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Faith, Finance, and Financial Reporting: Shariah Governance and Earnings Management in Pakistan

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Abstract
This study investigates whether Shariah governance reduces earnings management more effectively than traditional corporate governance in Pakistan's banking sector. Using a panel dataset of 60 firm-year observations from six banks (2016-2025), the research employs descriptive statistics, mean difference tests, correlation analysis, and pooled OLS regression. Findings reveal that Islamic banks differ significantly from conventional banks in governance features, particularly board size and public shareholding. However, earnings volatility—proxying earnings management—shows no significant difference between banking models. Board size positively and significantly affects earnings outcomes ($\beta = 0.441$, $p = .001$), while Shariah identity shows a significant negative coefficient in profitability models ($\beta = -1.217$, $p = .001$). Yet, Shariah governance does not substantially explain earnings volatility, indicating limited evidence of its superiority in constraining earnings management. The study highlights the importance of board composition and ownership characteristics over religious governance alone in affecting financial reporting outcomes.

Keywords: Islamic banks, corporate governance, earnings management, Shariah governance,

1. Introduction

In the recent years, earnings management has been a subject of great discussion in the financial literature especially after the large-scale corporate scandals and banking failures, both in the country and abroad. The failure of Bank of Credit and Commerce International (BCCI) and banking crises in general exposed the impact of manipulating financial statements on investor decisions that could be harmful to institutions and ultimately cause their collapse. Earnings management is often called "The Numbers Game" by Levitt (1998), and is defined as the manipulation, by managers, of earnings within the framework of Generally Accepted Accounting Principles (GAAP) for their

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own benefit. Such opportunism skews the institutions' real financial results, leading to understated and opaque financial accounts, and undermining confidence in the financial system among stakeholders.

To overcome this problem, corporate governance is required in conventional as well as Islamic banking. Governance provides a set of rules, policies and guidelines to guide banks. It protects client deposits, promotes honesty, transparency and trust in the financial system. Corporate governance also lowers the opportunity to commit to earnings management by creating internal controls, oversight bodies and monitoring mechanisms that curtail management discretion and limit the scope for opportunistic financial reporting (Mindaye et al., 2024). If banks lack a strong governance framework, their assets can be misused, they can take excessive risks or they can collapse, all of which would have a negative impact on the economy and livelihoods.

Background: Pakistan's Dual Banking System

The Pakistan banking system is a dual banking system comprising of conventional banks and Islamic banks. Islamic banks have added an extra layer, called Shariah governance, which involves Shariah supervisory boards, whose role is to ensure compliance with Islamic standards, and conventional banks use conventional corporate governance techniques. The principles outlined in these guidelines, which could help limit the scope for earnings manipulation, focus on good business practice, transparency and the prohibition of exploiting or dishonest business practices (State Bank of Pakistan, 2018).

It is fair to say that the effectiveness of the corporate governance systems in the Pakistani banking industry cannot be appreciated without taking into consideration the overall economy. Hanif et al. (2025) showed that there was a dynamic relationship between economic and monetary variables in Pakistan and macroeconomic factors had a significant impact on the performance of financial sector and effectiveness of financial institutions. The result confirms that the broader economic environment could have an impact on the effectiveness of governance in preventing earnings management. The research on Pakistani firms has also revealed several governance aspects affecting the businesses, such as board composition, ownership structure, and regulatory oversight (Hanif & Wahid, 2025).

The banking sector is one of the key pillars of Pakistan's economic development and sustainability and its stability is essential for sustainable economic growth in Pakistan. The presence of monetary policy asymmetry has been found to impact enterprise growth in Pakistan (Buzdar et al., 2022), which implies that macroeconomic factors could have an impact on the effectiveness of governance mechanisms in the control of earnings management in the country. Other institutional factors such as the quality of corporate governance, regulatory enforcement and market discipline also affect the performance of the financial sector (Hanif & Wahid, 2025).

Business organisation and Earnings Management

Corporate governance is a collection of policies, procedures and practices that regulate the conduct of businesses. It plays a key role in minimizing earnings management, the process of managing financial reporting to produce desired results. In agency theory (Jensen & Meckling, 1976), managers might not have the shareholders' interests in mind and may engage in opportunistic earnings management. The efficient governance procedures, which involve independent boards, audit committees and ownership monitoring, help to minimize such conflicts.

The failures in corporate governance have been associated with several negative consequences in Pakistan such as financial distress, market exit (Hanif & Wahid, 2025). This underscores the need to be aware of the potential impact of governance systems, such as Shariah governance, on the quality of financial reporting and the stability of financial institutions. The quality of corporate governance mechanisms was found to be a significant factor affecting the financial reporting standards, as higher quality of corporate governance mechanisms was associated with a lower level of earnings management (Iqbal et al., 2016).

According to agency theory, it is more appropriate to have a smaller board because it will help to reduce agency monitoring costs and facilitate the coordination and communication of the board members (Kaaroud et al., 2020). But larger boards are believed to be better at oversight, given that they do not have as much control of management. Also, they require greater assurance on the accuracy of the financial reporting, leading to increased audit fees. This positive correlation was confirmed in recent research (Drogalas et al., 2021; Farooq et al., 2018; Kalia et al., 2023; Shakhatreh & Alsmadi, 2021; Idzniah & Bernawati, 2020).

