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How does Financial Flexibility and Corporate Governance affect Firm Performance in Developed and Developing Countries?

[a] Muhammad Jahangir Ilyas, [b] Muhammad Abbas

[a] Student, Air University, Islamabad, Federal, Pakistan
Email: 181777@students.au.edu.pk
[b] Professor, Air University, Multan, Punjab, Pakistan
Email: mam@aumc.edu.pk

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ABSTRACT

Purpose: This study aims at determining the role of financial flexibility and corporate governance on firm performance.

Design/Methodology/Approach: This Research uses the sample of 5783 manufacturing firms form three developed nations (UK, USA and Germany) and three developing nations (India, Pakistan, Bangladesh) over the period of 2000 to 2021. System GMM Panel Data technique has been applied for data analysis. Cash holding and debt holding are used as measure of financial flexibility. Board size and board independence are used as corporate governance indicators.

Findings: Results indicate that financial flexibility and board size and board independence positively influences performance of firms. Larger and more independent boards were related with more cautious decision-making on investment and financing choices. While, financial flexibility acts as a buffer during economic uncertainties and allows firms to seize growth opportunities, which enhances firm performance.

Implications/Originality/Value: This study suggests that firms should adopt a systematic approach to manage appropriate cash reserves. This comprises keeping sufficient liquidity to mitigate risks without limiting investment opportunities. The number of integrated research that systematically examine the ways in which these variables interact and affect ROA together employing panel GMM in context on both developing and developed nations is, nevertheless, quite low.

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***Corresponding Author's email address:** mam@aumc.edu.pk

1. Introduction

1.1 Background of the study

Firm value, a critical indicator of a company's performance and prospects, serves as a benchmark for investment decisions of the investors and determines the success of a company (Gultom et al., 2024; Cynthia & Susanti, 2024; Dewi & Wirawati, 2024). It is influenced by many factors, including financial flexibility, corporate governance, financial constraints, depreciation, firm size, and tangibility. Understanding the elements that influence a

company's performance is crucial for stakeholders such as managers, investors, and policymakers in the modern business environment.

Financial flexibility is described as the ability of a company to access and utilize financial resources at minimum cost (Gamba & Triantis, 2008). Businesses have access to a variety of different funding options, such as internal resources or from outside sources in the form of debt or equity. Debt is provided by creditors who seek interest on it, while equity capital is provided by shareholders who seek return in the form of dividend and capital gain. Different financial policies and financial instruments are used to acquire funds from different markets in the different time periods in order to mitigate the survival risks, to deal with crises or to maximize the firm value. Firms need financial flexibility because it enables improved investment capacity and reduces dependency on internal finances, particularly during economic downturns (Arslan-Ayaydin et al., 2013). Businesses that maintain substantial capital reserves and prudent leverage guidelines tend to be more robust and able to maintain performance in times of crisis. According to Wu et al. (2024), financial flexibility enhances firm performance by reducing the overinvestment and inefficiencies. Fahlenbarch, Stulz and Rageth (2021) reported that firm that maintain financial flexibly were able mange the revenue shortfalls due pandemics. These businesses were more resilient and less likely to experience financial difficulties than less flexible businesses. The study highlights the need of maintaining financial flexibility to withstand unanticipated economic downturns.

Firm performance is significantly influenced by corporate governance, particularly in times of economic crisis. By lowering agency costs and increasing operational effectiveness, good governance can raise company valuations (Zaharia & Zaharia, 2012; Faoziyanti & Renny, 2024; Ratnawati & Hidayat, 2024). Corporate governance research shows that context-specific factors play a significant role in assessing how governance affects firm performance (Bhagat & Black, 1998; Garg, 2007). The company's performance is influenced by depreciation strategies related to assets, currency, and R&D costs. Organizations exhibit varying approaches to the depreciation of their R&D investments, with technologically advanced enterprises facing longer-term impacts (Kafouros & Wang, 2008). Another group of traits that have different effects on performance are tangibility and firm size. Tosi et al. (2000) state that there is evidence that larger companies have better performance metrics. Other scholars, however, propose that the impact of business size and asset tangibility on performance may differ according on the environment and industry (Setiaputra & Viriany, 2021; Olawale et al., 2017).

