IMPACT OF CORPORATE GOVERNANCE ON EARNINGS MANAGEMENT AND BANK PERFORMANCE IN ISLAMIC AND CONVENTIONAL BANKS OF PAKISTAN

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Abstract –
Purpose: The purpose of this research work is to find out the impact of corporate governance on bank performance through earnings management in Pakistan. Earnings management is our mediating variable and different dimensions of corporate governance are our independent variables. Our dependent variable is bank performance. Further, we also compare the impact of corporate governance in Islamic and conventional banks.
Design/methodology/approach: Data of 3 Islamic and 15 Conventional banks has been collected for the period from2006-2015 andPooled regression has been applied to investigate the impact of earnings management and corporate governance on bank performance. We measure bank performance with return on assets and return on equity; earnings management as (discretionary loan loss provisions) and corporate governance as board size, board independence, audit committee size, and audit committee independence. We also take bank size as control variable. Further, we apply structural equation modelling to investigate the mediating role of earnings management between bank performance (ROA/ROE) and corporate governance.
Findings: Results show that there is a significant impact of board size, audit committee independence and bank size on return on assets and return on equity in Islamic banks. On the other hand, there is a significant impact of Earnings Management (discretionary loan loss provisions), board independence, and audit committee size on return on assets in Conventional banks. Results also show that there is no mediation impact of Earnings Management (discretionary loan loss provisions) in Islamic banks. In Conventional banks;we find significant indirect as well as direct impact of board independence and audit committee size on return on assets. Further, we find significant indirect as well as direct impact of board size and audit committee independence on return on equity of conventional banks.
Practical Implication: This paper will help the Pakistani banks to know about the impact of Corporate Governance mechanisms and Earnings management practices on their performance. The results explain that there is no mediating role of Earnings management in Islamic banks but in conventional banks. These results explain that either Islamic banks are not involved in Earnings management practices due to their strong Sharia board or corporate governance practices in Islamic banks are too weak to have any impact of Earnings management. If it is the weak corporate governance mechanism in Islamic banks then there is need to improve the corporate governance practices in Islamic banks.
Originality/value:To the best of authors' knowledge, this is the first paper that investigates the mediating role of earnings management between corporate governance and bank performance in Pakistan.

Keywords - Islamic banks, Conventional banks, earnings management, and corporate governance.

I. INTRODUCTION

Corporate governance refers to the "set of mechanisms through which outside investors protect themselves against expropriation by the insiders"(La Porta et al., 2000), where "insiders" include the supervising management and shareholders. The main purpose of corporate governance is to secure the rights of creditors and shareholders.Corporate governance contributed to a country's economic and social development by enabling organizations to perform superior. One of the responsibility of a corporate governance is to give assurance that financial reporting systems are transparent.On the other hand, according to a broadly acknowledged definition by (Healy and Wahlen, 1999) "earnings management happens when managers use judgment in financial reporting to either deceive some stakeholders about the underlying economic performance of the firm or to manipulate contractual outcomes that rely on reported accounting numbers." Therefore, earnings management may create financial presentations less transparent. In Islamic banking, the concept of earnings management look different to the moral and ethical values on which these institutions are based, therefore,accounting manipulations and any other discretionary behaviors are considered as unethical exercises in Islamic banks. Although, these institutions,like other businesses, also facethe problem of information asymmetry and agency conflicts(Safieddine, 2009, Shamsuddin and Ismail, 2013, Mersni et al., 2016) that may assist to opportunistic behaviors opposite to Islamic regulations. A large number of studiesexplain the issue of earnings management in the banking sector of Middle East region, specifically. Previous empirical studies associated with earnings management show mixed results in Islamic banks. Such as some of the research studies provide evidence that the basic concept of Islamic banking restrict earnings management practices(Noreen et al., 2016), while others verified that same as conventional banks,the focus of Islamic banks is also on profit making which may lead Islamic banks towards

manipulation of financial reporting (Desta, 2017, Wafaretta and Rahman, 2016, Mersni et al., 2016). Although, these previous studies investigated the relationship between earnings management and bank performance or earnings management and corporate governance, but none of the previous studies investigated the mediating role of earnings management between corporate governance and bank performance. Accordingly, the objective of this study is to investigate the mediating role of earnings management between corporate governance and performance of Islamic as well as conventional banks in Pakistan.

