

# Impact of Corporate Governance on Islamic Banking: Evidence from Pakistan

Naveed Ahmad<sup>1</sup> M. Sajjad<sup>2</sup>

1. Department of Business Administration, Lahore Leads University, Pakistan

2. *Mphil Scholar*, Department of Business Administration, Lahore Leads University, Pakistan

## Abstract

**Purpose-** The intention of this experiential research is to investigate corporate governance effects on capital structure of all KSE listed firm in Pakistan.

### Design/methodology/approach:

Through expending wide-ranging sample of listed companies of Karachi stock exchange and through applying regression model in which fixed effect techniques has been used in order to get results and analyses the relationship between corporate governance and capital structure.

### Findings:

Finding shows that Board meetings are negatively correlated with short-term debt. ROA and CEO Duality are negatively correlated with long-term debt. Rest all variables are positively correlated with capital structure.

### Practical Implications:

The outcomes of this study are very helpful for all managers on all levels to better understand the corporate governance rules and their importance as well as also helpful for work effectively and efficiently in Pakistan environment. Study is also supportive for further more studies on this topic.

### Originality/value:

The study involves short-term debt ratio as corporate structure measure of listed companies in Karachi stock exchange in Pakistan.

**Keywords:** Corporate Governance, Capital structure, Islamic Banks

## 1. Introduction

Topics of “corporate governance” were first time studied by Berl and Means. Lawfully discourse that firms are different from owners. Moslemipour (2013) argues that all firms have separate authorized body and all firms are separate from their owners. And there is an interaction between a firm and their stakeholders. There are many agreements a firm do, the most important is between firm and their shareholders. This important contract is based on agency theory. Garkaz (2013) giving to this agreement all firms’ matters, activities and administration is assigned by shareholders to board of directors. And shareholders demand prosperity in return in the form of high earning per share or higher dividend. It is reality that board of directors wants their best benefits from firm, but is their responsibility to deliver higher wealth to shareholders. The expense in this contract is called agency expense.

Sound corporate governance practices are essential for increase growth in economy. Sheikh (2012) suggest that the attributes of corporate governance are also very much important for increase the firm’s performance, revenues and wealth .It is recognized that firm’s capital structure is stimulated by corporate authority. Shareholder interest is main and vital attention of any firm. It is protected by corporate authority instrument.

Wang (2011) argues that the traits of corporate authority are very useful to construct a corporate governance values that inspire the management, executives and firm’s administration.

Akbari (2013) says in specific, experiential investigation to assessment the effect of corporate controls traits i.e. "board size, Board meeting, Board committee, CEO duality, and internal auditor” on capital selections of Pakistan Karachi stock exchange’s listed companies are actual restricted. Firm having sound and effective traits of capital structure can easily access to capital marketplace Rahmani (2013).

Ahmadpour (2012) suggested corporate governance’s attribute leverage can be useful to resolve the conflict between shareholders and management. Because higher the leverage pointers high business risk in a firm and lower the leverage will result the lower business risk, similarly more debt will leads a firm to higher the financial leverage and higher the financial risk.

For finding the associations between “capital structure and corporate governance “many preceding researches have been completed in advanced and established countries but Pakistan have few research studies on this topic Mousavi (2012).

Mainly corporate governance resolves two types of conflicts. First a conflict between shareholders and management/Executives that is also refer to agency problem. Second type of conflict is conflict between minority shareholders and majority shareholders Gul (2012).

Hassan and Ali Butt (2012) claimed corporate governance traits defend the wealth of shareholders.

Company can develop better strategy and built effective structure with the help of “corporate governance” attributes

Corporate governance’s attribute leverage can be useful to resolve the conflict between shareholders and management. Because higher the leverage pointers high business risk in a firm and lower the leverage will result the lower business risk, similarly more debt will leads a firm to higher the financial leverage and higher the financial risk. Ahmadpour (2012)

## 2. Literature Review

Many literatures indicate that the efficiency of corporate governance instruments is associated with many factors Moslemipour (2013) mainly the effectiveness of corporate governance instruments associated with publicly listed companies that are the subject of widespread current research in various literatures including.