Shariah Governance and Its Potential Role:

In addition to the normal governance, religious procedures, and ethical checks, Shariah governance is an additional governance mechanism. This additional layer of legal and ethical constraints on managerial behaviour is expected to improve the quality of financial reporting. Opportunistic behaviour in Islamic banks (IBs) is negatively associated with effective shariah governance arrangements, including independent shariah boards and internal compliance processes; and shariah governance arrangements are positively associated with accounting quality in IBs (Jamal, 2025).

A number of recent studies has explored the question of whether there are alternate financial reporting outcomes associated with Islamic banking's use of Shariah compliant governance structures versus conventional banking's. Islamic banks have added more layers of governance mechanisms that focus on ethical practices, transparency, and ethics and avoid unethical and dishonest business practices (State Bank of Pakistan, 2018). Due to the principles that have been adopted based on Islamic teachings, it is possible that earnings management will be less likely to occur under these principles, both from a legal and ethical perspective on managerial behavior.

There are also institutional issues beyond the scope of traditional governance influencing the performance of the banking sector. Research on Pakistani financial institutions has explored various aspects of banking operations and their implications for financial stability and economic growth (Paghunda Ahmed Khan et al., 2025). The use of digital banking and inclusion measures has revolutionized the banking sector and could affect the way that governance mechanisms work in a banking system.

The Pakistani Banking Context

The banking sector in Pakistan has witnessed a remarkable change in the last ten years, as both conventional and Islamic banks have grown and extended their

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services. SBP has taken various steps to improve the quality of financial reporting and to improve corporate governance. However, policy measures such as the National Financial Inclusion Strategy have spurred banks to increase their services to those not served, which may have an impact on their governance practices and financial reporting behaviours.

The macroeconomic factors still influence the performance of the banking sector in Pakistan. Hanif et al. (2025) noted the interaction and mutual dependence of the economic and monetary variables and emphasized the importance of the impact of monetary policy and macroeconomic stability on the financial sector. This context is especially important in examining the effectiveness of governance across banking models, as economic conditions can either strengthen or weaken the ability of governance mechanisms to be effective.

In addition, recent research studies have investigated different aspects of Pakistan's financial system, such as the adoption and effect of digital banking on financial inclusion (Khushbakhtar et al., 2026; Paghunda Ahmed Khan et al., 2025), remittances and economic growth (Khan & Adnan, 2026), and the link between economic variables and financial performance (Hanif et al., 2025). All these studies underscored the complexity of the financial landscape in Pakistan and the need for context-specific analysis to appreciate the effectiveness of governance.

Problem Statement

Earning management happens over and over in banking because it may mislead a banking institution's actual financial performance and can reduce the exactness and transparency of financial reporting. Managers might make accounting estimates, accounting provisions and accounting disclosures to obtain the desired financial outcome. This practice can mislead investors, regulators and other stakeholders. Such actions erode stakeholders' trust in financial reporting and promote information asymmetry. Good governance systems are crucial to minimize opportunistic management and enhance financial reporting quality (Abdelsalam et al., 2022).

Pakistan has adopted several corporate governance practices within financial institutions, such as Audit committees, regulatory oversight, and board monitoring to boost transparency and accountability. However, in spite of the governance structures, there is still earnings management. Iqbal, Zhang and Jebran (2016) found that there is a relationship between the quality of corporate governance and the level of earnings management, meaning that the quality of corporate governance has a significant effect on financial reporting standards.

Therefore, this study's aim is to find out if there is any difference between the Shariah banking industry and the traditional banking industry in terms of how well they are able to minimize earnings management in Pakistan. The study adds something to the literature as it is based on empirical evidence from the unique dual banking system in Pakistan where Islamic banks and conventional banks are governed under the same regulatory framework but have different governing bodies. The findings of this study have significant implications for the regulators, policy makers and banking institutions with respect to whether Shariah governance offers extra advantages in restricting earnings management.

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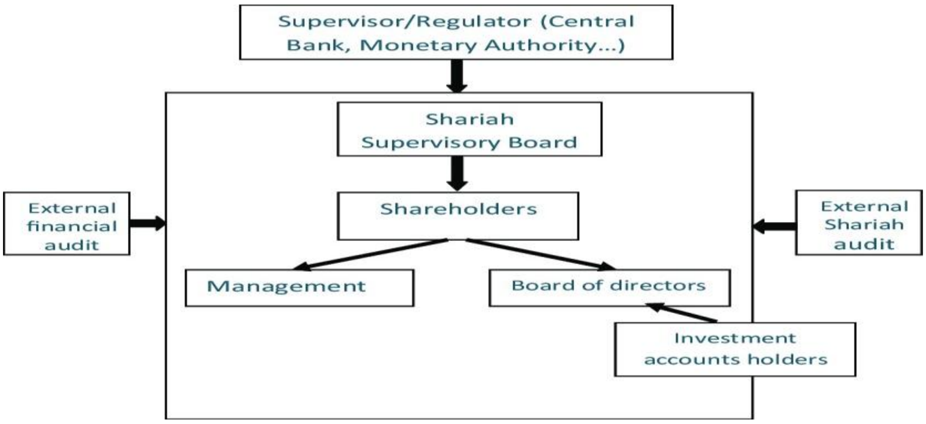

Research Questions

- Does Shariah governance reduce earnings management more effectively than conventional corporate governance in the banking sector of Pakistan?"
- Does Shariah governance strengthen the effectiveness of corporate governance mechanisms in reducing earnings management?
- Does board size affect more earnings management in Islamic in comparison conventional banks in Pakistan?"

