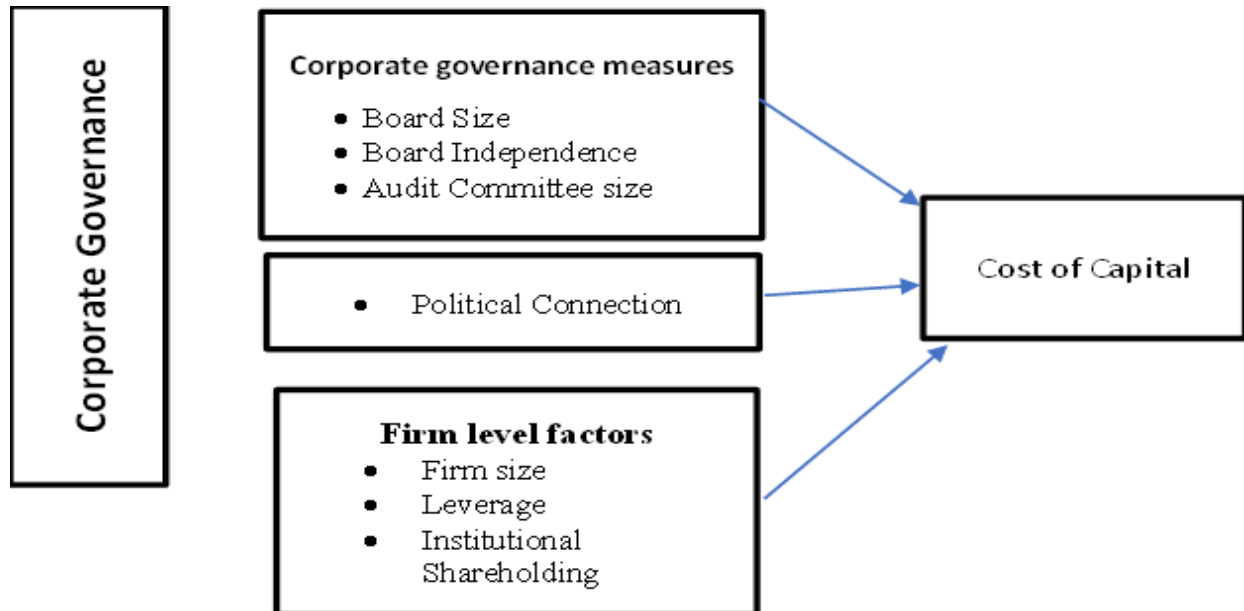


Figure 1: Theoretical Framework

3.2. Agency Theory

Traditionally, the concept of agency paradox has been linked with corporate governance. When managers operate and govern a company on behalf of investors who own the company, this is referred to as agency theory or agency relationship forming. Agency theory states that managers, as representatives of shareholders, should act in the best interests of principles; however, agents may fail to act in the best welfares of principles due to a lack of alignment of interests between the two parties, resulting in an agency problem in the end (Jensen & Meckling, 1976). As a consequence, a result of the agency issue, an agency cost is incurred. The monitoring expenditures incurred by the shareholders, the bonding charges incurred by management, and the residual costs are all included in the agency cost.

3.3. Pecking Order Theory

This idea is founded on the knowledge asymmetry that exists between insiders of a company and less-informed outsiders, and that exists in the actual world as a dynamic aspect of business (Myers, 1984). Management or insiders of the company are assumed to have more information about operations and future prospects than outside investors. As a result of this information asymmetry among investors and managers, pecking order theory proposes that financing sources should be arranged in order of preference. However, the top decision-making board, to make strategies and policies for retaining the cost of capital regarding debt and equity holder requirement. According to the composition of board researcher can study on the board meeting held in a year and its effect on cost of capital or company performance. However, world financial crises, in corporate governance have created the many problems. Consequently, the proposed study undertakings to answer the question, what is impact of board characteristics, firm level factors and political connections on cost of capital?

4. Research Methodology

4.1. Population & sample

The data for the study has been collected from the non-financial firms of Pakistan. The sample period for the study is thirteen years covering the duration of 2008 to 2021. In this section shows that research method that were finalized to observe the study and highlighted the sources of data collection. Secondary data were obtained and gathered from the firm's annual financial reports and statements published on Pakistan Stock Exchange for the period of 2008 to 2021. Some missing data in annual reports about firm's specific

variable that were gathered from the State Bank of Pakistan but if some type of data not available on SBA site then collect from the company's official websites.