The combined effects of financial flexibility, governance, and business characteristics are still not well understood, despite a wealth of study on the separate components influencing firm performance. This study provides vital information to industry stakeholders and policymakers by highlighting the critical role that financial flexibility and governance play in affecting company performance. These findings help the policymakers to develop frameworks that encourage transparency, accountability, and easy access to financial resources, fostering an environment that is conducive to company growth. The findings will improve our comprehension of how companies might optimize performance metrics in various economic conditions, so increasing their ability to compete and endure in global markets.

2. Literature Review

Research shows that maintaining financial flexibility improves a business's profitability, particularly during recessions. Financially flexible organizations have greater investment capacity, reduced reliance on internal funds, and enhanced performance during times of crisis (Arslan-Ayaydin et al., 2013; Arslan-Ayaydin et al., 2012). The primary means of achieving financial flexibility are large cash holdings and prudent leverage policies (Arslan-Ayaydin et al., 2013). According to Wu et al. (2024), the relationship between financial flexibility and corporate performance is modified by investment efficiency and investment scale, with investment efficiency having a larger impact. Furthermore, the value of financial flexibility varies among countries and regions due to differences in

macroeconomic policies as well as the economic and legal environments (Arslan-Ayaydin et al., 2013; Al-Slehat, 2019).

In the context of corporate governance, board independence is also crucial for improving the performance of the company. According to Fama and Jensen (1983), Independent directors are expected to bring objectivity to decision-making, lower agency costs, and guarantee that management acts in the best interests of shareholders. By lowering conflicts of interest and enhancing accountability, they can boost overall company performance (Klein, 2002). The impact of board size on corporate performance has been the subject of many studies, with differing degrees of impact across various markets. Guest (2009) conducted research in the UK and discovered a significant inverse association between board size and a number of performance indicators, such as ROA, and share returns. Larger boards' deficient decision-making and communication were answerable for this negative effect. In contrast, Kalsie and Shrivastav (2016) used both market-based and accounting-based measures in their analysis of NSE businesses in India and showed a positive and significant influence of board size on firm performance. Mixed findings have come from research on the effect of board independence on company performance. Bhagat and Black (1998, 1997) even proposed that supermajority-independent boards can be less lucrative and did not find any compelling evidence that increased board independence correlates with better business profitability or growth. They suggested that it could be advantageous to have a moderate number of inside directors. According to Garg's (2007) research, smaller boards are more effective, and there is an inverse association between board size and business success. The study also discovered that, maybe as a result of inadequate training, independent directors had not successfully raised firm performance. In contrast, Singhchawla et al. (2011) found that in Australian businesses, an independent main board led to better outcomes; however, this benefit did not carry over to subcommittees. The complex correlation between board size and business performance—which can be impacted by a number of variables, including institutional contexts, firm characteristics, and industry-specific conditions—is shown by these contradictory findings. These studies look at depreciation's effect on business performance from various perspectives. Major currency depreciations, according to Forbes (2002), increase market capitalization growth but decrease net income growth; companies with greater exposure to foreign sales fare better. Real exchange rate depreciations increase sales, investment, and profits, especially for enterprises with larger labor shares that are financially strapped, as demonstrated by Dao et al. (2017). A. R. (2023) investigates the effects of various depreciation techniques on the profitability and financial performance of businesses.