It is recognized that the sound corporate governance can improve the nation’s economy and firm’s performance. Companies can raise their investments by use of sound corporate authority tools. Gul and Sajid (2012) with the use of sound corporate authority firm can create clearness in the dealing with both creditors and investors. Good corporate authority can protect a firm from evils i.e. dishonesty.

In specific, experiential investigation to assessment the effect of corporate controls traits i.e. "board size, Board structure, Board meeting, Board committee, Managerial ownership, Firm size, CEO duality, and institutional shareholders ownership” on capital selections of Pakistan Karachi stock exchange’s listed companies are actual restricted Akbar (2013). Firm having sound and effective traits of capital structure can easily access to capital marketplace Rahmani (2013).

Mainly corporate governance resolves two types of conflicts. First a conflict between shareholders and management/Executives that is also refer to agency problem. Second type of conflict is conflict between minority shareholders and majority shareholders Gul (2012).

### Corporate Governance variables and capital structure

#### 2.1. Ownership structure and capital structure

Velnampy & Nireish (2012) Capital structure is very important corporate governance variable that is directly influence the different firm’s important decisions including profitability. Efficient and useful capital selection is one of the important decisions that have a direct influence in financial strategy of any firm.

The efficiency of debt depends upon some important factors. These important factors are sound established capital market, corporate supremacy, financial mediators and lawful security offered by a court. A country’s economy experience many critical factors. One of the critical factors is firm size. This is the reason most of firm’s CEOs do not have debt due to this firm size. Garkaz (2013) . Financial and monetary condition of any business in world depends upon two factors. 1st is resources and capitals that a business possesses and 2nd things is debt or requirements that a business must have meet.

For generate revenues, growth and further wealth companies bring out many different activities. Many authors and enterprises consider that finance is one of the most important factors that have directly influence on firm’s key dimensions Sheikh (2012). All successful and growing firms don’t use all their profits in their activities or as a compensation of management and stockholders. It must be re invested in business for their existence (Mousavi 2012). So due to insufficient financial intermediaries, weak security offered by a court and environment ambiguity, most of the firms don’t be contingent on debt market Wang (2012).

Though recent some little changes in corporate governance rule 2002 and 2012 and controlling outline many listed firm’s capital structure and decisions affected by these changes (Akbar 2013).

However there is individuality among worth of the firm and capital arrangement. Value of the firm is independent from capital structure.

What are the factors that affect a firm’s capital structure? This is very important question that is arising in the 19th centuries. For answer this question many researchers investigate the factors that have influence on firm’s capital structure. First of all Modigliani and Miller (1959) completed his study on factors affecting the capital structure. Modigliani and Miller’s expectations including the presence of perfect capital market, absence of agency costs, lack of revenue taxes, lack of insolvency costs, and the presence of information regularity among those who are energetic in capital market. After the study of Modigliani and miller, many researchers start study to investigate the factors that have an effect on capital structure.

Mir Askari and Rahmani 2013) investigated some important factors that have an effect on capital structure. These factors are "board size, Board meeting, Board committee, CEO duality, and internal auditor”.

Analysis in their connection among manages instruments as well as agency threat recommends that operators connected with companies using bad management and business governance desire increased return Ahmadpour (2012)

Control devices also play an important part in improving financial information quality. For example Samimi and Golmohammadi (2012) realize that firms be subject to Investments in addition to Security Exchange

Commission Pakistan (SECP) enforcement steps related to profits guidance are more motivated to use a panel dominated by simply inside directors.

For finding the associations between “capital structure and corporate governance” many preceding researches have been completed in advanced and established countries but Pakistan have few research studies on this topic (Mousavi 2012)

Thus, Jari (2012) examines the association among the nature of corporate administration and data irregularity around quarterly profit affirmations. It is discovered that directors more often than not have incentives to continue acquiring at minor ranks than ideal in light of the fact that this declines the likelihood of liquidation.