Significance of the Study:

This research has several significant contributions in the literature. First, it offers empirical evidence on the relative effectiveness of Shariah governance and conventional corporate governance in Pakistan's dual banking system as a regulator of earnings management. Second, it adds to the scanty literature on Islamic banking accounting and governance in developing country settings. Thirdly, the results are of interest to regulators, policy makers, and banking institutions who would like to improve governance practices and the quality of financial reporting. The study also adds to the growing body of research on corporate governance and earnings management that investigates the consequences of religious governance mechanisms on financial reporting. The evolution of Islamic banking in the world necessitates clarifying whether Islamic banking governance offers any other advantages in addition to conventional banking governance in terms of regulatory design and institutional development. Results of this study can help in designing a specific policy for Islamic banking standards in the field of governance and may help in the current discussion on the effectiveness of religious governance system in financial institutions.

Literature Review:

Earning Management: The Concept and the Laws

Corporate governance refers to a collection of polices, procedures and practice which regulate the operation of businesses. It is important in combating earnings management a practice of managers in manipulation of financial reporting to obtain desired results (Levitt, 1998). Under the agency theory (Jensen & Meckling, 1976), managers can pursue their own agenda in addition to the shareholders' agenda and that may lead to opportunistic earnings management. Proper governance mechanisms such

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as independent boards, audit committees and ownership monitoring are in place to limit such conflicts.

According to agency theory, the smaller board size is suitable because it will reduce the cost of agency monitoring and will provide an effective coordination and communication of the board members (Kaaroud et al., 2020). Larger boards are believed to do a better job of monitoring, however, they are less likely to be "controlled" by management. They also require greater confidence on the reliability of financial statements, leading to higher audit costs. This positive correlation is confirmed by the research in recent years (Drogalas et al., 2021; Farooq et al., 2018; Kalia et al., 2023; Shakhatreh & Alsmadi, 2021; Idzniah & Bernawati, 2020).

Independent directors are more likely not to have any conflict of interest and to be able to give objective checks on managerial decisions. Abdelsalam et al. (2022) have consistently reported that boards with greater independent directors' percentages are negatively related to earnings management. Independent directors are, however, effective only if they are knowledgeable, diligent and operate in an institutional setting.

However, some studies have identified the factors of governance that affect the corporate performance of Pakistani firms such as the composition of the board, ownership structure, and the regulatory supervision (Hanif & Wahid, 2025). The corporate governance failures in Pakistan have been associated with adverse events such as financial distress and market exit (Hanif & Wahid, 2025). This underscores the need to appreciate the various forms of governance, such as Shariah governance, and how these forms can affect the financial reporting quality and stability of institutions. A high quality of corporate governance has been found to have a significant effect on the quality of financial reporting, and it has been shown that an effective governance mechanism is associated with a low level of earnings management (Iqbal et al., 2016).

Shariah governance and earnings management will be discussed:

In Islamic banking, the additional governance layer is via Shariah compliance. Shariah governance is a mechanism for the monitoring and control of Islamic banks to ensure that they are functioning in an Islamic manner (State Bank of Pakistan, 2018). This governance level consists of Shariah Supervisory Boards of Islamic scholars to audit products, transactions and financial reporting to make sure that it is in line with Shariah principles.

Under Shariah governance, managerial behavior is restricted and must not include certain things like interest-based transactions (riba), excessive uncertainty (gharar) or speculative investments (maysir). These principles may reduce the discretion in accounting choices and increase transparency, which make it less possible to engage in earnings management. It was found that the governance structure of Shariah plays a positive relationship with the accounting system quality among Islamic banks and reduces the opportunistic behavior in Islamic banks (Jamal, 2025).

But the empirical findings are inconclusive whether Shariah governance is more effective in reducing earnings management than conventional governance. Others research studies have discovered that Islamic banks demonstrate lower earnings administration because of the moral constraints positioned by Shariah in banking

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(Mollah, 2020). Others, however, have not observed any significant difference in earnings management between Islamic banks and conventional banks; meaning that a conventional governance mechanism is equally effective (Lassoued et al., 2018; Elnahass et al., 2018).

The overall economic and institutional context also influences effectiveness of governance in the banking sector in Pakistan. Hanif et al. (2025) illustrated the relationship between economic and monetary variables in Pakistan and their dynamic relationship, which shows that the performance of the financial sector and efficiency of the financial institutions are affected by the economic and monetary variables. This implies that the role of governance in mitigating earnings management could be influenced by the general economic environment. Monetary policy asymmetry has been found to have an impact on enterprise growth in Pakistan (Buzdar et al., 2022), suggesting that macroeconomic policies can impact the impact of governance mechanisms on earnings management.

