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EXPLORING THE FIRM LEVEL TRANSPARENCY AND ITS IMPACT ON FIRM VALUE

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ABSTRACT

Increased transparency encourages management to perform efficiently which leads to increase profitability of Firm. Firms in Pakistan are exposed to political risk but they are adopting strategies for the risk management and performing well. The objective of this study is to examine the relationship between firm level transparency and firm value of non-financial firms in Pakistan. Sixty registered firms in KSE 100 Index of Pakistan were considered for analysis for the period 2014-2018. The researchers had developed an index for measuring the firm's transparency (disclosure). Regression analysis technique was used to find important relationships between the variables. The results showed higher firm level transparency leads to accelerate firm financial value. The results provide singifcnat information about the issues under study. On the other hand higher level of transparency on firm level decreases firm value in Pakistani market. While inverse relationship was thus found amid political risk, transparency and firm financial value. This study had unveiled fact that mostly Pakistani firms are undervalued, riskier and slow growing which disclose more to combat with negative assessments in market from participants.

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INTRODUCTION

After the collapse of many firms in developed countries the role of corporate governance (CG) practices were felt crucial for the investors and policy makers all over the globe. One of the CG practices, corporate governance reporting is very much important in insuring transparency in financial market. CG reporting is not confined to only financial disclosure but it also includes other vital information about firm's day to day matters (Aman, Beekes & Brown, 2021). Annual reports now-a-days provides financial and non-financial (board meetings, risk management, pattern of shareholding, management, governance) informatin. After these accounting scandals

Sarbanes-Oxley act was issued in 2002 to regulate the firms and financial market. Majority of businesses in Pakistan are family oriented, their main purpose is to earn only the profit. In this connection, it results in great challenge for policy makers in protecting dual objectives, minority shareholder protection and sustaining incentive for the maximizing profit of family-oriented business (Ali, Ansari & Memon, 2020). Thus, the stock Exchange Commission of Pakistan has presented the code for corporate governance in 2002 and made it obligatory for the companies to adopt it. Later on corporate governance code was revised in 2012 (Azeem, Kouser & Saba, 2015).

Transparency is a vital component of corporate governance along with accountability as it is a source of providing information regarding all financial and non-financial matters. The effective transparency mechanism of the firm leads toward growth and profitability (Nuskiya, Ekanayake, Beddewela & Meftah, 2021). Market regulators and academics both have realized importance of reliable and timely information (Devi, Ko & Subramaniam, 2019). Now transparency is not only limited to disclosing details regarding policies and corporate governance practices, instead it is more proactive and comprehensive disclosure. According to the new concept towards the transparency, the responsibility of the corporations is not only to tell the fact to public but it imposes the firm to inform every stakeholder. Collapse of Enron, World Com was the result of poor disclosure of the financial statements (Fung, 2014). Thus, information asymmetry with managerial incentives can hinder implementation of corporate governance effectively (Jensen, 1979). The prime concern in this study it to construct a firm's transparency index first and then find the impact of transparency both at firm and country level on enterprise value. The rest of the article describes the brief literature review on the topic, data and methodology with the explanation of variables under study, detail results and discussion and finally, the conclusion section.

LITERATURE REVIEW

According to Jensen (1979), agency relationship is an agreement amid principal and an agent in which the principal authorizes the agent to make decisions for him/her. But the problem is each party wish to work for sake of its own interest, their interests diverge and create problem which is called agency problem. The corporate governance protects shareholder interest, reduce agency problem, and resolve the clashes between shareholders and stakeholders who are not investors (Jo & Harjoto, 2011). Many evidences proved that application of corporate governance is associated with the firm performance (Black et al., 2006; Durnev and Kim, 2005). There is difference of the governance level between emerging and developed markets (Durnev & Fauver, 2008; Bebchuk & Hamdani, 2008). According to agency theory, difficulties in to be transparent is due to the asymmetric information between stakeholders and managers. The agency theory is founded on separation interest of manager and owner thus creating relationship amid an agent and a principal. One of reason of conflicts amid principal and agent take place due to different attitudes for maximizing profit (Ali et al., 2020; Nuskiya et al., 2021). Thus, managers are in search of long run benefit but shareholder wants to maximize their profit in the short time. This results in agency problem, it may be mitigated/minimized by higher level of disclosure (Sharma, 2013).