Sound corporate governance practices are essential for increase growth in economy. Sheikh (2012) suggest that the attributes of corporate governance are also very much important for increase the firm’s performance, revenues and wealth.

As expressed by this perspective, chiefs with more noteworthy proprietorship are less motivated to participate in quality diminishing exercises on the grounds that they bear some piece of the expenses of their activities. These recommendations lead to an anticipated positive relationship between managerial possession and influence (motivation arrangement impact).

## **2.2. Board size and capital structure**

The leading group of executive is height of an organization that is responsible for dealing with the firm and its operation. It plays key part in key choices in regards to money related blend. Aliahmadi (2012) proposes a huge association among capital arrangement and size of board. The proof in regards to course of relationship between board size and capital structure is blended. He contends that organizations with bigger governing body by and large have low equipping levels.

The results give prove about harmful association among size of board and influence proportions and SMEs with bigger sheets for the most part have low level of outfitting. Then again, Afzal (2012) discovers optimistic association among size of board and capital construction. He examines that substantial sheets take after an approach of higher amounts of equipping to improve firm regard particularly when these are dug in because of more noteworthy checking by administrative powers. It is additionally recommended that bigger board may discover trouble in landing at an agreement in choice which can at last influence the nature of corporate administration and will decipher into higher fiscal power levels.

## **2.3. CEO duality and capital construction**

After some changes in corporate governance rules of 2002 and 2012 there is a clear rule that CEO don’t serve as chairman of the board. It is a very important corporate governance factor that must consider in the study of impact of corporate governance on capital structure. This dual position of CEO is called CEO/Chair Duality. Farma and Jensen (1983) deliberate that in a firm there is separation among decision management and decision control functions.

Internal checked system must guarantee that there is no CEO duality. Therefore role of chairman and chief executive officer must be separated.

Afzal (2012) finds the association among CEO duality and capital structure in the form of leverage. He suggests that a firm will be high leverage if there is separation among chief executive officer and chairman of board. And there will be a firm less leveraged if there is no separation between chief executive officer and chairman of board.

Another positive relationship found by Aliahmadi (2012) among capital structure and separation of chairman of board and chief executive officer.

## **2.4 Internal auditor and capital structure**

Ahmed pour, saimi and golmohammadi (2012) found statistically important association in the case of “ownership structure, Board size, internal auditor and institutional share ratio”.

Saimi (2012) used F statistics; the variables that are used by saimi were named “ownership structure, Board size, internal auditor and institutional share ratio”. The purpose of this study was to find the association between corporate authority and firm’s capital organization.

Golmohammad (2012) found a positive association among “ownership concentration, Board structure, internal auditor, and capital structure”.

## **2.5 Board meeting and capital structure**

Various researchers have completed research work on the topic of “Board meeting and capital structure” to find out the association among them.

Achuchuthan, Kajanathan, and Sivathaasan (2013) found the corporate authority practices subsidize

and significantly to capital arrangement. For this purpose 28 manufacturing forms were selected from stock exchange.

Sivathaasan Achuchuthan, Kajananthan, (2013) found that there is no major association board meeting and capital structure.

Kajanantahn (2013) found that there is no important association between board meeting and capital structure among listed manicuring firm in Srilanka.

Achuchuthan (2013) found a positive association among board meeting and capital structure.

## **2.6 Board committee and capital structure**

To find out the association between capital structure and corporate governance many researchers do work in this area of study but few found the relationship between board committee and capital authority.

Kajananthan (2013) addressed that board committee as a best exercise in the code of best practices of corporate governance.

Achchuthan and sivathaasan (2013) studied on 28 manufacturing firms in Srilanka and found that there is no significant association between capital structure and board meeting.

Debt repay on time is very important for any firm. This can be easily achieved by strong corporate governance practices. One of the important tools of corporate governance is board committee.

Sivathaasan (2013) found a positive association board meeting and capital authority. Clearly corporate governance issues impact on capital structure because traditional elements of corporate authority i.e. board committee have effect on capital authority and more board committees can higher the gearing position.