4.2. Model Specification

Following the econometrics model will be advanced by keeping in mind the research objectives and nature of research work:

$$WACC = \beta_0 + \beta_1 BODS_{it} + \beta_2 BOD IN_{it} + \beta_3 LEV_{it} + \beta_4 ACS_{it} + \beta_5 PC_{it} + \beta_6 FS_{it} + \beta_7 IS_{it} + \varepsilon_{it} \quad (1)$$

The above model WACC (*it*) indicate that I represent the sample and t represent the time period, WACC is to measure the dependent variable Cost of Capital. β_0 Was used as constant and co-efficient having a marginal effect on cost of capital, while ε_{it} is the error term in the model.

The co-efficient of independent variables are from β_1 to β_7 while BODS (board of director size), BOD IN (board independence), LEV (leverage), ACS (audit committee size), PC (political connection), FS (firms' size) and IS (institutional shareholding) is included in this study as a control variable.

5. Results

Table 1
Descriptive Statistics

Variable	Mean	S.D.	Min	Max
WACC	0.089	0.3180	0.01500	0.6870
BS	8.250	1.7300	4.0000	16.0000
BOD IN	0.671	0.2910	0.0000	0.8220
ACS	1.840	0.8150	0.0000	4.0000
PC	0.493	0.5010	0.0000	1.0000
LEV	0.629	0.4470	-0.2570	4.1400
FS	19.000	2.560	0.0609	26.9000
IS	0.0441	0.0621	0.0000	0.4940

Note: The table sows the descriptive statistics of the data.

Table 2
Fixed Effect Model Results

Variable	Coefficient	Std. Error	Prob.
WAAC			
BS	0.00298	0.00125	0.01880***
BOD IN	-0.01495	0.00695	0.03212**
ACS	0.00306	0.00171	0.07933*
PC	-0.00065	0.00299	0.80145
FS	0.00039	0.00076	0.49632
LEV	-0.04023	0.00398	0.00000***
IS	-0.00533	0.01594	0.69151
C	0.11656	0.01436	0.00000***
R-squared	0.58770		
Adjusted R-squared	0.53250		
F-statistic	13.10100		
Prob. (F-statistic)	0.0000		

(***= Significant at 1%, **= significant at 5 %, * =significant at 10 %)

Note: The table shows fixed effect results of the data.

Table 2 show the result of fixed effect model allied on panel data to check the impact of corporate governance on cost of capital along with Cost of Capital (WACC). Board size (BS), Board Independence (BOD IN), Board Committee (BC), Political Connection (PC), Leverage (LEV) and Institutional shareholding (IS) are dependent variables.

The probability value of (BS) Board size is 0.01880 significant at the level of ($P < 0.05$). So, it means that Board size significantly / positively influence on cost of capital. When board size increase then cost of capital also increase there is positively relationship among board size and cost of capital. Jensen (1986) shows a positive relation amongst

board size and cost of capital. So, that results in moderately better performance by the firm, which may boost the investor's sentiments, entrusting them about the safety of their capital invested.

The probability value of (BOD IN) Board independence is 0.03212 significantly/positively the level of ($P < 0.05$). The value of (ACS) Audit Committee 0.07933 is insignificant at the level of ($P > 0.05$) these value shows that audit committee has positive and insignificant impact on cost of capital. According to Alsaeed (2006), audit committee size revealed negatively effect on financial position of the companies.

The probability value of (PC) Political connection is 0.80145 significant at the level of ($P > 0.05$). So, based on data spanning the year 2008 to 2021, they also demonstrate a negative relationship among political connection and the cost of capital. This indicates that companies with political ties are favorably assumed by investors, as opposed to the opposite.

The probability value (FS) Firm size is 0.49632 found significant at the level of ($P > 0.05$). So, it means that the firms with more growth potential need more working capital, which has a negative impact on their profitability and other business operations in turn.

