

PRIMARY RESEARCH

## The Impact of Corporate Governance Index and Earnings Management on Firms' Performance: A Comparative Study on the Islamic Versus Conventional Financial Institutions in Pakistan

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**Abstract.** This study investigates the impact of corporate governance index and earnings management on firms' performance and makes a comparative analysis of the selected Islamic and conventional financial institutions in Pakistan for the period of 2005-2015. Data of 20 KSE listed Islamic financial institutions (i.e., a few Islamic banks and mostly *muḍārabah* companies), and 35 KSE listed conventional financial institutions (i.e., conventional banks, mutual funds, insurance companies, and investment companies) have been used for analysis. The fixed effect model and random effect model have been used for analysis. The study finds that the corporate governance structure of conventional financial institutions is sound as compared to Islamic financial institutions. The study also concluded that the manipulation for earnings management is less in Islamic financial institutions as compared to conventional financial institutions in Pakistan. Therefore, it does not affect firm's performance of Islamic financial institutions whereas the results of conventional financial institutions indicate that the manipulation of earnings management has an impact on their performance. Results of this study suggest that compliance with corporate governance practices is equally significant for both Islamic and conventional financial institutions.

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## INTRODUCTION

A highly publicized collapse of high-profile companies such as Enron, Adelphia, World-Com, Tyco, Global Crossing, and Lehman Brothers has reinforced the need for sound corporate governance practices (Financial Crisis Inquiry Commission, 2011; OECD, 2009; Sarbanes-Oxley Act, 2002; World Bank, 2002). It is believed that poor corporate governance was one of the prime reasons for their failure (Sarbanes-Oxley Act, 2002). In emerging economies, an escalating demand of resources for business has also increased the significance of corporate governance. According to the Financial Crisis Inquiry Commission (2011) financial crises began in 2008 when investment bank Lehman Brothers went into bankruptcy due to poor governance practices.

Studies on corporate governance are not new in the context of Pakistan. Numerous studies have been conducted after the world financial crisis in 2008. Mir and Nishat (2004) and Nishat and Shaheen (2004) explained the association between corporate governance and financial performance of the listed manufacturing firms in Pakistan. Mehar (2005) examined the relationship of corporate governance and dividend policy among the listed manufacturing firms in Pakistan. Javid and Iqbal (2008) also explicated the relationship of corporate governance mechanism and financial performance of the industrial firms in Pakistan.

Ali Shah, Butt, and Hassan (2009) described the impact of corporate governance practices on the cost of equity among Pakistan's manufacturing firms. Afza and Mirza (2011) found a significant association between governance structure and dividend policy of the manufacturing sector of Pakistan. Tariq and Abbas (2013) scrutinized the negative performance of firms due to the absence of sound governance practices. It shows that while sufficient research has been conducted regarding corporate governance practices and earnings management in the manufacturing sector of Pakistan, only a few studies have covered the banking industry of Pakistan. Further, the financial sector of Pakistan as a whole has been ignored by the researchers with regard to the impact of corporate governance practices and earnings management (Rehman & Mangla, 2010).

Haider, Khan, and Iqbal (2015) conducted a similar study to check the relationship between corporate governance practices and financial performance in the Islamic banking segment in Pakistan and found a positive connection in this regard. Burki and Ahmad (2007) conducted a similar study to review the effect of changes in the governance on the performance of banks in Pakistan and discovered that financial distress affects the performance of banks.

The study in hand has compared the Islamic and conventional financial institutions and selected two full-fledged Islamic banks and 18 *muḍārabah* companies as the sample for analysis.<sup>1</sup> Amer and Sajjad (2014) indicated issues relevant to the relationship between "*rabb al-māl*" and "*muḍārib*" and concluded that *muḍārabah* companies were facing some major issues also including agency problems. Further, corporate governance structure has an integrating connection with earnings management to affect firms' performance. Therefore, the current study is taking these variables in combination with examining the integrating

<sup>1</sup>Islamic financial institutions in Pakistan, other than banks, are mostly *muḍārabah* companies; therefore, a major portion of the study is based on them.

impact on firms' performance.