Ownership Structure and Earnings Management

Another important factor that affects earnings management is the ownership structure. Different groups of stakeholders can have different ownership structures, which can impact the interests of managers and shareholders. Managers with substantial ownership interest will have a stronger incentive to take actions that will benefit the external shareholders of the firm, which will limit the opportunistic action of earning management.

Theoretical Framework:

Agency Theory: The Foundational Framework

Theoretically, the main theory that is used in this study is Agency Theory. The theory was first formulated by Jensen and Meckling (1976) and deals with the fundamental conflicts of interest which arise in modern corporations in which ownership is divorced from control. Agency theory states that managers (agents) are employed by shareholders (principals) for the benefit of the shareholders. But managers are driven by their own self-interest and lack of information, which may lead them to act in ways that are not in the best interests of the shareholders. The agency theory is that the managers have more information regarding the operations, finances, and future prospects of the firm compared to the shareholders. The information asymmetry allows managers to engage in opportunistic behaviour, which in turn may involve earnings management, in order to pursue their own personal goals, such as performance-based bonuses, job security, and reputation building (Kathleen M. Eisenhardt, 1989; Jensen & Meckling, 1976). Earnings management is in fact one of the classic examples of agency problems in corporate settings, where financial statements are manipulated within the acceptable boundaries of accounting principles to achieve the desired results.

According to the theory there are three main agency costs: monitoring costs (the cost of managing managerial behaviour), bonding costs (the cost of making managerial interests align with shareholders' interests), and the residual loss (the cost of aligning managerial decisions with optimal shareholder decisions). These agency costs are addressed in the development of corporate governance structures such as the composition of the board of directors, who holds the majority of the control rights, and

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the enforcement of regulatory standards. Agency problems are especially severe in the banking industry because of multiple issues. Firstly, banks are highly leveraged, and this leads to conflicts between shareholders who want to invest in risky ventures and the depositors who want to play it safe. Second, banks' business models are complicated and opaque, and stakeholders have difficulties enough monitoring managerial behavior. Third, the systemicity of banks can have economy-wide implications because of governance failures.

Board Governance and Agency Theory:

The agency theory approach sees the board of directors as an important monitoring device, designed to act in the interests of shareholders. Some of the key functions of the board are to review financial statements, approve large scale decisions, assess management performance and monitor compliance with regulatory requirements. Effective monitoring of the board by others will limit the opportunities for earnings management because it will lead to a board that will be more transparent in financial reporting and less subject to managerial discretion (Kaaroud et al., 2020). The size of the board is an important governance attribute when considering earnings management. The agency theory provides a rationale for having smaller boards as more efficient in monitoring, as it lowers the costs of coordination and communication. Larger boards may offer a more varied mix of skill sets, a more independent management team, and more extensive oversight, however (Drogalas et al., 2021; Farooq et al., 2018). The studies that have been conducted among Pakistani companies have revealed a number of governance elements affecting company performance, like board composition and ownership structure (Hanif & Wahid, 2025), which highlights the importance of agency theory in Pakistan. Ownership Structure and Agency Theory, which are discussed.

Ownership Structure and Agency Theory:

Another key aspect of agency theory is ownership structure. Ownership structure has an impact on the congruence between managers' and shareholders' interests. Managers' interests are more closely tied to the outside shareholders' interests when they have a large ownership stake in the firm, which decreases the motive for opportunistic behavior, like earnings management. However, having the ownership spread widely can give managers greater flexibility to pursue their own goals. The importance of public shareholding (also known as external ownership) in regards to governance effectiveness. The increase in public shareholding might improve the discipline of the markets and raise the pressure on managerial choices. Yet there are also collective action problems arising from that form of ownership where individuals shareholder may not have sufficient incentive to monitor the managerial activities. Directors' shareholding, on the other hand, ensures alignment of directors' interests with shareholders' interests which may decrease the motivation for earnings management (Hanif & Wahid, 2025).

Extending Agency Theory: Shariah Governance

Shariah Governance Islamic banking is an extra layer of governance due to its Shariah compliance and could be conceptualized from an agency theory perspective. However, in Islamic banks the principal agent relationship is complicated with the demand of Shariah compliance, which makes the managers liable to both the shareholders and Shariah Supervisory Board, a situation that creates a “dual agency” problem. The Shariah Supervisory Board monitors adherence to Islamic principles and may limit the managerial opportunism to a greater extent than is possible through regular governance arrangements. Shariah governance puts ethical restrictions on managerial actions, bans some practices (e.g. allowing transactions based on interest) and mandates others (e.g. sharing profits and risks). Such principles can help narrow the window of accounting opportunity and improve transparency, which may help mitigate the opportunity for earnings management. According to research, there is a positive relationship between good shariah governance and accounting practices for Islamic banks and better reduction in opportunistic behaviour (Jamal, 2025). Agency relationship in the banking sector is also determined by the general economic and institutional setting in Pakistan. Hanif et al. (2025) showed that economic and monetary factors are dynamic and worked out in Pakistan, and that the financial sector performance is influenced by macroeconomic factors and the effectiveness of financial institutions.