II. RESEARCH METHODOLOGY

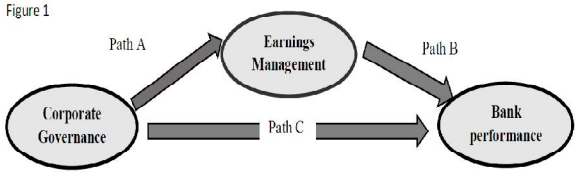
Secondary data has been collected from the annual financial reports published by the banks (Islamic, Conventional)included in the study for the period from 2006 to 2015. After collecting secondary data appropriate regression test is applied. Tables 1 presents the variables included in our study along-with their measurement proxies. Further, to investigate the impact of corporate governance and earnings management on bank performance Pooled Regression has been applied following the results of Breusch and Pagan Lagrangian multiplier test(Baltagi, 2008). Following equation explains our regression model:

$$P_{it} = \beta_0 + \beta_1 DLLP_{it} + \beta_2 BS_{jt} + \beta_3 BI_{it} + \beta_4 ACS_{it} + \beta_5 ACI_{it} + \beta_6 S_{it} + \varepsilon_{it}$$

Where P_{it} is one of the two measures of performance (ROA_{it}, ROE_{it}) for the ith bank at time t, $DLLP_{it}$ are discretionary loan loss provisions of ith bank at time t and β_1 iscoefficientof $DLLP_{it}$; BS_{it} is natural logarithm of total number of directors of ith bank at time t and β_2 is coefficient of BS_{it}; BI_{it} is the ratio of non-executive directors to total directors of ith bank at time t and β_3 is coefficient of BI_{it}; ACS_{it} natural logarithm of total number of audit committee members of ith bank at time t and β_4 is coefficient of ACS_{it}; ACI_{it} is the ratio of non-executive members to total audit committee members of ith bank at time t and β_5 is coefficient of ACI_{it};S_{it} natural logarithm of total assets of ith bank at time t and β_6 is coefficient of S_{it}; β_0 is intercept; ε_{it} is the error component for the ith bank at time t.

Further, to investigate the mediation impact of earnings management between bank performance and corporate governance we develop following (Figure 1) conceptual framework and apply structural equation modelling following (Preacher and Hayes, 2008).

Figure 1



Where Path A and Path B measures indirect effect while Path C measures direct effect.

Table 1: Variables, their model name and proxies

	Variable name	Model name	Proxy
Dependent	Return on assets	ROA_{it}	Profit before tax / Total assets
	Return on equity	ROE_{it}	Profit before tax / Total equity
Mediating	Discretionary loan loss provisions	$DLLP_{it}$	Natural logarithm of loan loss provisions
Independent	Board size	BS_{it}	Total number of directors
	Board independence	BI_{it}	Non-executive directors / Total directors
	Audit committee size	ACS_{it}	Total number of audit committee members
	Audit committee independence	ACI_{it}	Non-executive members / Total number of audit committee members
Control	Bank size	S_{it}	Natural logarithm of total assets