Majority of businesses in Pakistan are family oriented, their main drive is to earn only profit. It results in great challenge for policy makers in protecting dual objectives, minority shareholder protection and sustaining incentive for maximizing profit of the family-oriented business. To solve these issues institute of chartered accountant Pakistan and securities exchange commission of Pakistan presented first code of the corporate governance in 2002 (Zaman et al., 2014). The average level of Corporate Governance Index (CGI) has been improved i.e. from 51% to 89% in Pakistan i.e. 38% increase in CGI. PSX listed the firms have high level of block holdings, firms having large block holdings have low level of cost of capital. Cost of capital and disclosure are inversely correlated with each other (Arslan & Abidin 2019). Very few studies focused upon impact of both firm and country level transparency on the firm value. Enikolopov et al. (2014) studied association of enterprise value and transparency in crisis of 2007-2009 and dependence of this relationship on the quality of institutions. Other studies tried to study the relationship of transparency & corruption (Devi, 2019). Audit committee, board size, annual general meetings & independent board directors are positively implied with enterprise performance (Khudhair et al., 2019).

Annual published reports are lacking transparency and disclosure as they are the only cheap source for the investors to get information. Speculations in the market, weak implementation of the law and organizational structure affect corporate governance (Ali et al., 2011). There is scarce literature which explored impact of both levels of transparency (firm and country level) on enterprise value in emerging countries particularly in Pakistan. According to our knowledge very few or the almost no previous studies has paid attention to see the combined impact of the transparency (firm and country level) on the firm value. Mostly, the previous research done in Pakistan was confined only to one sector and firm level (Zaman et al., 2014: Banking sector; Ali et al., 2020: Automobile sector; Ullah et al., 2017: Cement sector; Azhar & Mehmood, 2018: Textile sector). Agency theory is founded on the separation interest of manager and owner thus creating relationship amid an agent and a principal. This study is valuable as it includes all the sectors of KSE 100 Index and throws light on the previous studies by analyzing the impact of transparency (country & firm level) on enterprise value. Also, we have used the self-constructed firm level transparency index by considering the codes for desired corporate governance 2012, Pakistan.

DATA AND METHODOLOGY

Sample included non-financial firms registered in KSE 100 Index for time period 2014-2018. The selection of sample was based upon one criterion i.e. merely those non-financial firms were considered whose annual reports were available from 2014-2018. All the data regarding firm level transparency and financial variables was collected manually from published annual reports of the firms. While data regarding country level transparency was collected from website of World Bank (WGI), International Country Risk Guide (ICRG) and transparency international. The transparency on the firm level is measured by making self-constructed index by following corporate governance codes for year 2012. To measure transparency on country level used rule of law, control of corruption and corruption insight index as independent variables along with transparency.

Operationalization of Variables

The variable rule of law introduced by Kaufmann et al., (2008), which is used for measuring the degree of confidence of agents and following rules of the society i.e. property rights, courts, the police and probability of violence and crime. It varies from -2.5 to +2.5. -2.5 indicates the lower of rule of law, +2.5 indicates higher rule of law. Higher value of government effectiveness is considered to be good and vice-versa (Enikolopov et al., 2014). The law and order are two components where law measures impartiality and strength of legal system and order measures execution ion of law. In emerging markets effective enforcement and origin of laws are linked with reforms and diverse level of the corporate governance instead of financial system, market-based or bank-centered (Porta et al., 2000). Countries having weaker legal systems show lower average corporate governance (Klapper & Love, 2004). Javaid and Saboor, (2015), poor law enforcement is obstacle in getting place in stock market. Institutions and CG plays crucial role in raising external financing. Legal and protective laws also plays a crucial role in getting better return.

Corruption is considered to be one of the most significant challenge in making better quality of life of people and economic growth. Corruption could be bribery, fraud, diversion of resources from those who are in more need. It measures the degree of public power which is used for personal gains, that includes both grand (to use the state for own benefits by elites and private individuals) and petty form of corruption. Its value varies between -2.5 to +2.5. Higher value of index states lower corruption and vice versa (Morris & Gray, 2007). For measuring corruption we have used Corruption Perception Index which is presented by Transparency International. The range of its value is 0 to 100, greater value states as reduced corruption and vice versa (Enikolopov et al., 2014). Previous literature suggests analyst ratings and self-constructed index has been used for measuring transparency and disclosure (Bhagat & Bolton, 2008). Also theses indices consider board features and pattern of shareholding. There occurs positive undertone amid market value and corporate governance of a firm, regarding anti-corruption initiatives and better policy disclosure of firm rather than sustainability and financial disclosure (Devi et al., 2019).