Research on the relationship between firm size and tangibility and performance has yielded conflicting results. According to Tosi et al. (2000), firm performance explains less than 5% of the variation in CEO pay, whereas firm size accounts for over 40%. On the other hand, Setiaputra and Viriany (2021) found that, in Indonesian manufacturing enterprises, firm size and tangibility had a negligible negative impact on firm performance. Little evidence was presented by Boyd and Runkle (1993) to support theoretical hypotheses about the size and performance of banking firms. Olawale et al. (2017) found that among Nigerian non-financial enterprises, firm size as defined by total assets had a negative influence on performance, whereas size as evaluated by total sales had a favorable impact. According to the studies, there may be variations in the relationship between tangibility, performance, and firm size depending on the industry and context. To completely comprehend these connections and the results they have for management and company strategy, more research is required. A number of important variables affecting business performance across studies are covered in the research study.

Researchers have found that developing economies have high volatile capital flows and are most effected during the financial crises (Joyce and Nabar, 2009; Demir, 2009) and it has been found that financial flexibility firms are more capable of absorbing the financial distress situations. Financial flexibility is the developing field of corporate financial in developed while, in developing economies it is at the infant stage (Mahmood, Rashid, Rizwan and Ahmad, 2019).

In the light of above discussion, it is important to investigate the nexus among financial flexibility, corporate governance and firm performance in the context of developed and developing nations.

3. Methodology

3.1 Data

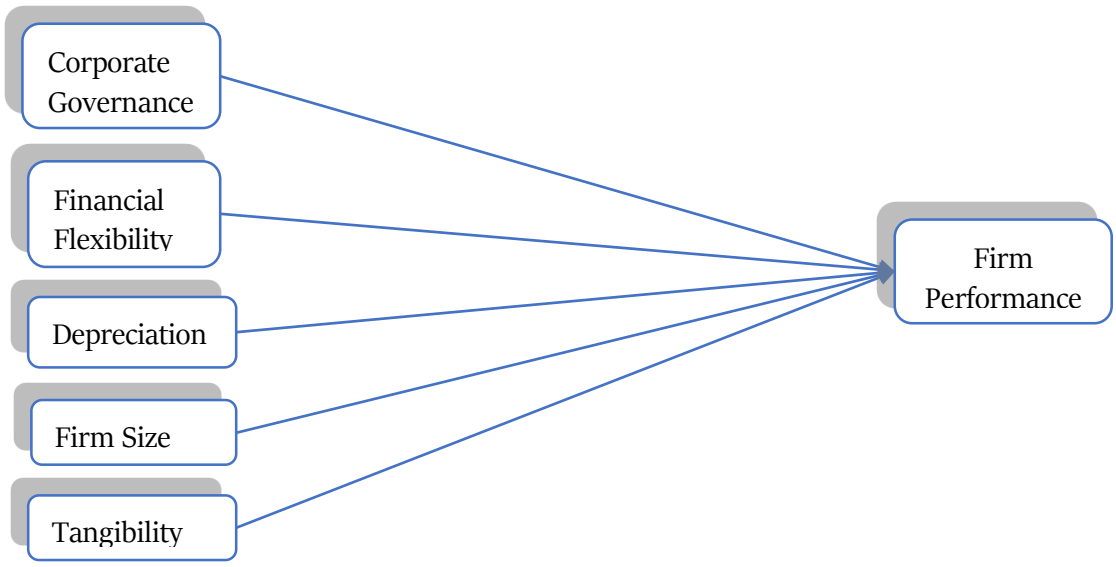
Research uses the sample of 5783 manufacturing firms form three developed nations (UK, USA and Germany) and three developing nations (India, Pakistan, Bangladesh) over the period of 2000 to 2021 of 5783 manufacturing firms and the data gathered from DataStream. The comparison of these states offers a more complete picture. As used data set with a time, country and firm dimensions for that three-dimensional panel data set is used in this study. The study used System Generalized Method of Moments (System GMM) technique capability to handle endogeneity and unobserved heterogeneity, two significant econometric issues, makes it especially appropriate for our investigation. These problems frequently come up in panel data studies like this one, which examine how governance, financial flexibility, and company performance interact across several firms and time periods.