Hypotheses Development

The literature review and theoretical background, led to the following hypotheses:

H1: There is a negative relationship between board independence and earnings management.

Independent directors monitor with objectivity and decreases managerial opportunism. Boards that have more independent directors are likely to be more effective in reining in earnings management.

H2: The size of the board is significantly related to earnings management.

Bigger boards could offer more effective supervision and control because of the presence of different skills and the lack of management influence. But the size of the board and earnings management might be contingent on the particular institutional surroundings and the nature of the board relations. The findings indicate that shariah governance has a more negative impact on earnings management than conventional governance.

H3: Shariah governance has a stronger negative effect on earnings management compared to conventional governance.

Shariah principles' ethical restriction, as well as the supervision of Shariah Supervisory Boards, should limit the possibilities of earnings management in Islamic banks relative to conventional banks.

H4: There is a negative relationship between the directors' shareholding and the earnings management.

Ownership of a large stake of the bank by the directors makes their interests more closely tie in with that of the shareholders, which decreases the incentive of opportunistic behaviour like earnings management.

H5: There is a strong relationship between public shareholding and earnings management.

Greater public shareholding would improve market discipline and add to the scrutiny of managerial decisions, which could help to limit earnings management.

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H6: The governance variables and Shariah variables can explain earnings management behaviour together.

The existence of both corporate governance mechanisms and Shariah governance practices should account for the differences in earnings management among banks.

Data Methodology

Research Design:

In this study, the quantitative research methodology has been used and secondary data for banks listed on Pakistan Stock Exchange has been collected from annual reports of the banks. A quantitative method was found to be suitable because the study was intended to quantify the characteristics of governance and the financial results numerically and to test pre-established hypotheses with statistical methods. The research used a positivist approach with a philosophy that states that there is objective reality which can be measured by observable and quantifiable indicators. A panel data design was used, as the study spanned 10 years from 2016 to 2025, which is deemed adequate to reflect trends in the earnings management practices and effectiveness of governance between Islamic and conventional banks. The panel nature of the data, where the dimension of cross sections (across banks) interacted with the dimension of time (over years), facilitated better estimation and control of unobserved heterogeneity across banking institutions.

Sample Selection:

A total of six Pakistani commercial banks were chosen and categorized into two groups based on the governance system. The Shariah-compliant banks were Meezan Bank, Faysal Bank and BankIslami Pakistan Limited while the conventional banks were Bank Alfalah, Allied Bank Limited and United Bank Limited. The choice of banks was made to ensure that both groups of banks were of similar size, market exposure, and regulatory climate, which allowed them to be compared in the context of governance models. The reasons for selecting these banks were that they are the biggest and oldest banks in Pakistan's dual banking system, and there was sufficient data to be analysed for the study period. The number of the firm-year observations in the final sample (60 firm-years (6 banks × 10 years) is adequate for panel data analysis and gives the required level of statistical power to investigate meaningful relationships between firm-years and the variables of interest.

Data Sources:

Financial and governance information were gathered from publicly available annual reports of individual banks on their websites and Pakistan Stock Exchange. Annual reports were deemed to be the most useful and complete source of information on financial and governance matters, since they are subject to external auditing and regulatory oversight. The State Bank of Pakistan's Shariah Governance Framework (2018) was referred to to gain insight into regulatory requirements for Islamic banks, and to identify the relevant governance variables. Careful extraction of financial data, governance characteristics, and ownership data from the annual reports of each bank for each year of the study period were fundamental to data collection. This data was

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then assembled into a balanced panel data set, which was consistent and complete for all observations. A variable is a quantity that changes.

Variable Definitions and Measurement:

A variable is a quantity that varies. The dependent variable in this study is earnings management, which was proxied using an earnings-volatility indicator. The earnings volatility was assessed by using an absolute measure of the growth in earnings, which was derived from the annual net profit. This method is based on previous studies that have relied on earnings volatility as a proxy for earnings management because greater earnings volatility could be indicative of greater financial reporting discretion. Some governance attributes were used as independent variables. The Board Size variable was defined as the number of directors on the board, which is consistent with the agency theory literature that explores the link between board composition and the financial performance of a company. A dummy variable was created for the CEO, coded 1 if the CEO was also the Chairman and 0 if he/she was not also Chairman. Shariah Governance was introduced by taking the dummy variable of Islamic banks (dummy for Meezan Bank, Faysal Bank and Bank Islami) and conventional banks (dummy for Bank Alfalah, Allied Bank and United Bank) as 1 and 0 respectively. Public Shareholding was defined as the percentage of shares held by the public and Directors' Shareholding as the percentage of shares held by the directors. To account for temporal effects a Year Trend variable was added ranging from 1 (for 2016) to 10 (for 2025). Due to skewness in the data, Net Profit (in PKR billion) and its natural log (Ln Net Profit) were used to measure profitability.

Analytical Framework

An extensive set of statistical techniques were used for data analysis. In order to describe the sample, all variables were subjected to descriptive statistics (mean, standard deviation, minimum and maximum). Independent samples t-tests were used to determine differences in means between the Islamic and conventional banks on important governance and financial variables to determine if significant differences existed between the two banking models. Pearson correlation analysis was carried out to check the bivariate relationships between the variables to detect any possible relationship and multicollinearity problems. Pooled Ordinary Least Squares (OLS) regression was used to estimate the relationship between the governance variables and the earnings outcomes.