The political Risk is composed of twelve weighted variables including social as well as political elements. Political risk focuses on government strength, social and economic conditions of the country, corruption, conflicts (internal and external), law and order situation, and association of armed forces in government, religious pressures, democratic responsibility and bureaucratic quality. Its range is 0-100, where the higher value represents low political risk and lower value represents high risk. According to Porta et al. (2000) political risk measures impact of political decisions (discrimination against overseas firms, tax policies alteration, changes in exchange rate and trade policies) and events on business environment (Kyaw et al., 2011). Impact of risk is higher on investment when there is low level of transparency and vice versa (Barry et al., 2019). Previous literature suggests analyst ratings and self-constructed index has been used for measuring transparency and disclosure (Bhagat & Bolton, 2008). The self-constructed index is constructed by seeing corporate governance codes of country. Many studies are conducted by using self -constructed index (Javid & Iqbal, 2008a; Tariq & Abbas, 2013), while some studies are conducted by taking into consideration analyst rating indices (Clacher et al., 2008; Henry, 2008).

The analyst rating indices are based upon corporate governance rules of developed countries. These corporate governance rules are different in developed and developing countries. Thus, indices are not much appropriate for developing country due to contrasts in socioeconomic factors (Arslan & Roudaki, 2017). Additionally theses indices consider board characteristics and pattern of shareholding (Chung & Zhang, 2011), while self-constructed index is comprised of all the corporate governance features recommended by a country corporate governance standards and literature. Firm level index is made by following dichotomous scoring approach i.e. if an attribute exists in a firm's annual report then 1 is assigned and if some attribute is not found in the annual report of a firm 0 is assigned for that. By taking the average ($\Sigma x/n$) of all scores we will get transparency index where Σx = summation of all attributes existing in a firm and n = total number of attributes (Zaman et al., 2014; Othman & Zeghal, 2010; Morris & Gray, 2007).

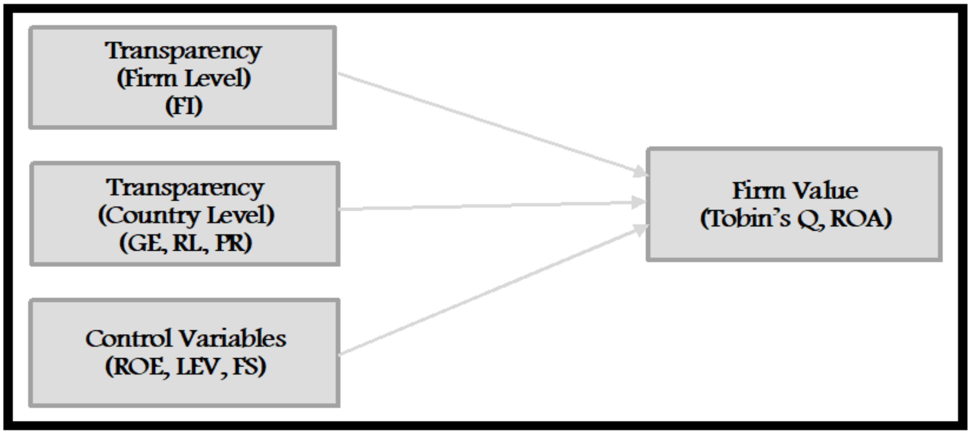
Data for Study

Data regarding all 76 items was extracted manually or directly from 300 annual reports for 5 years. The transparency index of this study has seven components, Composition of Board (12 provisions), Board Meetings (3 provisions), Committees of Board (11 provisions), Corporate & financial reporting framework (25 provisions), Pattern of Shareholding (8), Management (12 provisions), Related party information (5 provisions) which is composed of total 76 provisions. To avoid endogeneity problem, thus, the study used leverage, firm size & profitability as control variables.

Research Framework & Model

Dependent variable used for research is firm value. These formulae are divided in two categories i.e. market based and accounting based. ROA is accounting based measures, while Tobin's Q is a market based measure.