The probability value of (LEV) Leverage 0.000 is significant at the level of ($P < 0.05$) so, in this model leverage significant impact on cost of capital. Thus influence them to demand a more return for their investment. The probability value of (IS) Institutional shareholding is 0.69151 is insignificant the level of ($P > 0.05$). So, in this model Institutional shareholding impact on cost of capital. Pillai and Al-Malkawi (2018) used institutional shareholdings as a degree of corporate governance. Both the scholars indicate negative but first show in significant. It also has a significant relation on cost of capital.

According to the results, the R-square is 0.58770 and adjusted R-square is 0.53250. It means that model has approximately 59% power to explain cost of capital variations due to independent variables. F-statistics is 13.10100 with the significant probability value of 0, it shows that the model is best fit on the data set and is properly specified.

Table 3
Hypothesis Results

Hypothesis	Result
H ₁ : Board size has positive effect on Cost of Capital.	Support
H ₂ : The board Independence has negative impact on Cost of Capital.	Support
H ₃ : Leverage negatively affect the Cost of Capital.	Support
H ₄ : Audit committee size has a positive influence on Cost of Capital.	Support
H ₅ : The political connections has a positive impact on Cost of Capital.	Does not support
H ₆ : The Firm size has a positive impact on Cost of Capital.	Does not support
H ₇ : Institutional shareholding has a positive association with Cost of Capital.	Does not support

6. Conclusions and Recommendations

The study determines the impact of board characteristics, firm level factors and political connections on cost of capital in non-financial companies of Pakistan as a developing economy during the 2008 to 2021. In this study try to analyze that link among internal corporate governance and cost of capital has been considering the valuable them in the area of finance through literature support and empirical evidence. So, the objective in the background of the research work is to analyze either corporate governance has any meaningful impact on cost of capital in manufacturing sector of Pakistan. In this research also examined how non-financial firms were going to overcome specific issues related with corporate governance. Check the impact of corporate governance on cost of capital along with Cost of Capital (WACC). Board size (BS), Board Independence (BOD IN), Audit Committee Size (ACS), Political Connection (PC), Leverage (LEV) and Institutional shareholding (IS) are dependent variables. Corporate governance shows impact on cost of capital. The probability value of (BS) Board size is significant. So, it means that Board size significantly / positively influence on cost of capital. When board size increase then cost of capital also increase there is positively relationship among board size and cost of capital.

So, that result in moderately better performance by the firm, which may boost the investor's sentiments, entrusting them about the safety of their capital invested. The probability value of (BOD IN) Board independence is significantly/positively. The value of (AC) Audit Committee is insignificant at the level of the value shows that audit committee has positive and insignificant impact on cost of capital. According to Alsaeed (2006), audit committee size revealed negatively effect on financial position of the companies. The probability value of (PC) Political connection is significant at the level. So, based on data spanning the year 2008 to 2021, they also demonstrate a negative relationship between political connection and the cost of capital. This indicates that companies with political ties are favorably assumed by investors, as opposed to the opposite. The probability value (FS) Firm size found significant at the level. So, it means that the firms with more growth potential need more working capital, which has a negative impact on their profitability and other business operations in turn. The probability value of (LEV) Leverage is significant at the level of so, in this model leverage significant influence on cost of capital. Thus influence them to demand a more return for their investment. The probability value of (IS) Institutional shareholding is insignificant the level. So, in this model Institutional shareholding impact on cost of capital. Pillai and Al-Malkawi (2018) used institutional shareholdings as a degree of corporate governance. Both the scholars indicate negative but first show in significant. It also has a significant relation on cost of capital.

6.1. Recommendations

Following are the recommendations of this study:

- i. Study recommended to the Security Exchange Commission of Pakistan take a reasonable step for the transparency of annual reports for listed companies on Pakistan Stock Exchange because there was a many issue regarding to the financial statement analysis measurement.
- ii. Most adjusted the reasonable part of the cost of debt and cost of equity.
- iii. To minimize the fraud and gossips in firm must kept a reasonable audit committee like smaller audit committee size, independent director and must manage a committee every quarter annually.

Authors Contribution

Muhammad Bilal Ijaz: Finalize and proof read the final draft.

Awais Javeed: Data analysis and proof reading.

Sahar Afshan: Data collection and drafting

Conflict of Interests/Disclosures

The authors declared no potential conflicts of interest w.r.t the research, authorship and/or publication of this article.

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