Islamic Financial Institutions (IFIs) operate under the defined Islamic norms and codes (El-Gamal, 2006). Muslim investors and businesses prefer to secure their investments with such institutions that implement Islamic principles (Rehman & Mangla, 2010). IFIs are different from conventional financial institutions in three ways. First, to pay and get interest is prohibited for the IFIs. Second, investors in Islamic finance have to share the profit and losses according to the defined rules (Khan, 2012). Third, *gharar* is also prohibited which means taking the absolute and undue risk leading to speculation and gambling (Merchant, 2012).

## LITERATURE REVIEW

Investment and funding models in the Islamic financial institutions are different from those of the conventional financial institutions. These differences have a significant impact on the governance structure of both the systems (Leventis, Dimitropoulos, & Owusu-Ansah, 2013). Corporate governance had been neglected in the developing countries. Asian financial crises and the globalization of capital market are two major reasons for impending corporate governance reforms in emerging economies (Tsamenyi, Noormansyah, & Uddin, 2008).

Rahman, Moniruzzaman, and Sharif (2013) described that earnings management is a strategy to manipulate the firms' real earnings deliberately. Therefore, the manipulated figures can match with the predetermined targets presented to stakeholders of the firm. Manipulated earnings management is conducted to inflate the volume of earnings. Therefore, Ashbaugh, Collins, and LaFond (2004) concluded that the effective corporate governance features and mechanisms could be used as a tool to reduce agency problems and costs through sound monitoring and surveillance of management's actions and restricting their opportunistic behavior. Quality standards of accounting and relevant information disclosures by the Islamic financial institutions are foremost elements for governance of the IFIs. Hence, corporate governance is becoming the most important element for the success of the IFIs regionally and globally (Akhtar, 2006).

Kun Liew (2008) found that internal politics harmed the corporate governance practices and effective management and effective corporate governance resolved the concentrated ownership structure problems in the Malaysian corporations. Coles, Daniel, and Naveen (2014) find that the extent of independent directors who are selected before the CEO expect that the control has more logical energy to monitoring viability than the regular measure of board independence.

In China, the process of designating independent directors is to, a great extent, affected by the senior management, and these independent directors are concerned about their order in the organization when they act as per their observing and supervisory capacities (Ye & Zhang, 2011). Likewise, controlling shareholders have the final say in the matter of whether an independent director may remain or not. Thus, the independent directors of the Chinese organizations are firmly connected with the CEOs or the controlling shareholders. Thus, they are not independent in such a manner and, in this way, may think that it's hard to adapt to the CEOs when offering counsel on CEO's remuneration and different issues. When they

have been designated, these independent directors have a solid motivating force to keep up a decent association with the senior management (Du Plessis et al., 2012).

Ghaffar (2014) led a review to see the effect of corporate governance practices on the profitability of Islamic banks in Pakistan. The review uncovered that each one of these factors of corporate governance has a critical association with the profitability of the banks. Furthermore, the profitability of Islamic banks in Pakistan tends to increment with the selection of good corporate governance hones.

Safi and Shehzadi (2015) analyzed the effect of earnings management on firm's performance in Pakistan and found that it has a significant positive effect on Return on Assets (ROA). The outcomes proposed that the family-dominated firms pervasive in Pakistan empower the controlling shareholders, checking the supervisors and limiting them from utilizing out of line earnings management practices. A strong corporate governance index does not allow manipulating in the earnings and monitors the financing of the firm which yields an impact on the performance and profitability of the firm.

Researchers on corporate governance and related areas have used many indicators for analyzing the performance of the firms. Following table gives the summary of the indicators used by various researchers:

**TABLE 1**  
**Summary of the indicators used in recent studies' variables**

Indicators	Corporate Governance	
	Sources	
CEO's duality	Bhagat and Bolton (2008); Chapple, Clout, and Tan (2014); Dey, Engel, and liu (2011); OECD (2009); OShannassy and Leenders (2016); Pham, Oh, and Pech (2015); Zhou, Fan, An, and Zhong, (2017)	
Board size	Bhagat and Bolton (2008); Manzaneque, Priego, and Merino (2016); Pham et al. (2015); Zabri, Ahmad, and Wah (2016); Zhou et al. (2017)	
Inside directors	Bhagat and Bolton (2008); Manzaneque et al. (2016); O'Shannassy and Leenders (2016); Pham et al. (2015); Zhou et al. (2017)	
Independent directors	Bhagat and Bolton (2008); Manzaneque et al. (2016); Pham et al. (2015); Zabri et al. (2016); Zhou et al. (2017)	
Non-executive directors	Bhagat and Bolton (2008); Manzaneque et al. (2016); Pham et al. (2015); Zabri et al. (2016); Zhou et al. (2017)	
Audit committee size	Bhagat and Bolton (2008); Gombola, Ho, and Huang (2016); Magnis and Iatridis (2017) Pham et al. (2015)	
	Earnings Management	
Discretionary accruals	An, Li, and Yu (2016); Farooqi, Harris, and Ngo (2014); Gombola et al. (2016); Liu, Shi, Wilson, and Wu (2017); Shayan-Nia, Sinnadurai, Mohd-Sanusi, and Hermawan (2017)	
Non-discretionary accruals	An et al. (2016); Farooqi et al. (2014); Gombola et al. (2016); Liu, et al. (2017); Shayan- Nia et al. (2017)	
	Firms' Performance	
ROA	Bhagat and Bolton (2008); Farooqi et al. (2014); Lin & Fu (2017); Pham et al. (2015); Zhou et al. (2017)	
ROE	Bhagat and Bolton (2008); Farooqi et al. (2014); Pham et al. (2015)	
Tobin's Q	Bhagat and Bolton (2008); Ducassy and Guyot (2017); Farooqi et al. (2014); Lin & Fu, (2017); O'Shannassy and Leenders (2016); Pham et al. (2015)	

**TABLE 1 Contin....**

Control Variables	
Firm size	Agustini (2016); Bhagat and Bolton (2008); Farooqi et al. (2014); Gombola et al. (2016); Heinrich and Dai (2016); Lin and Fu (2017); OShannassy and Leenders (2016); Pham et al. (2015); Zhou et al. (2017)
Total debts	Bhagat and Bolton (2008); Farooqi et al. (2014); Gombola et al. (2016); Pham et al. (2015)

The study by Hassan and Ahmed (2012) which was conducted in the context of Nigeria, examined the impact of corporate governance and earnings management on the financial performance of the manufacturing firms in the country. The study employed the Jones discretionary accrual model to measure earnings management and the ordinary least square regression model to measure the relationship between earnings management and performance. The study indicated a significant relationship between the firm's performance, corporate governance, and earnings management. The study by Eka Putri (2013) on the relationship between earnings management and value relevance in the Indonesian Stock Exchange reported that earnings management has a negative impact on the value relevance and the book value.

Moreover, a study conducted by Llukani (2013) on earnings management and firm size in Albanian Market, reported that firms in the Albanian market engage in earnings management activities and there were no significant differences in this regard between small and large-sized companies. This study used the Jones modified model for discretionary accruals to measure the earnings management level of the firms. The study by Dimitropoulos and Asteriou (2009) on the other hand, examined the relationship between financial ratios calculated out of the financial statement and the share price of the firms listed on the Athens Stock Exchange for the period of ten years. The study also examined the effect of discretionary, non-discretionary accruals, earnings per share, and other six financial ratios as the proxy measure of earnings manipulation in the share price. The results of the study show that share prices were highly affected by the ratios as well as the accrual both discretionary and non-discretionary. Gong, Louis, and Sun (2008) inspected the securing, profit administration, and association's execution in Malaysia.

## METHODOLOGY FOR DATA ANALYSIS

The study considers corporate governance index and earnings management as independent variables and firms performance as a dependent variable. Corporate governance structure consists of various elements, and it is complicated to take those elements separately in research. Hence, researchers have been considering the index of selected elements to study the integrated impact. According to Gompers, Ishii, and Metrick (2003), corporate governance index is an appropriate proxy to analyze governance structure as a whole, rather than to evaluate individual components. Chen, Kao, Tsao, and Wu (2007) and Gompers et al. (2003) developed corporate governance index consisting of four significant elements; i.e., CEOs' duality, board size, individual block holders' holding, and managerial ownership.