3.2 Theoretical model

The study's theoretical framework shown in Figure 1, is based on a number of management and financial theories that describe how corporate governance, financial flexibility, depreciation, firm size, and tangibility relate to the performance of a company. According to agency theory (Jensen & Meckling, 1976), good corporate governance practices reduce disputes between managers and shareholders, which improves financial judgment and boosts business performance. According to the resource-based view (RBV) (Barney, 1991), businesses with more financial flexibility are able to utilize resources more effectively, guaranteeing a long-term competitive edge. Furthermore, the trade-off hypothesis (Modigliani & Miller, 1958) emphasizes how business size and depreciation impact capital structure choices, which in turn impact firm performance.

Figure 1

Theoretical Framework



Source: Author

3.2 Empirical model

Based on above research model, I propose the following empirical equations. The purpose of this analysis is to find out whether financial flexibility, board size, board independence, log of depreciation, firm size, and tangibility on accounting performance (ROA).

$ROA_{it} = \alpha + \beta 1BS_{it} + \beta 2BI_{it} + \beta 3LogDEP_{it} + \beta 4FF_{it} + \beta 5FS_{it} + \beta 6TAN_{it} + \mu_{it}$ ..... (1)

While, BS is the board size, BI is the board independence, logDEP is the log of depreciation, FF is the financial flexibility, ROA is the Return on Assets, FS is the firm size, and TAN is the tangibility. μit is the error term. i represents the cross section and t represents the time series.

3.3 Definition of Variables

Operational definition of the independent, dependent and control variables are given in table 3.3.

Table 1

Description of variables under study

Variable Name	Variable Definition	Source of Data
Dependent Variable		
Return on Assets	Net Income /Total Assets	DataStream world scope
Independent Variable		
Board Independence	Proportion of outside to total directors	(Rashid, 2018)
Board Size	Natural log of total number of directors on board	(Rashid, 2018)
Financial Flexibility	FF= Financial flexibility = Cash flexibility + Liability flexibility	(Arslan-Ayaydin, Florackis and Ozkan 2014)
Depreciation	Cost of a depreciable asset to the accounting periods covered during its expected useful life to a business.	DataStream world scope
Firm Size	Natural log of firm total assets	(Boermans, and Roelfsema, 2016)
Tangibility	Property, plant, and equipment to book value of total assets	DataStream world scope

Source: Author

3.3.1 Measure of Financial Flexibility.

Company leverage and cash holdings are proxies of financial flexibility (Arslan-Ayaydin, Florackis and Ozkan, 2014). Companies with extreme cash holdings and low leverage are more elastic because they can increase external funds more easily. Companies with high leverage and a small cash status, on the other hand, are less flexible. According to Ma and Jin (2016), financial flexibility is measured by taking into account a firm's leverage, liquidity, and internal funds.

The methodologies of Arslan-Ayaydin, Florackis, and Ozkan (2014), Meier, Bozec, and Laurin (2013), and Al-Slehat (2019) are used in this study in order to evaluate the financial flexibility of businesses using two indicators: debt flexibility and cash flexibility.

4. Results and discussion

Table 4.1's descriptive statistics provide important information about the distribution and properties of the variables being studied in the dataset. First, the mean value for board independence analysis points to a preponderance of observations that are close to 1, suggesting a high degree of board independence throughout the dataset. This suggests that the majority of the sample's companies have boards that are highly independent of management, which could indicate sound corporate governance procedures.

Moving to board size has a comparatively high standard deviation of 3.347 and a mean value of 10.276. However, the presence of outliers, as evidenced by the maximum value of 138, suggests the existence of firms with notably large boards.

The variable log of depreciation, representing the logarithm of depreciation, displays a right-skewed distribution, with a mean of 13.892 and a maximum value of 21.128. This indicates a wide disparity in depreciation expenses among the firms surveyed.