Figure 1 Research Framework



Return on assets (ROA) is profitability ratio which measures net income earned from investing total assets. It tells us about efficiency of the firm in using its assets for producing net profit. Transparency performs a vital role in enhancing return on assets of firm. Zaman et al. (2014) conducted a study by taking into the consideration banking sector of Pakistan and concluded transparency is positively related with ROA i.e. transparent firm will perform well. In Pakistan level of disclosure is at higher level in the banking sector. Tobin's Q is used for measuring firm value which is measured by division of market value of firm by the book value of its total assets. It measures the market based performance of the organization, higher value of this ratio shows higher firm performance. This study has used Tobin's Q for measuring firm value in the market that is similar to research studies like (Devi et al., 2019; Javaid & Saboor 2015; Gharaibeh & Qader 2017). The value of firm (dependent variable), is proxied by Tobin's Q since it takes into consideration risk (Lindenberg & Ross, 1981). Model is used in study to find relationship of enterprise value and transparency. Where, value of firm 'i' at time 't' is measured with ROA and Tobin's Q.

$$Firm\ Value_{i,t} = \alpha_1 + \beta_j Transparency_{i,t} + \gamma_j Control_{i,t} + \delta_{i,t}$$

RESULTS & DISCUSSION

The average value of Tobin's Q, ROA and ROE are 2.02, 0.10 and 0.22 respectively. These values representing that Pakistani firms are able to generate profit from shareholders investments. It is a significant ratio for potential investors because they analyze how efficiently a company will be able to generate profit from their investment. Average value of firm transparency index (FI) i.e. 0.82 demonstrations that most of Pakistani companies are transparent in disclosing their information with very minor variation in it. In this connection, the degree of association among the variables is given in the table 1 below. Firm transparency index (FI) has significant negative relationship with Tobin's Q and ROA while it has positive but insignificant relationship with ROE.

Table 1 Correlation Analysis among the Variables

	TQ	ROA	ROE	LEV	FS	FI	RL	GE	CRP	CRTI
TQ	1									
ROA	0.38*	1								
ROE	0.26*	0.48*	1							
LEV	-0.10***	-0.16*	-0.08	1						
FS	-0.18*	-0.08	0.05	0.20*	1					
FI	-0.26*	-0.14***	-0.09	0.17*	0.48*	1				
RL	0.00	-0.02	0.07	-0.05	0.10	0.13*	1			
GE	-0.02	-0.04	0.07	0.00	0.12**	0.17*	0.41*	1		
CRP	0.01	-0.03	0.03	-0.04	0.06	0.09	0.81*	0.38*	1	
CRTI	-0.03	-0.03	0.09	-0.01	0.14***	0.17*	0.52*	0.86*	0.18*	1
PR	-0.02	-0.02	0.06	0.02	0.07	0.07	-0.18*	0.61*	-0.40*	0.68*

Level of significance is presented by *, **, *** at 1%, 5% and 10% level of significance

The return on equity and Tobin's Q have positive and statistically significant relationship. While relationship of ROA with FI is negative and statistically significant at 5% significance level. The ROA and Tobin's Q have positive and statistically significant relationship. The results of pooled regression analysis of Tobin's Q while taking only corruption at country level are shown in table 2 (model 1). Results show negative and significant connotation between Tobin's Q and FI which indicates that transparency may not be the norm in Pakistan which results in poor performance of the firms. In this connection, the higher level of transparency may lead to difficulty in getting funds and maintaining their staff. It means in Pakistan investors do not rely on annual report of the firms or information provided in annual reports do not fulfil their requirements a firm in Pakistan disclose its information. Thus, it can be due to problem with disclosure framework in Pakistan i.e. unequal access of the investors to disclosed information, some investors receives information earlier than others. While association of TQ and ROE have been thus positive and significant.

The value of R-squared is 0.13 which depicts that explanatory variables explains approximately 13% of variation in the dependent variable. While Adjusted R-squared of our model is 0.119 i.e.

explanatory variables collectively explains approximately 12% of change in dependent variable. The value of Durbin-Watson statistic is 0.2168, which indicates that there does not exists the problem of first order serial correlation. The value of F statistic is 9.05 and its P value is 0.000, which concludes that transparency has significant influence on TQ. The regression analysis of Tobin's Q and WGI is explained in table 2 model 2. Association between Tobin's Q and return on equity is significant and positive. Which implies that if an enterprise is operating better in market i.e. people trust and invest in that firm. The return on assets will also be increases. The connotation amid Tobin's Q and FS is negative and insignificant which is identical to previous researches.