Furthermore, authors argued that corporate governance structure must be evaluated during and after the merger and acquisition of firms. For this study, we considered that corporate governance index consisted of seven indicators included CEOs' duality, board size, audit committee size, non-executive directors, independent directors, inside directors, and board of directors meetings.

### Sampling

In total, the financial sector of Pakistan comprises 31 commercial banks (i.e., conventional banks and Islamic banks), 08 mutual funds, 29 *muḍārabah* companies, 32 insurance companies, 28 investment companies, and 10 leasing companies. Typically, Islamic financial institutions in Pakistan are 5 Islamic banks, a large number of conventional banks also offering Islamic banking services, 29 *muḍārabah* companies, and a number of *takāful* companies. As this study is based on data available from Karachi Stock Exchange (KSE), we have selected those institutions on which secondary data for the period of study were available. Listed firms have been considered for two reasons. First, there is a compulsion on the listed firms to publish their audited financial statements. Second, the firms listed on KSE reflect the major market capitalization for each sector. In this study, data from 20 Islamic financial institutions (i.e., 2 Islamic banks and 18 *muḍārabah* companies listed on KSE) and 35 KSE-listed conventional financial institutions (i.e., conventional banks, mutual funds, insurance companies, and investment companies) for the period of 2005-2015 have been taken for analysis.

### Methodology

The study adopts the quantitative set of data for the analysis rather than qualitative or a mix of both. It uses panel data, the combination of the time series, and cross-sectional design for estimation and discussion. In such a design, variable changes its value over time, e.g., weight and age where weight is a random variable but age is a deterministic variable. In addition, weight involves probability. In panel data, the cross-section involves some probability whereas the time series data do not involve any probability. For this purpose, the study has adopted the fixed effect model and the random effect model. In addition, Hausman test is applied to check which model is appropriate.

### Fixed Effect Model

In panel data analysis, fixed effect model is used to estimate the coefficient in the regression model. This model controls the unobserved, constant heterogeneity problem in data. Fixed effect model, Random effect model, and mix methods are used alternatively to estimate the value of coefficients.

$$Y_{it} = \alpha p + X_{it}\beta + \mu_{it} \quad (1)$$

$\mu_{it}$  (homoscedasticity, no autocorrelation means zero), (Distribute endogeneity). Example 1 can be written as:

$$Y_{it} = \sum \alpha_j D_{ij} + X_{it}\beta + \mu_{it} \quad (2)$$

$D_{ij}$  is the dummy for individuals  $i = j$

If all the assumptions of CLRM are fulfilled, we can apply OLS. The OLS estimator can be estimated as from equation:

$$\bar{Y}_p = \hat{\alpha}_i + \bar{X}_i \hat{\beta}$$

$$\hat{\alpha}_i = \bar{Y} - \bar{X} \beta'$$

Substitute  $\alpha_i$  in equation 1;

$$Y_{it} = \bar{Y}_i - \bar{X} \hat{\beta} + X_{it} \hat{\beta} + \mu_{it}$$

$$Y_{it} - \bar{Y}_i + \hat{\beta}(X_{it} - \bar{X}_i) + \mu_{it}$$

$$\hat{\beta}_{FE} = [\sum(Y)_{i=1} \sum(Y)_{t=1}][\sum(X_{it} - \bar{X}_i)(X_{it} - \bar{X}_i)]$$

### Random Effect Model (REM)

A statistical hierarchical linear model, which is also termed as variance component model, is known as the random effects model. Eq. (1) and Eq. (2) are presenting the error component model, it is also known as the random effect model. In Eq. (2), the  $\beta$  is inefficient. What if we impose Eq. (2) on Eq. (1)? It will result in a more generalized form which is efficient than earlier. So  $E_{it}$  and  $E_{du}$  are correlated and generate the problem of inconsistency. In panel data, the estimators are inconsistent and inefficient. Inefficiency is covered through GLS fixed effect model. To remedy the inconsistency, we can estimate the above equation; each parameter is acting as a coefficient. Name of the coefficient is random or  $\beta$ , and it is taken as a derivation. In addition,  $\beta$  shows the mean value of the whole model. The difference lies in the treatment of the  $\alpha_i$ , here  $\alpha_i$  is deterministic, and this equation is now fixed effect model.  $\alpha_i$  is now considered as an independent characteristic intercept i.e., fixed. It can happen as the variable changes over time, and it happens for all the independent variables.