## **Control variables and Capital structure**

### **2.7 ROA and capital structure**

The capital structure consists of debt and equity. Of course more debt will increase the probability of liquidation or insolvency.

Hassan and Butt (2010) found a negative association between ROA and capital structure. ROA can be calculated by firm's net income divided by its total assets.

Akbari and Rehmani (2013) found that profitability have negative impact on debt ratio. For this purpose he selected 78 financial firms from Tehran stock exchange by Iran during the time period of (2008-2012).

### **2.8 Profitability and Capital Structure**

There are some ways to increase finance for a firm. A firm either can use internal finance or issue debt. According to the **pecking order theory** a firm favors internal finance. Any firm will issue liability if internal finance is tired. But a firm would have minimum charm in issue new additional equity Askari (2013).

It is important to have more retained earnings if a firm is a profitable firm. Rehmani (2013) found a negative association between leverage and historical profitability. The reason is clear that more profitable firms have minimum chances to insolvency and nonpayer.

## **3. Hypothesis Development**

**H1:** There is positive relationship between BS and Capital structure.

**H2:** There is a positive relationship between board meetings and capital structure.

**H3:** There is a positive relationship between CEO duality and Capital structure

**H4:** There is a positive relationship between Board committee and Capital structure

**H5:** There is a positive relationship between IA and Capital Structure

**H6:** There is a positive relationship between ROA and capital structure.

## **4. Research Methodology**

### **4.1 Sampling**

This study examines the association of "corporate governance with capital structure" for all listed companies of Karachi stock exchange in Pakistan. The sample period is 2009-2013. Total data consist of 2570 observations for 514 companies. Firstly study started with all listed (580) companies from all (33) sectors listed in Karachi stock exchange. Due to lack of financial information reports 66 companies are excluded from sample, so total selected sample is 514 companies by which result are analyzed and extracted. Data had been collected from annual reports from relevant companies.

In this study the capital structure in which both long-term debt and short-term debt has been taken as dependent variable where as "Board Size, Board Meetings, CEO Duality, Board Committee, Internal Auditor, Tobin's Q, ROE, ROA, Profitability" has been taken as independent variable.

#### 4.2 Regression Model

Fixed effect model has been used to analyze the data in order to get the results of this study.

Although every study use changed sample sizes for finding the results that's why outcomes of effect sizes differ from each other's. In fixed effect model this is assume that effect sizes will be different due to sampling error that's why a common mean will be share for all.

Fixed effect model is a statistical technique that is used to analyses the quantities. Fixed effect model signifies the experimental quantities in relations of explanatory and descriptive variables that are preserved as all variables are non-random values.

According to Fixed effect model following variables are as follows in equations:

First equation is long-term debt equation that tells about the relationship between Long-term debt and other corporate governance mechanisms named board size, board meetings, board committees, CEO duality and internal auditor.

$$LDR = \beta_0 + \beta_1 (BS) + \beta_2 (NBM) + \beta_3 (CED) + \beta_4 (NBC) + \beta_5 (IA) + \beta_6 (ROA) + \epsilon_t$$

