

## **IMPACT OF CORPORATE GOVERNANCE ON FIRM FINANCIAL PERFORMANCE IN ISLAMIC FINANCIAL INSTITUTION**

Areeba Suleman<sup>1</sup>, Faiza Akhter<sup>2</sup> and Amir Shakeel<sup>3</sup>

### **Abstract**

*The paper discusses the influence and relationship between corporate governance practices and firm financial performance in Islamic banking sector. The main purpose of this study is to find or identify various factors or variables that affect the firm financial performance. Corporate governance focuses on three meters as board size, a number of meeting and audit committee size and firm financial performance has also three indicators return on equity, return on asset and earning per share. Data relates to corporate governance and firm financial performance is collected from annual reports of different Islamic banks to analyze the results. Data reveals the positive relationship between corporate governance and financial performance of Islamic banking sectors. The most outstanding results of this study has considerable and strong positive relationship in large board size and firm financial performance in developing countries as Pakistani circumstance as Pakistani circumstance.*

**Key Words:** Corporate Governance, Islamic Financial Institutions, financial Performance, Pakistan

**JEL Codes:** C10, C59, G10, G21.

### **1. Introduction**

Corporate Governance defined as the mode in which an organization is aimed at, controlled and administrated. The corporate governance formation indicates the distribution of roles responsibilities and rights among different contestant in the organization like as all stakeholders, management, and shareholders. They identify policies practices and procedures and assist with accurate decision making for

---

<sup>1</sup> M.Phil. Scholar, University of Central Punjab, Lahore

<sup>2</sup> M.Phil. Scholar, University of Central Punjab, Lahore

<sup>3</sup> M.Phil. Scholar, University of Central Punjab, Lahore

various corporate issues and affairs. By this, they offer a composition where organization's goals are developed and adopting creative methods for getting and accomplishing those goals through monitor performance in the whole process. Corporate governance perhaps work as to bring out the interest of corporate clients and investors and make sure that firms aim is to maximize the profit for investors. Modern business organizations, the major grouping of internal and external stakeholders such as BODs, top management, subordinates, customers, suppliers, debt holders and creditors, and shareholders involved and influenced due to corporate activities". BODs liable for supremacy and set the corporation's strategic goals and leading them till implement and facilitate and supervise their personnel management capabilities then they provide the overall report to shareholders. As county Corporate governance in a managerial system have profound inference for trading and capital formation as well as enhancing employment opportunities.

Development of corporate culture by maximizing performance to motivate board of directors Entrepreneur and managers for increasing efficiency to attain long lasting achievement. Profitability of financial institutions has been influenced by corporate governance. Cornett, Gou, Akhter (2006). Corporate governance and profit maximization for firms are positively correlated. Maher (2008). Various research has conducted to evaluate the connection between Mechanism of corporate governance and financial performance of Islamic financial institution. They found out the strong connectivity by them. Stable mechanism of corporate governance is much essential for increasing the worth of firm in both developing and developed financial institutions. Financial stability and value for corporation vary by the reason of disparate forms of corporate governance in rising and well established financial institutions. It is compulsory to monitor the operational efficiency of corporations for maximizing performance that can be achieved by conducting the meeting of BODs at regular basis". Islamic finance is defined as the mechanism based on religious guidelines and rules over and above Islamic Law called Shari's. It offers directions for various aspects of life involving economies, banking sector, business industry, and also in the legal and political system.

Basic financial doctrine of Shari's include a prohibit on uncertainty and interest devotion of sharing in both risk and profit. Banking sector of Pakistan positively influenced by modification of corporate governance and link with its managerial efficiencies and

effectiveness. To assess and measure corporate governance and its impact on firm performance by different variables like as Board Independence & meeting, board structure, CEO Duality, ownership, and leadership. Burki and Abid (2006) Supremacy of financial institutions negatively influenced due to Merger and Acquisitions because rules and regulations changed by business expansion. Corporate governance is decisive for the capacity of a corporation to defend the stakeholders' interests, basically those interests in the form of moral, pious, as well as financial values.

As an association providing Islamic financial services, stakeholders anticipate its operational activity keep up in conformity with Islamic Law. Corporate governance has momentous for expanding and developing economies of countries. It is also rapidly emerging and developing in Pakistan by circulated corporate governance code in March 2002. Banking sector inefficiencies arose many financial issues and problems and lead to minor economic growth. So as confined from this inefficiency and ineffectiveness the financial institution is needed to administrate and preside over in the proper way.

Core purpose of this research is to explore the influence and relationship between corporate governance and financial performance of Islamic banks in Pakistan. This research will find out the gap which has been recognized. This research will facilitate and help to corporate clients and investors to maximize investment in Islamic financial institution.”