Two regression models were estimated: Model 1 examined the determinants of Ln Net Profit, while Model 2 examined the determinants of the earnings-volatility proxy. The general form of the regression models was:

$$Y_{it} = \beta_0 + \beta_1(\text{Board Size})_{it} + \beta_2(\text{Shariah Dummy})_{it} + \beta_3(\text{Public Shares})_{it} + \beta_4(\text{Directors' Shares})_{it} + \beta_5(\text{Year Trend})_{it} + \varepsilon_{it}$$

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Results:

Table 1

Descriptive Statistics

Variable	N	Mean	SD	Minimum	Maximum
Net Profit (PKR billion)	60	22.44	26.41	0.24	130.02
Ln Net Profit	60	23.10	1.45	19.28	25.59
Board Size	60	9.10	1.23	7.00	11.00
CEO Duality	60	1.00	0.00	1.00	1.00
Shariah Dummy	60	0.50	0.50	0.00	1.00
Public Shares (%)	60	9.46	6.37	2.90	33.27
Directors' Shares (%)	60	6.24	8.69	0.00	27.97

Interpretation: The dataset includes 60 firm-year observations from six banks. CEO duality has no variation because all observations are coded as 1, so it cannot be used in regression analysis.

Table 2

Shariah vs Conventional Banks: Mean Difference Test

Variable	Shariah Mean	Conventional Mean	t-value	p-value	Result
Net Profit (PKR billion)	18.39	26.49	-1.19	.238	Insignificant
Ln Net Profit	22.74	23.46	-1.96	.054	Weak difference
Board Size	9.70	8.50	4.30	.000**	Significant
Public Shares (%)	12.02	6.90	3.38	.002**	Significant
Directors' Shares (%)	5.08	7.39	-1.03	.308	Insignificant
Profit Growth (%)	69.36	275.08	-0.88	.386	Insignificant
Absolute Profit Growth Proxy	0.90	2.82	-0.82	.419	Insignificant

Interpretation: Shariah banks have significantly larger board size and higher public shareholding. However, there is no statistically significant difference in average net profit or earnings-volatility proxy between Shariah and conventional banks.

Table 3

Correlation with Ln Net Profit

Variable	r	p-value	Result

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Board Size	.263	.043*	Significant positive
Shariah Dummy	-.250	.054	Weak negative
Public Shares (%)	-.381	.003**	Significant negative
Directors' Shares (%)	-.193	.140	Insignificant
Year Trend	.623	.000**	Significant positive

Interpretation: Net profit is positively related to board size and year trend, while public shareholding has a significant negative relationship with earnings outcome.

Table 4
Pooled OLS Regression Results
Dependent variable: Ln Net Profit
Robust HC3 standard errors used.

Predictor	**B**	**Robust t**	**p-value**	**Result**
Constant	18.640	16.40	.000**	Significant
Board Size	0.441	3.68	.001**	Significant positive
Shariah Bank Dummy	-1.217	-3.58	.001**	Significant negative
Public Shares (%)	-0.017	-0.72	.473	Insignificant
Directors' Shares (%)	-0.024	-2.18	.034*	Significant negative
Year Trend	0.304	5.43	.000**	Significant positive

Model summary:

Statistic	**Value**
R^2	.638
Adjusted R^2	.604
F-statistic	19.01
Prob. F-statistic	.000**
Observations	60

Interpretation: Board size has a positive and significant effect on earnings outcome, while Shariah identity and directors' shareholding show negative significant effects in the model. The year trend is positive and significant, showing that earnings increased over time.

Table 5
Earnings-Volatility Proxy Regression
Dependent variable: Absolute profit growth proxy

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Predictor	B	Robust t	p-value	Result
Constant	7.486	1.32	.192	Insignificant
Board Size	-0.151	-0.28	.780	Insignificant
Shariah Bank Dummy	-1.336	-0.47	.639	Insignificant
Public Shares (%)	-0.094	-0.95	.349	Insignificant
Directors' Shares (%)	-0.021	-0.30	.764	Insignificant
Year Trend	-0.516	-0.95	.348	Insignificant

Model summary:

Statistic	Value
R^2	.042
Adjusted R^2	-.058
F-statistic	0.42
Prob. F-statistic	.835
Observations	54

Interpretation: Governance and Shariah variables do not significantly explain the earnings-volatility proxy. This means the available data does not provide strong evidence that these variables affect earnings-management-related behaviour.

Table 6

Multicollinearity Test

Variable	VIF	Result
Board Size	6.22	Moderate multicollinearity
Shariah Dummy	2.88	No serious issue
Public Shares (%)	4.65	Acceptable
Directors' Shares (%)	1.98	No serious issue
Year Trend	3.56	No serious issue

Interpretation: Board size has moderate multicollinearity, but the remaining variables are within acceptable limits.