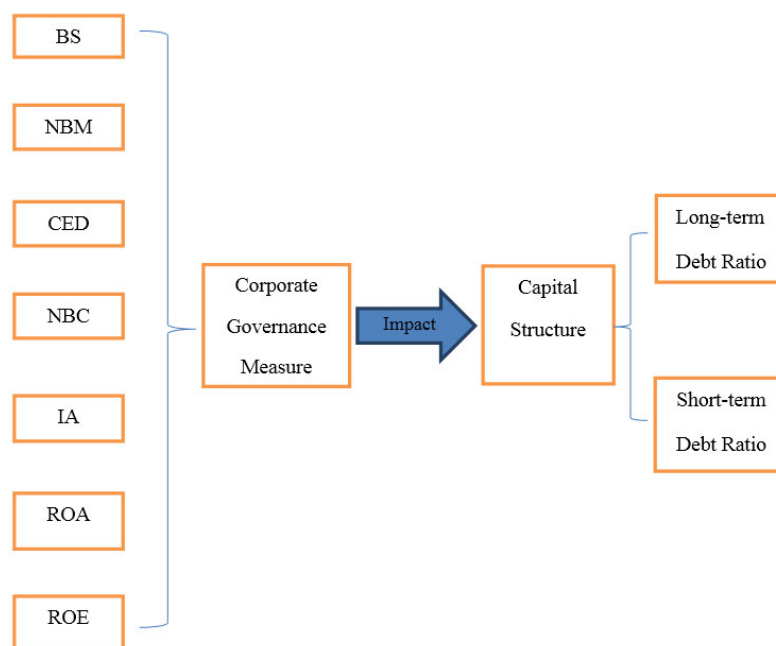
Second equation explores the association among short-term debt and other corporate governance measures .Corporate governance tools named board size, board meetings, board committees, CEO duality and internal auditor has been used in Short-term debt equation

$$SDR = \beta_0 + \beta_1 (BS) + \beta_2 (NBM) + \beta_3 (CED) + \beta_4 (NBC) + \beta_5 (IA) + \beta_6 (ROA) + \epsilon_t$$

#### 4.3 Table of variables

Variables	Definitions
<b>Dep Var</b>	
Long-term debt	LTD has been measured by long-term debt divided by total assets.
Short-term debt	STD has been measured by short-term debt divided by total assets.
<b>Ind Var</b>	
Board Size	Board size has been measured by number of board members.
Board Meetings	BM has been measured by company's board meetings in a year
CEO Duality	CEO Duality has been measured as 1 is for just chairman, 0 for chairman and as well as member of audit committee
Board Committee	BC has been measured as company's number of board committees
Internal Auditor	1 If Internal Auditor has accounting background, 0 otherwise
<b>Con Var</b>	
Tobin's Q	Tobin's Q has been measured by market value of firm divided by its total asset value
ROA	ROA is measured by company's net earnings by its total asset
ROE	ROE has been measured by company's net earnings by its total equity.

#### 5. Theoretical framework



## 6. Empirical Results

Table: 1

Dependent Variable: SDR

Method: Panel EGLS (Cross-section weights)

Date: 11/15/14 Time: 15:58

Sample: 2009 2013

Periods included: 5

Cross-sections included: 514

Total panel (unbalanced) observations: 2521

Linear estimation after one-step weighting matrix

White cross-section standard errors & covariance (d f corrected)

WARNING: estimated coefficient covariance matrix is of reduced rank

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	27.97183	3.559095	7.859256	0.0000
BS	0.405226	0.396855	1.021093	0.3073
BM	-1.239904	0.376576	-3.292572	0.0010
CEO	6.364668	1.529351	4.161679	0.0000
BC	1.337610	0.335242	3.989989	0.0001
IA	2.068017	1.081373	1.912399	0.0560

### Effects Specification

Cross-section fixed (dummy variables)

Weighted Statistics			
R-squared	0.921884	Mean dependent var	812.4641
Adjusted R-squared	0.901673	S.D. dependent var	891.3162
S.E. of regression	355.4991	Sum squared resid	2.53E+08
F-statistic	45.61131	Durbin-Watson stat	2.310712
Prob (F-statistic)	0.000000		
Unweighted Statistics			
R-squared	0.200615	Mean dependent var	31.76835
Sum squared resid	5.85E+08	Durbin-Watson stat	3.174076

- Table: 1 shows the results of the study. It confirms the H1 which is “there is positive relationship between BS and Capital structure. It means that listed companies have large board size so that they inclined for acquiring more Debt.
- Results of Table: 1 reveals that BM (which is Abbreviation of Board Meeting) has negative correlated with Capital structure which contradicts H2. It means there is higher number of board meetings in listed companies of KSE than SDR would be lower.
- CEO duality has positive relationship with Capital structure. It confirms the H3 which is” there is positive relationship between CEO duality and Capital structure.”
- BC has positive relationship with Capital structure. This result of the study follows the H4 which is” there is positive relationship between Board committee and Capital structure”.
- IA has positive relationship with Capital Structure which follows the H5 which is “there is positive relationship between IA and Capital Structure.