## **2. Literature Review**

Corporate governance is positively associated with the firm financial performance of Islamic banks in Pakistan. There is the significant effect of corporate governance on the return of shareholders in pharmaceutical sector of Pakistan. Muhammad (2008) explored various results in his empirical study and found the positive relationship between board size and firm financial performance in Islamic institutions. Safieddine (2009) has focused that corporate governance apparatus in Islamic financial institution is distinctive that is hold on Shari'a governance. Ibrahim et al (2010) Enhanced practices of corporate governance is identified as that become the significant elements in escalation for a long lasting economic growth of corporations.”

Hassan *et al.*, (2011) have discussed the theoretical aspects of Shari'a Governance of Islamic financial institutions. Francis et al. (2012) possessed that good governance corporations performed well during the

financial crisis because risk taking and financial stability is the concerned issue during global financial dilemma. To assess and measure link and connectivity between corporate governance mechanism and financial performance through using different variables like as CEO status and Audit committee. Khan *et al.*, (2014). Hassan & M.K (2014) financial institution based on Islamic philosophy founded on a real prescription of receipt of a few determined and assured rate of return. This system encouraged Entrepreneurship and promotes Risk sharing and emphasized on a purity of contracts with proper governance and supremacy.

### 3. Methodology

This study occupied both primary and secondary data just to analyze the results. The population of this study is formed by Islamic banks in Punjab, Pakistan. Financial data of this selected population is got through annual published reports by state bank of Pakistan in the phase of 2008-2012. This phase is much more essential for Islamic financial institutions of Pakistan due to implications of different codes of corporate governance. Data is analyzed by adopting statistical tool of SPSS, correlation and linear regression. Analyze the data just to find and confirm significance link between financial performance of Islamic banks and corporate governance

**Table1: Corporate governance and performance of Islamic banks**

Correlations				
		Return on Equity in %	Board Size	Number of Meetings
Pearson Correlation	Return on Equity in %	1.00	0.37	-0.22
	Board Size	0.37	1.00	0.09
	Number of Meetings	-0.22	0.09	1.00
	Audit Committee size	0.24	0.18	0.00
Sig. (1-tailed)	Return on Equity in %	.	0.00**	0.03
	Board Size	0.00	.	0.24
	Number of Meetings	0.03	0.24	.
	Audit Committee size	0.02**	0.07	0.50

The Analysis of Table 1 prove that corporate governance make subject for the performance of Islamic banks that is in according to the existing literature (Muhammad 2008, Safieddine 2009, Ibrahim 2010, Hassan 2011, Francis 2012, Khan & M.K 2014). There is positive relationship between board size and audit committee and bank

performance that is theoretically proved. By strength of audit committee size financial performance of the firm can be get and enhanced. A fascinating finding in Table 1 possess negative connectivity and correlation between ROE and the no of meetings. Board meeting holds different sort of costs or expenses as like investing management time, traveling cost, meeting payments. But the board size much motivating for outsourcing personnel by contributing in the board and enhance the financial performance Governance Influence on ROE, ROA, & EPS. Governance influence on performance (ROE, ROA, & EPS) has been tested through linear regression models as given below.

$$\begin{aligned} \text{ROE} &= \alpha + \beta_1 \text{BS} + \beta_2 \text{AC} + \beta_3 \text{NM} + \epsilon && \text{i} \\ \text{ROA} &= \alpha + \beta_1 \text{BS} + \beta_2 \text{AC} + \beta_3 \text{NM} + \epsilon && \text{ii} \\ \text{EPS} &= \alpha + \beta_1 \text{BS} + \beta_2 \text{AC} + \beta_3 \text{NM} + \epsilon && \text{iii} \end{aligned}$$

where:

ROE (Return on Equity), ROA (Return on Asset), EPS (Earning per share), BS (Board Size), AC (Audit Committee) and NM (Number of meetings)

**Table 2: Model 1 Estimates**

Model Summary								
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson			
1 <sup>*</sup>	0.47	0.22	0.19	27.80	2.1			
ANOVA								
Model		Sum of Squares	df	Mean Square	F	Sig.		
1 <sup>*</sup>	Regression	15039.67	3	5013.22	6.48	0.00**		
	Residual	51032.23	66	773.22				
	Total	66071.90	69					
Coefficients								
Model		Un-standardized Coefficients	Standardized Coefficients		T	Sig.	Collinearity Statistics	
			Std. Error	Beta			Tolerance	VIF
1 <sup>*</sup>	(Constant)	-62.05	23.59		-2.63	0.01		
	Board Size	6.46	2.01	0.35	3.21	0.00**	0.96	1.04
	Number of Meetings	-3.59	1.55	-0.25	-2.32	0.02**	0.99	1.01
	Audit Committee Size	7.02	4.38	0.18	1.60	0.11	0.97	1.03