III. EMPIRICAL RESULTS AND DISCUSSION:

Descriptive statistics

Table 2 presents descriptive statistics and according to the mean value of return on assets (mean ROA_{it} Islamic banks = 0.001; mean ROA_{it} conventional banks = 0.009) and return on equity (mean ROE_{it} Islamic banks = 0.123; mean ROA_{it} conventional banks = 0.672) explains that conventional banks are more profitable as compared to Islamic banks. Further, mean value of 11.675 for discretionary loan loss provisions of Islamic banks and mean value of 13.608 for conventional banks explains that Islamic banks manage lower loan loss provisions. Furthermore, mean value of 9.90 for board size of Islamic banks and mean value of 8.67 for board size of conventional banks explains that on averageboard size of Islamic banks is bigger as compared to conventional banks. Further, mean value of 0.667 for board independence of Islamic banks and mean value of 0.641 for board independence of conventional banks explains that on average Islamic banks have more independent directors in their board as compared to conventional banks.Opposite to this, mean value of 0.744 for audit committee independence of Islamic banks and mean value of

0.778 for audit committee independence of conventional banks explains that on average conventional banks have more independent audit committee members as compared to Islamic banks. Moreover, mean value of total assets (mean S_{it} Islamic banks = 17.964; mean S_{it} conventional banks = 19.097) explains that conventional banks are bigger in size as compared to Islamic banks.

Regression analysis

Table 3 presents the results of regression analysis for two proxies of bank performance (ROA_{it}, ROE_{it}) for Islamic and conventional banks, separately. Our model explains 66.93% to 80.75% of the variations in performance of Islamic banks and 25.12% to 42.17% of the variations in performance of conventional banks. Further, the results explain that the relationship between earnings management measured as discretionary loan loss provisions and performance (ROA_{it}, ROE_{it})of Islamic banks is not significant. On the other hand, discretionary loan loss provisions have significant negative relationship with the performance (ROA_{it}, ROE_{it}) of conventional banks. Further, the results explain that board size has significant positive impact on ROA_{it}as well as ROE_{it} of Islamic banks and on ROE_{it} of conventional banks but it has no impact on the ROA_{it} of conventional banks. Furthermore, we find positive but weakly significant relationship between board independence and ROA_{it} of Islamic as well as conventional banks, explaining that increase in board independence increases bank performance irrespective of bank type. Audit committee size has significant positive relationship with ROA_{it} of conventional banks only. On the other hand, audit committee independence has significant positive relationship with ROA_{it} as well as ROE_{it} of Islamic and $ROE_{it}$of conventional banks. Moreover, bank size has significant positive relationship with both the proxies of bank performance of Islamic as well as conventional banks, explaining that bigger banks are more profitable in Pakistan irrespective of bank type.

Table 2: Descriptive statistics

	Islamic Banks (30 obs.)				Conventional Banks (150 obs)			
	Mean	Std.	Min.	Max.	Mean	Std.	Min.	Max.
ROA_{it}	0.001	0.016	-0.040	0.022	0.009	0.049	-0.103	0.511
ROE_{it}	0.123	0.306	-0.665	0.842	0.672	1.199	-3.188	4.109
$DLLP_{it}$	11.675	1.893	6.909	14.202	13.608	1.600	6.999	16.753
BS_{it}	9.900	2.324	7.000	14.000	8.667	1.487	6.000	13.000
BI_{it}	0.667	0.222	0.330	0.889	0.641	0.216	0.130	0.920
ACS_{it}	3.267	0.583	3.000	5.000	3.413	0.647	3.000	5.000
ACI_{it}	0.744	0.309	0.330	1.000	0.778	0.248	0.000	1.000
S_{it}	17.964	1.188	15.208	20.092	19.097	1.137	15.538	21.520

Table 3: Regression results

	Islamic Banks				Conventional Banks			
	ROA_{it}		ROE_{it}		ROA_{it}		ROE_{it}	
	Coef.	Prob.	Coef.	Prob.	Coef.	Prob.	Coef.	Prob.
$DLLP_{it}$	-0.002	0.221	-0.024	0.202	-0.016	0.000	-0.158	0.009
BS_{it}	0.003	0.018	0.032	0.076	0.000	0.970	0.109	0.057
BI_{it}	0.022	0.100	-0.169	0.369	0.034	0.099	0.173	0.687
ACS_{it}	0.000	0.933	-0.026	0.594	0.013	0.061	0.123	0.386
ACI_{it}	0.026	0.004	0.602	0.000	-0.001	0.938	0.604	0.089
S_{it}	0.008	0.001	0.173	0.000	0.018	0.000	0.721	0.000
R-Sq.	0.7377		0.8473		0.2814		0.4450	
Adj. R-Sq.	0.6693		0.8075		0.2512		0.4217	
No. of obs	30		30		150		150	