## RESULTS AND DISCUSSION

This section presents the result of the model applied for the analysis. The descriptive statistics are presented in Table 2, while the result of the panel regression (fixed effect model) for both conventional and Islamic banks is presented in Table 3 respectively.

**TABLE 2**  
Impact of CGI and DIS/NDA on firms' financial performance (TQ)

	CGI	DIS	NDA	NPL	TA	TD	TQ
Mean	2.583102	0.396531	0.601286	3.347755	5.280570	5.119908	2.202332
Median	2.374619	0.386593	0.615561	3.433636	5.344231	5.155671	2.238306
Maximum	4.105940	0.999404	0.999731	4.702364	6.259556	6.330650	2.912015
Minimum	1.313142	0.000269	0.000596	0.000000	2.753683	2.106106	1.313142
Std. Dev.	0.584387	0.206716	0.200652	0.586904	0.457112	0.483784	0.237161
Skewness	0.286660	0.437727	-0.468437	-1.163179	-0.822719	-0.803610	-0.658235
Observations	578	578	578	578	578	578	578

The above analysis presents that our data are normally distributed as the mean value of all the variables considered for the study is close to the median value. In addition, the

maximum value of none of the variables is too high which shows that there is no outlier in our data. Hence, fixed effect model and random effect model are applied to see the impact of corporate governance index and earnings management on firms' performance.

**TABLE 3**  
**Impact of CGI and DIS/NDA on firms' financial performance (TQ)**

	Panel Regression	
	Fixed Effect (Islamic)	Fixed Effect (Conventional)
Constant	1.721 (0.000)	1.689 (0.000)
CGI	0.129 (0.06)	0.089 (0.000)
DIS	0.038 (0.187)	.095 (0.054)
NDA	0.062 (0.214)	0.342 (0.018)
LG	0.076 (0.019)	0.076 (0.106)
NPL	-0.034 (0.046)	-0.034 (0.028)
TA	0.56 (0.005)	0.53 (0.000)
TD	-0.516 (0.004)	-0.516 (0.000)
R-squared	0.429	0.549
Adjust R-squared	0.403	0.493
F-statistic	7.418	9.391
Prob (F-statistic)	0.000	0.000
Hausman Test ( $\chi^2$ )	0.000	0.000

The table given above presents the relationship of Corporate Governance Index (CGI), earnings management, and firms' market performance (Tobin's Q) with other variables. Panel regression is used with fixed and random effects. Firms' specific characteristics are sensitive to the estimated results; therefore, the study would incorporate fixed effect model and random effect model. The suitability of fixed effect model and random effect model is identified through Hausman test. As presented in the Table above, the  $p$ -value of Chi-square ( $\chi^2$ ) is 0.000, which is statistically significant at 1%. The results suggest the retention of fixed effect model.

Corporate governance index shows a positive and significant impact on the performance of conventional financial system because of being the main pillar of the financial system. It shows that the market positively reacts to the corporate governance reforms in the conventional financial institutions. A weakly significant impact ( $p$ -value 0.06) on firms' performance is presented in the table above for corporate governance index of the Islamic financial institutions. It shows that corporate governance does not have an impact on firms' performance at 5% significance level, but it is significant at 10% significance level. Hence, corporate governance index has a significant impact on firms' market performance for both conventional and Islamic financial institutions. The size of the firms' Total Assets (TA) and Total Debts (TD) creates a significant impact on firms' performance (Tobin's Q). Conventional firms have the tendency to take risks as they yield high returns. The availability of resources or asset-backed securities provides confidence to the investors and hence, generates a positive and significant impact on firms' performance. In addition, it is observed for both Islamic and conventional financial institutions that an association between TD and

firms' performance is significant but the direction is inverse which means that if the total debts of any firm increase, it brings a negatively significant impact on firms' performance (Tobin's Q).