Regarding financial flexibility, the mean value of 0.823, coupled with a standard deviation of 0.274, denotes moderate variance across companies in this metric. Notably, the minimum value of -2.606 suggests the existence of firms grappling with financial constraints or liquidity challenges.
Lastly, firm size exhibits a mean of 2.741, indicating that, on average, firms in the dataset possess assets of moderate magnitude. However, the broad range, spanning from 2.132 to 3.088, underscores significant diversity in asset sizes among the sampled companies.

Tangible assets exhibit a mean of 0.254, indicating that, on average, a relatively small proportion of firms' assets are tangible. The maximum value of 10.145 suggests the presence of outliers or errors in the data.

Lastly, the mean of Return on Assets is 0.053, which suggests that the sample's average return on assets is moderate. The presence of enterprises experiencing losses during the time under examination is shown by the negative minimum value of -1.612.

The distribution, central tendency, and variability of the major variables in the dataset are all well-explained by these descriptive statistics, which are crucial for comprehending the traits of the companies as well as the dynamics of their financial performance and market valuation

Table 2
Descriptive statistics of all variables

Variable	Observations	Mean	Std. Dev.	Maximum	Minimum
Board Independence	5783	0.7611	0.426	1.000	0.000
Board Size	5783	10.276	3.347	138.000	1.000
Log of Depreciation	5783	13.892	1.920	21.128	4.584
Financial Flexibility	5783	0.823	0.274	2.607	-2.606
Firm Size	5783	2.741	0.116	3.088	2.132
Tangibility	5783	0.254	0.387	10.145	0.000
Return on Assets	5783	0.053	0.141	3.924	-1.612

Source: Author

Relationships between the variables examined in the dataset are explained in great detail by the correlation matrix in Table 4.2. At first, there appear to be only minor linear correlations between board independence and the other variables, according to the correlation coefficients. With the exception of moderately positive correlations with log of depreciation (0.407) and firm size (0.349), board size also shows weak correlations with other variables, indicating that larger boards may be associated with higher depreciation costs and larger asset sizes.

Strong positive association between log of depreciation and firm size (0.840) suggests that companies with bigger asset sizes typically have higher depreciation charges. Furthermore, a somewhat negative connection (-0.385) has been found between log of depreciation and tangibility, indicating that businesses with a larger percentage of intangible assets can have lower depreciation costs.
Weak correlations between financial flexibility and other factors suggest that there aren't many linear relationships in the matrix. It does, however, a slight negative correlation (-0.089) with tangibility, suggesting that this variable may be related to financial flexibility.

The firm size has a moderately positive correlation (0.112) with tangibility and a significant positive correlation (0.112) with log of depreciation. In conclusion, the correlation matrix offers information about the connections between important variables, suggesting possible correlations and directions for additional research or investigation.

Table 3

Pearson Pairwise Correlation Matrix

Variable Name	BI	BS	LOGDEP	FF	FS	TAN	ROA
BI	1.000						
BS	0.033	1.000					
LOGDEP	-0.002	0.407	1.000				
FF	-0.011	-0.137	-0.215	1.000			
FS	-0.015	0.348	0.840	-0.140	1.000		
TAN	-0.110	0.112	0.176	-0.385	-0.089	1.000	
ROA	-0.013	0.050	-0.036	0.024	-0.103	0.312	1.00

Where ROA is Accounting Performance, BI is Board Independence, BS is Board Size, FF is Financial Flexibility, LogDep is Log of Depreciation, FS is the Firm Size, Tan is the Tangibility

Source: Author

The results of the panel unit root test, which is intended to ascertain if variables are stationary over time, are presented in Table 4.3. The test results' significance is shown by the t-statistic and related probability values. A high probability value denotes non-stationarity, whereas a low probability value, usually less than 0.05, suggests stationarity.