Table 7

Diagnostic Tests for Main Regression

Test	Statistic	p-value	Result

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Jarque-Bera Normality	111.19	.000**	Residuals not normal
Breusch-Pagan Test	6.89	.229	No heteroskedasticity
Durbin-Watson	1.36	—	Possible positive autocorrelation
Breusch-Godfrey Test	5.47	.019*	Autocorrelation issue
Ramsey RESET	1.49	.228	Specification acceptable

Interpretation: The model has no heteroskedasticity and no specification issue, but residual normality and autocorrelation are concerns. Therefore, results should be reported with caution and robust standard errors.

Table 8

Hypothesis Testing Summary

Hypothesis	Statement	Decision
H1	Shariah/religious orientation significantly affects earnings outcome	Supported
H2	Board size significantly affects earnings outcome	Supported
H3	CEO duality significantly affects earnings outcome	Not tested because CEO duality is constant
H4	Public shareholding significantly affects earnings outcome	Not supported
H5	Directors' shareholding significantly affects earnings outcome	Supported
H6	Governance/religion variables explain earnings-volatility proxy	Not supported

The results show that religion and corporate governance characteristics have mixed effects on the earnings outcome of selected Pakistani banks. The descriptive results indicate that Shariah banks have larger boards and higher public shareholding than conventional banks. The mean difference test shows that board size and public shareholding differ significantly between Shariah and conventional banks, while net profit and directors' shareholding do not show significant group differences.

Correlation analysis shows that board size is positively associated with earnings outcome, while public shareholding is negatively associated with earnings outcome. The pooled OLS regression results further indicate that board size has a positive and significant impact on Ln Net Profit. Shariah bank identity has a significant negative coefficient, while directors' shareholding also shows a significant negative effect. Public shareholding is statistically insignificant in the regression model. The year trend is positive and significant, indicating that earnings increased over the study period.

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Results and Discussion

The study investigated the effectiveness of Shariah governance in Pakistan's banking sector in minimizing earnings management compared to the traditional corporate governance. The study used 60 observations of firm-year data from six banks over the period 2016–25. The results suggest inconclusive evidence on the effectiveness of Shariah governance in restraining earnings management activities relative to the conventional corporate governance.

The descriptive statistics showed that there was a wide range of profitability within the sample banks. Average net profit was PKR 22.44 billion, and the standard deviation (SD = 26.41) was high, which showed that there existed high heterogeneity in bank performance. The average size of the board was about nine, as required by the regulations for Pakistani banks. This variable was also not found to be varied (all observations were coded to 1), implying that CEOs of Pakistani banks are usually the chairmen of the boards. This is an interesting result, since it indicates that the separation of the CEO and Chairman functions – which is widely regarded as a good governance practice – does not happen in the sample banks.

The mean difference analysis revealed significant differences between Islamic and conventional banks in terms of board size and public shareholding. Islamic banks had significantly larger boards ($M = 9.70$ vs 8.50, $p < .001$) and higher public shareholding ($M = 12.02\%$ vs 6.90%, $p = .002$). This implies that Islamic banks can move towards more inclusive governance models with a wider representation of stakeholders. The discovery is in tandem with the principles of the Shariah governance, which has a focus on transparency and accountability to several stakeholders. Financial performance, as measured by net profit, and the growth of earnings, as measured by profit growth, were relatively similar across the two banking systems, however, whereas the earnings-volatility proxy, net profit, did not differ significantly. This discovery indicates that despite governance variations, both banking models are able to deliver similar financial results, possibly due to the presence of common regulatory environment and market conditions at the Pakistani banking industry.

The board size was positively correlated with profitability ($r = .263$, $p < .05$) in the correlation analysis, which indicates that larger boards may have greater oversight and monitoring. The results are in line with the work of Drogalas et al. (2021) and Farooq et al. (2018) which found that larger boards provide better oversight and monitoring. There was a significant negative correlation between public shareholding and profitability ($r = -.381$, $p < .01$), which may suggest that the implications of public ownership are different from banks with higher public ownership. The Shariah dummy variable had shown a weak negative correlation with earnings ($r = -.250$, $p = .054$), suggesting that Islamic banks had slightly lower levels of profitability than conventional banks. This is not at odds with previous studies that indicated that Islamic banks could have a different business model or risk profile, which in turn can impact the profitability of the Islamic banks (Mollah, 2020).

The pooled OLS regression analysis indicated that board size was a positive and statistically significant influence on the earnings outcomes ($\beta = 0.441$, $p = .001$). This result aligns with earlier studies (Drogalas et al., 2021; Farooq et al., 2018; Kalia et al.,

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2023) which imply that bigger boards are suspected to provide stronger oversight and monitoring, resulting in improved financial performance. In the agency theory, bigger boards of directors can offer greater variety of expertise, more independence from management, and more full oversight (Jensen & Meckling, 1976). In Pakistan's banking context, the positive correlation between board size and profitability indicates that the advantages of improved monitoring are greater than the cost of coordination of larger boards.