Table 2 Regression Analysis (Dependent Variable: Tobin's Q)

Variable	Model 1	Model 2	Model 3
C	9.6973	11.2168***	-3.8314
FI	-8.6612***	-8.6095***	4.9420*
ROE	2.1790***	2.1595***	0.0881***
LEV	-0.0003	-0.0324	0.00001
FS	-0.2073	-0.1964	-0.051
CORTI	-0.0094	-	-
GE	-	0.0303	-
RL	-	-1.9811	-
CRP	-	4.0706	-
PR	-	-	0.0718***
FI*PR	-	-	-0.0894***
R-squared	0.1337	0.1346	0.6805
Adjusted R-squared	0.1190	0.1137	0.5914
F-statistic	9.0474	6.4638	7.6347
Prob(F-statistic)	0.000	0.000	0.000

GE is the government effectiveness with minimum and maximum value -2.5 and 2.5. RL stands for rule of law having minimum and maximum value -2.5 and 2.5. CRP stands for control of corruption having minimum and maximum value -2.5 2.5. Level of significance is presented by *** at 1%.

Relationship of Tobin's Q and government effectiveness (GE) is positive but insignificant. It implies that if there is no political pressure and government is making and implementing fair policies in country then firms in that country will perform better. Association between Tobin's Q and rule of law (RL) is negative but insignificant. The relationship of Tobin's Q and Control of corruption (CC) is insignificant and positive which states that firms will better perform in the market in case of the low corruption level. The value of R-squared is 0.13 which depicts that explanatory variables explains approximately 13% of variation in dependent variable (Tobin's Q). While Adjusted R-squared of our model is 0.113 i.e. the explanatory variables collectively explains approximately 11% of change in dependent variable (Tobin's Q). Value of F statistic is 6.46 and its P value is 0.000, which concludes that our model is significant. Connotation amid Tobin's Q and ROE is positive and significant which means that those firms perform better in the market which use the efficiently their shareholders investments. Such firms enjoys higher levels of profitability. Thus, the connotation amid Tobin's Q and FI is negative and significant, which means that as the transparency of the enterprises increases, their performance in market fall.

Fixed effect regression of ROA is depicted in table 2 model 3, which shows that there is positive and significant connotation of FI and ROA which in line with previous studies. The association amid ROE and ROA is positive and significant, our results are similar to a research carried out by Khudhair et al. (2019). It implies that the management of Pakistani firms are utilizing their shareholders investments efficiently and getting profit from it, ultimately it will accelerate its ROA. Increased profitability persuade firms to give the dividends to their shareholders. Political risk (PR) and ROA has positive and significant Firms can adapt in different environments and cope with different types of uncertainty. FI and PR have negative and significant influence on firm performance, our results are identical with a research study carried out by Kyaw et al. (2011). This concludes that as political risk and firm level transparency is inverse proportional to financial performance of enterprise. Value of R-squared depicts that explanatory variables explains approximately 68% of variation in the dependent variable (ROA). While the Adjusted R-squared of our model is 0.59 i.e. explanatory variables collectively explains 59% of change in dependent variable (ROA). The value of Durbin-Watson statistic is 1.98, which indicates that there does not exists the problem of the first order serial correlation. The value of F statistic is 7.6347 and its P value is 0.000, which concludes that transparency has significant influence on ROA.

CONCLUSION

The goal of this research is to analyze the association of transparency (firm and country level) with enterprise value. The focal point of this research study is to answer the research questions e.g. Is there any connotation between the country level transparency and enterprise value in Pakistan? Is there any connotation between the firm level transparency and enterprise value in Pakistani firms? Is there any connotation between transparency (firm and country level) and enterprise value in Pakistan? When Tobin's Q is used for measuring enterprise value, results indicates significant but negative association between enterprise value and Tobin's Q. Negative connotation amid Tobin's Q and transparency illustrates that undervalued, riskier and slow growing enterprises disclose more to combat with negative assessments in the market from participants. Reason of negative relationship can be due to anticipated gap between information published in annual reports and the contents presented by Pakistani companies in the annual reports.

Therefore investors in Pakistan rely on speculations. As transparency increased on firm level financial performance of enterprise also increased. It indicates the transparency increases the efficiency of management. Combined impact of political risk and transparency is negative on financial performance of an enterprise. Thus, from the findings of this study we conclude that transparency is considered to be a significant factor in evaluating the firm performance. This research work supports the evidence that show negative association of the market value with transparency. It can be due to problem with disclosure framework in Pakistan i.e. unequal access of the investors to disclosed information, some investors receives information earlier than the others, contents of disclosure in annual reports do not fulfill investor requirements. While firm level transparency increases financial performance of enterprise which contributes positively towards the performance of the firm's management. In this regard, Pakistani firms are facing political risk but they can manage such type of risks by adopting risk management strategies.

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