All of the variables in this case show exceptionally low probability values of 0.0000, indicating their stationarity at the level. These variables include BI, BS, DEP, FF, FS, TAN, and ROA.

Stationarity guarantees that statistical characteristics stay constant across time, it is an essential prerequisite in time-series analysis. The findings suggest that the variables under investigation exhibit recurrent, long-term patterns, strengthening the validity of additional investigations and conclusions drawn from the information. However, it is important to keep in mind, though, that even if these variables might show stationarity at the level, more research might be necessary to examine their time-dependent fluctuations and any dynamic interrelationships.

Table 1

Panel unit root test: Summary

Variable Name	Prob.**	Status
Board Independence	0.0000	Stationary at a level I(0.000)
Board Size	0.0000	Stationary at a level I(0.000)
Depreciation	0.0000	Stationary at a level I(0.000)
Financial Flexibility	0.0000	Stationary at a level I(0.000)
Firm Size	0.0000	Stationary at a level I(0.000)
Tangibility	0.0000	Stationary at a level I(0.000)
Return on Assets	0.0000	Stationary at a level I(0.000)

Source: Author

4.1 Determinants of ROA using GMM

Table 4.1.1 displays the findings of a Generalized Method of Moments (GMM) analysis of the variables impacting Return on Assets, a metric used to evaluate accounting performance, in emerging, developed, and combined

economies. The variables being examined are firm size, log of depreciation, financial flexibility, board independence, board size, and tangibility. The findings show notable differences between economic contexts and offer insightful data on the ways in which corporate governance and financial factors affect company performance.

Board independence has a strong positive relationship with Return on Assets in developed economies (0.1384) and the combined sample (0.1534), but not in developing economies (p-value = 0.1893). This suggests that independent boards may be more effective in improving firm performance in developed nations with more robust and transparent corporate governance arrangements (Dahya, Dimitrov, & McConnell, 2008). The lack of significance in developing nations could be a result of either a different dynamic where board independence has less bearing on company success or of weaker governance structures. The board size coefficient is marginally significant in the combined sample (0.0040, p-value = 0.0560), although it is not statistically significant in either the developed or developing countries. This weak link may suggest that board size has minimal bearing on business success in a variety of economic situations, which is in line with conflicting research findings. Some studies suggests that there is little impact on corporate performance, while others demonstrate that larger boards lead to less effective decision-making because of coordination problems (Yermack, 1996).

Financial flexibility has a negative but slightly significant impact in developing economies (-0.0005, p-value of 0.0520). While, it has a significant positive impact on Return on Assets in developed economies (0.4385) and the combined sample (0.5015). In developed markets, where companies can use flexible financial resources to boost performance, this finding highlights the significance of financial flexibility. However, the somewhat adverse impact in developing nations may be linked to restrictions on the financial sector or inefficiencies that prevent the efficient application of financial flexibility (Gamba & Triantis, 2008).

The Log of Depreciation is negatively and significantly associated to Return on Assets in all economies, with the greatest influence in developed economies (-0.0941) and the combined sample (-0.0724). This negative association suggests that higher depreciation charges lead to lower accounting performance, reflecting the impact of capital aging and asset write-downs on business profitability (Chen & Zhang, 2003). The persistent negative effect across economic circumstances emphasizes the significance of managing capital expenditures and asset usage.

Firm size has a negative and significant association with Return on Assets in developing economies (-0.0005) and the combined sample (-0.0059), but is positively associated in developed economies (0.0517). This contrasted impact implies that larger enterprises in developed economies may benefit from economies of scale and increased market power, hence improving their performance (Hall & Weiss, 1967). In contrast, in developing economies, larger enterprises may confront inefficiencies or hurdles that impede their success, such as bureaucratic overheads or market limits.