Dependent Variable: LDR  
 Method: Panel EGLS (Cross-section weights)  
 Date: 11/15/14 Time: 16:19  
 Sample: 2009 2013  
 Periods included: 5  
 Cross-sections included: 514  
 Total panel (unbalanced) observations: 2486  
 Linear estimation after one-step weighting matrix  
 White diagonal standard errors & covariance (no d.f. correction)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	40.29743	0.772391	52.17229	0.0000
CEO	-1.024778	0.384619	-2.664400	0.0078
BC	0.807136	0.321228	2.512654	0.0121
IA	0.459767	0.550135	0.835736	0.4034
ROA	-0.019695	0.017256	-1.141351	0.2539

#### Effects Specification

Cross-section fixed (dummy variables)

Weighted Statistics			
R-squared	0.792808	Mean dependent var	76.00601
Adjusted R-squared	0.738378	S.D. dependent var	69.32334
S.E. of regression	20.39667	Sum squared resid	818735.8
F-statistic	14.56567	Durbin-Watson stat	2.368773
Prob (F-statistic)	0.000000		
Unweighted Statistics			
R-squared	0.301007	Mean dependent var	40.50841
Sum squared resid	820687.5	Durbin-Watson stat	2.358312

Table: 2 show the results of the study. It confirms the H1 which is “there is positive relationship between BS and Capital structure. It means that listed companies have large board size so that they inclined for acquiring more Debt.

- Results of Table: 1 reveals that ROA (which is Abbreviation of Return on assets) has negative correlated with Capital structure which contradicts H6. It means that if firm wants to increase its ROA so the firm have to be decreases its LDR.
- CEO duality has negative relationship with Capital structure. It Contradicts the H3 which is” there is positive relationship between CEO duality and Capital structure.”
- BC has positive relationship with Capital structure. This result of the study follows the H4 which is” there is positive relationship between Board committee and Capital structure”.
- IA has positive relationship with Capital Structure which follows the H5 which is “there is positive relationship between IA and Capital Structure.

#### 7.Limitations

The study has following restrictions

- In fact more variables and data are required to measure the impact of corporate governance on capital structure, but lack of time constraint study include only selected variables to measure.
- Study only covers listed firms of Karachi Stock Exchange having 5 year data from 2009 to 2013 and consequently does not signify time period outside this.
- Study only Included listed firms of Karachi Stock Exchange and does not include unlisted companies.
- As data has been gathered from annual reports of KSE listed companies, so some companies have not financial data on their web site.

## 8. Conclusions

The intention of this experiential research is to investigate whether corporate governance effects on capital structure of all KSE listed firm in Pakistan. For this purpose out of 580 companies sample of 514 companies has been taken from all sectors which are listed in Karachi Stock Exchange for the period 2009 to 2013. 66 companies had been excluded due to limitation of data. In this study corporate governance has been taken as independent variable whereas Capital structure has been taken as Dependent variable. To measure corporate governance BS, BM, BC, CEO duality, ROA and IA has been taken as parameter of corporate governance whereas long-term debt and short-term debt has been taken as parameter to measure the capital structure.

The results show that there is a negative relationship between board meetings and short-term debt, Achchuthan, Kajanathan, and Sivathaasan (2013) conclude that there is no significant relationship between board meetings on capital structure. It means there is higher number of board meetings in listed companies of KSE than SDR would be lower. All other variables named board size, board meetings, board committees, CEO duality, and internal auditor has positive relationship with capital structure.

In the long-term debt analysis, results shows that there is negative relationship between ROA, CEO duality and long-term debt. Rest of the variables which are taken in this study to find out the results named board committee, and internal auditor has positive correlated with capital structure.

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