Tobin's Q is the ratio of market value of a company. In the above analysis, it reflects that if the firm increases its leverage, then the investors in Pakistan do not perceive it a positive indication with regard to the firms growth; rather it is considered as a bailout plan to avoid financial distress. In addition, the capital structure theory refers to the systematic approach of financing and concludes that debt financing beyond a certain level may create a reduction in the market value of the firm and unnecessary leverage on it. Likewise, the excessive debt financing not only increases the interest burden but also raises the cost of capital which adversely affects the profitability and market value of the shares. After the global financial crisis of 2008, the financial institutions across the world are under tremendous pressure due to a high leverage ratio. Moreover, the global economy has slowed down after the financial crisis. Hence, in such a situation, any increase in leverage is perceived as an indication of financial distress. The reported results for these variables yield a similar impact on Islamic and conventional financial institutions. Further, the analysis mentioned above presents that the total assets bring a positive and significant impact on firms' performance. Financial institutions that possess a large volume of assets tend to take more risk compared to the financial institutions with a lower amount of assets. It brings a positive insight for the investors, and they show more confidence in such financial institutions because high risk will yield a high return. Non-performing loans have always been unfavorable for any financial institution because a high NPL ratio indicates inefficient credit/collection policy. Therefore, the increase of non-performing loans adversely affects the firms' performance.

The earnings management techniques in case of conventional financial intuitions (discretionary and non-discretionary accruals) have an impact on firms' performance suggesting that the earnings manipulation done by the managers adds insult to the injury. On the other hand, in the case of Islamic financial institutions, earnings management yields no significant impact on firms' performance which is evident through the *p*-values of discretionary accruals (0.187) and non-discretionary accruals (0.214).

## CONCLUSION

The study focuses on a comparative analysis of Islamic and conventional financial institutions on the basis of corporate governance index, earnings management, and firms' performance. In addition, this study indicates one of the prime reasons for the failure of *muḍārabah* companies in Pakistan. Islamic financial institutions in the study sample are mainly the *muḍārabah* companies; therefore, it is concluded that the corporate governance structure of *muḍārabah* companies is weak. This study concluded that weak corporate governance is one of the prime reasons for principle-agent problem (*rabb al-māl* and *muḍārib*). According to Amer and Sajjad (2014), a weak corporate governance structure generates issues between *muḍārib* (agents) and *rabb al-māl* (investors). On the other hand, the results show that earnings management has less impact on firms' performance in the Islamic financial institutions. Islamic financial institutions operate under a given mandate as per the

Islamic teachings; therefore, there may not be any earnings manipulation.

The corporate governance structure of the conventional financial institutions is sound as compared to the Islamic financial institutions. The major reason of that sound governance structure is the prudential regulation of the State Bank of Pakistan. Commercial banks are bound to follow the codes defined by the State Bank of Pakistan. Specifically, in this study, the selected conventional financial institutions are mainly the banks. For the Islamic financial institutions, most of them are *muḍārabah* Companies with only two banks. Therefore, the conventional financial institutions have shown sound governance structures as compared to the Islamic financial institutions. Further, earnings management has an impact on firms' performance while the manipulation for earnings management is higher in the conventional financial institutions as compared to the Islamic financial institutions.

The study suggests that the application of rigorous corporate governance practices is equally significant for Islamic and conventional financial institutions. The Islamic financial institutions, particularly the *muḍārabah* companies, must consider resolving the principle-agent/agency problem. On the other hand, earnings management in the Islamic financial institution is more controlled; therefore, trust gaining is higher as compared to the conventional financial institutions.

### Limitations and Delimitation

The present study has few limitations which need to be kept in view. Although, the study considered a sample of 20 Islamic and 35 conventional financial firms which is comparatively bigger than the previous studies on the financial sector, yet the Islamic financial institutions pertained more to the *muḍārabah* sector than to the banking sector that was due to the availability of relevant data. The construction of corporate governance index could have been more comprehensive. There is a general lack of theoretical basis on the development of corporate governance index. For the non-financial sector, an extensive literature is available on CGI, but it is not available in the parameters of the financial sector. The findings of the study could have been more above board if it had been done on a cross-country data set.

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