Tangibility correlates favorably and significantly with Return on Assets in developing economies (0.0034), developed economies (0.5191), and the combined sample (0.0553). The stronger effect in developed economies shows that tangible assets, such as property, plant, and equipment, have a greater impact on business performance in these markets, presumably due to improved utilization and asset quality. The beneficial effect in developing economies, while modest, shows that tangible assets continue to play an important role in company success by supporting productive capacity and providing collateral for funding.

Table 5

Determinants of ROA using GMM

Dependent Variables	**Return on Assets (ROA)**

	Developing	Developed	Combined
ROA(-1)	0.2075	0.088133	0.093067
	(0.0000)***	(0.0000)***	(0.0000)***
Board Independence	0.0003	0.138417	0.153431
	(0.1893)	(0.0000)***	(0.0000)***
Board Size	0.0000	-0.000637	0.004045
	(0.6153)	(0.7673)	(0.0560)**
Financial Flexibility	-0.0005	0.438454	0.501494
	(0.0520)**	(0.0000)***	(0.0000)***
Log of Depreciation	-0.0005	-0.09405	-0.07239
	(0.0001)	(0.0000)***	(0.0000)***
Firm Size	-0.0005	0.051749	-0.005945
	(0.0051) ***	(0.0000)***	(0.5353)
Tangibility	0.0034	0.519113	0.055338
	(0.0000)***	(0.0000)***	(0.0001)***

*p-values in parentheses: * * *P < 0.01, * * P < 0.05, *P < 0.1*

Source: Author

5. Conclusion and Policy Implications

This study shows that companies with higher financial flexibility have better performance. This is consistent with earlier studies that propose financial flexibility helps businesses minimize financial suffering while taking advantage of investment possibilities (Gamba & Triantis, 2008; Denis & Sibilkov, 2010). A comprehensive 20-year examination using data from both developed and developing economies found that having adequate cash reserves and a limited amount of debt are essential for both market success and accountingThese findings endorse the value of financial flexibility as a protective method that businesses can employ to increase productivity and cut costs, especially during unpredictable economic times. In a similar vein, return on assets and board independence are strongly positively correlated. These findings are consistent with earlier studies that found independent boards improve oversight, which reduces managerial opportunism and raises business value (Fama & Jensen, 1983; Klein, 2002). Similar to this, a larger board improves strategic decision-making and offers a wider spectrum of experience, both of which have a favorable effect on firm performance (Dalton et al., 1999). The link is nonlinear, though, because too big boards might result in ineffective cooperation (Jensen, 1993). This study validates the argument that companies need an ideal board structure in order to attain higher performance and financial flexibility.

5.1 Policy Implications

The study's findings have broad policy implications for investors, politicians, and corporate executives. The importance of financial flexibility for organizational management cannot be overstated. Businesses should aim to optimize their capital structure by finding a balance between debt and cash holdings to ensure their capacity to seize growth opportunities and withstand economic downturns. However, investors may sway their decisions by considering financial flexibility as a crucial indicator of a company's stability and future growth prospects. Furthermore, policymakers should offer tax breaks to companies that keep the best liquidity reserves, just like developed market regulations that promote cautious cash holdings (Bates, Kahle, & Stulz, 2009).

In order to improve access to capital markets and the financial flexibility that businesses of all sizes need for stability and long-term growth, the study offers policymakers regulatory framework proposals that should be put into effect. With the support of regulations that promote sound lending markets and transparent financial reporting, businesses may be able to maintain the greatest level of financial flexibility. During economic downturns, targeted interventions that support businesses with significant development potential may also be particularly beneficial

since they ensure that these businesses have the financial resources to expand and make investments. This encourages the economy as a whole to grow and recover.

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Muhammad Jahangir Ilyas is a student at Department of Business Administration, Islamabad, Pakistan. He got a MS degree in Management Sciences from Air University Multan Campus, Pakistan. ORCID: 0000-0002-1507-3961

Dr. Muhammad Abbas is a Professor at Department of Business Administration, Air University Multan Campus, Punjab, Pakistan.