Once other factors were controlled for, the Shariah bank dummy had a significant negative coefficient ($\beta = -1.217$, $p = .001$) indicating that Islamic banks' earnings outcomes were poorer than conventional banks. This discovery corroborates the study of Mollah (2020), which discovered that Islamic banks' governance constructions can result in varied performances. The negative link among Shariah identity and profitability could be due to the constraints of operating under the Shariah compliance such as the restrictions on interest-bearing transactions, investment activities and other constraints that could restrict the opportunities for revenue generation. It could also be due to the fact that Islamic banks have a relatively less size in the banking industry, impacting their profitability.

The finding of the negative effect of the direct ownership of shares in the bank by directors ($\beta = -0.024$, $p = .034$) indicates that when the proportion of share ownership by the directors in the bank is higher, the directors are probably more conservative in reporting bank earnings or are more concerned about long-term stability than short-term profits. This is in line with agency theory, which argues that the interests of a director and shareholders are aligned, thus decreasing the incentives to engage in opportunistic behaviour like earnings management (Jensen & Meckling, 1976). However, the results indicated that there was no statistical significant relationship between public shareholding and profitability of the sample companies, possibly because the percentage of public shareholding in the sample companies was not high, with the average being 9.46%. The year trend variable was highly significant and positive ($\beta = 0.304$, $p < .001$), which implied that the overall profitability of banks during the study period increased, likely due to the overall economic growth or better performance of the banking sector in Pakistan (Hanif et al., 2025).

A proxy regression for earnings volatility was constructed to analyse the behaviour related to earnings management. The results indicated that all the governance proxies, including the Shariah governance proxy, were not significant in explaining the variations in earnings volatility. The model's very low R^2 (0.042) suggests that the governance features did not have a significant impact on the selected earnings management measure. This insignificance could be due to the difficulty of using earnings volatility as an indicator of earnings management because a number of other factors may cause volatility in earnings. The small difference between earnings volatility of Islamic and conventional banks could be due to the overall economic climate in which these banking models operate as a whole. Hanif et al. (2025) found that macroeconomic conditions have a significant impact on financial sector performance in Pakistan that can outpace governance-related impacts. Moreover, if no significant findings are generated, it could be an indication that both banking systems

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have effective governance mechanisms in place, or that earnings management practices are comparable in both banking systems because the State Bank of Pakistan regulates both.

Conclusion

This study investigates if the Shariah governance in banking industry is more effective in minimizing earnings management than traditional corporate governance in Pakistan. The results provide limited evidence in support of Shariah governance's superiority in limiting earnings management.

The findings showed the presence of differences between Islamic banks and conventional banks regarding governance features particularly the number of banks' board and public shareholding. There were no differences, however, in regards to the earnings volatility, which was used to measure behaviour associated with earnings management, between the two banking models. When the Shariah bank variable was also included in the earnings-volatility model, it did not seem to have an effect on that model despite it being statistically significant in the profitability model. The study does not support the argument that the Shariah governance has a more effective reduction of earnings management than the traditional corporate governance.

Among the governance factors examined, it was determined that the number of board members is the most important factor affecting the earning outcome of the company, indicating that the larger the board, the more effectively it monitors the company and the better it will perform. This discovery highlights the role of the composition of the board in financial reporting results. The negative significant effect of director's control of shares suggests that director's ownership can be used as a good monitoring tool to motivate the interest of the management towards the interest of the shareholders. Neither public shareholding had any clear influence over the earnings of the companies.

According to the study, overall, it could be stated that the effect of Shariah governance on bank performance might exist but there was not enough evidence that suggests that the governance nature of sharia would better lead to less earnings management than the conventional corporate governance. The findings support the studies of Mollah (2020) and Hanif et al. (2025) which reported that the effectiveness of governance varies by banking models and that macroeconomic context plays a crucial role in determining the outcomes of the financial sector. The study emphasizes the value of other ownership features and board composition for the outcomes of financial reporting, which can be more significant factors in determining earnings management than the presence of Shariah governance.

In Pakistan, further research is needed using more advanced earnings management indicators (e.g., discretionary accruals), larger sample sizes, and other governance indicators for a more effective assessment of how efficient is the Shariah governance in Pakistan's banking sector. Longitudinal studies could analyse the changes in governance effectiveness over time, and comparative studies across countries could reveal contextual factors that influence governance outcomes. Furthermore, research should examine whether certain Shariah governance mechanisms (e.g., Shariah audit quality, independence of Shariah boards, or internal

Shariah control processes) are more effective in mitigating earnings management, rather than just the presence of Shariah governance.

The results have policy implications for regulators and policymakers in Pakistan. Absence of significant differences between earnings management of Islamic and conventional banks indicate that both the governance models have proven to be equally effective in controlling opportunistic behavior. The significance of board size and directors' shareholding highlights the importance of ownership composition and board characteristics in influencing financial reporting quality. To enhance transparency and minimise earnings management, the State Bank of Pakistan could consider implementing more stringent board monitoring norms, increase the accountability of bank directors and increase the public holding in banks. Secondly, the regulatory framework should continue to highlight the role of Shariah governance in Islamic banks and the importance of the independence, qualification and effectiveness of Shariah Supervisory Boards over Islamic banks. The results further indicate that the macro-economic environment, such as monetary policy, and macro-economic stability (Hanif et al., 2025) are key factors affecting financial outcomes and should be taken into account when designing interventions on governance.

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