Mediation analysis

Table 4 presents the results structural equation modelling for Islamic and conventional banks, separately. We run structural equation modelling to investigate the mediation impact of earnings management, measured as discretionary loan loss provisions, between bank performance and corporate governance. We do not find any significant indirect relationship of corporate governance with any of the proxies of performance for Islamic banks, explaining that there is no mediating role of earnings management ($DLLP_{it}$) between corporate governance and performance (ROA_{it}, ROE_{it}) of Islamic banks. On the other hand, the results show that indirect effect of $BI_{it}$and ACS_{it}on ROA_{it} is significant negative and direct effect of $BI_{it}$and ACS_{it}on ROA_{it} is significant

positive for conventional banks. These relationships explain that earnings management plays a partially mediating role between BI_{it} and ROA_{it}as well as between ACS_{it} and $ROA_{it}$of conventional banks. Further, we find negative significant indirect impact of BS_{it} and ACI_{it} on ROE_{it} and positive significant impact of BS_{it} and ACI_{it} on $ROE_{it}$of conventional banks only. These significant relationships provides evidence about the mediation role of earnings management ($DLLP_{it}$) between BS_{it} and ROE_{it} as well as ACI_{it} and ROE_{it} of conventional banks.

Table 4: Mediation results

Path	Islamic Banks					Conventional Banks				
	Indirect effect		Direct effect		Mediation	Indirect effect		Direct effect		Mediation
	Coef.	Prob.	Coef.	Prob.		Coef.	Prob.	Coef.	Prob.	
BS→DLLP→ROA	0.001	0.708	-0.003	0.976	None	0.001	0.473	0.005	0.138	None
BI→DLLP→ROA	0.001	0.987	0.020	0.110	None	-0.019	0.003	0.055	0.002	Partial
ACS→DLLP→ROA	0.005	0.756	-0.001	0.694	None	-0.007	0.046	0.023	0.000	Partial
ACI→DLLP→ROA	0.001	0.525	0.029	0.000	None	-0.008	0.113	0.013	0.403	None
BS→DLLP→ROE	0.004	0.706	0.009	0.707	None	-0.010	0.008	0.235	0.000	Partial
BI→DLLP→ROE	0.002	0.987	0.085	0.725	None	0.126	0.192	1.046	0.018	None
ACS→DLLP→ROE	0.013	0.754	-0.093	0.307	None	-0.013	0.658	0.534	0.000	None
ACI→DLLP→ROE	0.042	0.508	0.553	0.000	None	-0.121	0.051	0.604	0.023	Partial

CONCLUSION

The study investigates the impact of earnings management and corporate governance on the performance of Islamic and conventional banks of Pakistan. The study also investigates the mediating role of earnings management between corporate governance and bank performance of Islamic and conventional banks in Pakistan. To carry out the purpose of the study, data of 15 conventional and 3 Islamic banks has been collected for the period from 2006 to 2015 and pooled regression and structural equation modelling has been applied. No mediation of earnings management in Islamic banks may explain that these banks do not follow earnings management practices or corporate governance mechanism in Islamic banks of Pakistan does not have any impact on earnings management practices. Another plausible reason may be the role of Sharia board is more significant as compared to traditional board in Islamic banks. The results also provide evidence that corporate governance mechanism can control the practices of earnings management in conventional banks. Future research may be carried out to investigate the impact of Sharia board size and Sharia board structure on earnings management practices in Islamic banks.

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