**Table 3: Model 2 Estimates**

Model Summary								
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson			
2 <sup>a</sup>	0.39	0.15	0.12	2.90	1.95			
ANOVA								
Model		Sum of Squares	df	Mean Square	F	Sig.		
2 <sup>a</sup>	Regression	112.37	3	37.45	4.44	0.00**		
	Residual	640.45	76	8.42				
	Total	752.83	79					
Coefficients								
Model		Un-standardized Coefficients	Standardized Coefficients		t	Sig.	Collinearity Statistics	
			Std. Error	Beta			Tolerance	VIF
2 <sup>a</sup>	(Constant)	-2.15	2.41		-0.89	0.37		
	BS	0.44	0.20	0.23	2.19	0.03**	0.96	1.04
	NM	-0.37	0.14	-0.26	-2.53	0.01**	0.99	1.00
	AS	0.41	0.44	0.10	0.92	0.35	0.96	1.04

**Table 4: Model 3 Estimates**

Model Summary								
Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson			
3 <sup>a</sup>	0.46	0.21	0.18	6.67	2.05			
ANOVA								
Model		Sum of Squares	df	Mean Square	F	Sig.		
3 <sup>a</sup>	Regression	922.37	3	307.46	6.91	0.00**		
	Residual	3294.07	74	44.51				
	Total	4216.44	77					
Coefficients								
Model		Un-standardized Coefficients	Standardized Coefficients		t	Sig.	Collinearity Statistics	
			Std. Error	Beta			Tolerance	VIF
3 <sup>a</sup>	(Constant)	-14.92	5.56		-2.68	0.01		
	BS	1.16	0.23	0.26	5.04	0.00**	0.96	1.04
	NM	-0.54	0.25	-0.16	-2.14	0.02**	1.00	1.00
	AS	0.35	0.40	0.31	0.88	0.30	0.96	1.04

The declared findings showed the positive relationship between corporate governance variables and ROE. The overall model is momentous, the P value is less than 5 % & 1% that shows board size and no of meetings has the strong link with return on equity. The second model is revealing the anticipated findings the strong impact of corporate governance on return on assets. Governance variables have strong positivity on ROA and Durbin Watson value 2.05 grant potency and power to the conclusion. Next model is also more important and has significance at 1% level correspondingly same too before discussed model. Earning per share is also influenced by corporate governance variables.

#### **4. Conclusion and Discussion**

The prime role of this research is to find out the relationship in governance variables and firm financial performance. In developing countries like as Pakistan, study concluding that enhanced board size is best for performance. A Large board is beneficial to defend and protect the rights of shareholders which exist in minorities. So this study idealizes Resource dependent theory. This Theory emphasizes on large board that encourages and appreciates accountability, transparency to maximize the firm performance. But it's hard to manage large board size in firms due to accruing different sort of costs and become a reason for the postponement in the execution of the vital decision. Thus we find that how various corporate governance variables and measures have the positive impact on the performance of Islamic financial institution. Performance and profitability are measured by ROE and ROA and EPS. So banks must pursue best corporate governance practices for achieving high profitability.”

#### **References**

- Akhtar, Shamshad. (2006). “Syariah Compliant Corporate Governance”. Keynote address by the governor of the State Bank of Pakistan at the annual Corporate Governance Conference, Dubai, United Arab Emirates
- Burki, A., & Ahmad, S., 2007, “Corporate Governance Changes in Pakistan’s Banking Sector: Is there a Performance Effect?” Center for Management and Economic Research, working paper No. 07-59
- Mahar, M., & Andersson, T., 2008, “Corporate Governance: Effects on Firm Performance and Economic Growth”, *Contemporary Accounting Research* Vol. 25, pp 351-405.
- Mohamad, S. Hassan, T. and Bader, M.K.I. (2008) Efficiency of conventional versus Islamic banks: International evidence using the stochastic frontier approach (SFA). *Journal of Islamic Economics, Banking and Finance* 4 (2): 107-130.
- Safieddin, A. 2009, Islamic financial institutions and corporate governance: New insights for agency theory, *Corporate Governance: An International Review*, 17, pp. 142-158

- Ibrahim, Q., Rehman, R., and Raoof, A., 2010, "Role of Corporate Governance in Firm Performance: A Comparative Study between Chemical and Pharmaceutical Sectors of Pakistan" *International Research Journal of Finance and Economics*, Issue 50 (2010)
- Hassan, M. K., 2011, Corporate governance practices in emerging economies: initial findings from the UAE", *China-USA Business Review Journal*, Vol. 10, No. 9, pp. 856-864.
- Francis, B., Hasan, I., and Wu, Q. 2012, Do Corporate Boards Affect Firm Performance? New Evidence from the Financial Crisis. SSRN Working Paper: [ssrn.com](http://ssrn.com)
- Khan, 2014, D. G. Student of M. Phil, National College of Business Administration and Economics, Dera Ghazi Khan.
- Hassan, M.K, Yu, J-S, and Kim, D-W. (2014) Financial inclusion and economic Growth in OIC countries. Paper presented at the seminar on Finance and Development in Muslim Economies, sponsored by Islamic Research Training Institute (IRTI), Islamic Development Bank and the Journal of Financial Services Research, 15 September, Bangor University, UK