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Do managers of sharia-compliant firms have distinctive financial styles?

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ABSTRACT

Financial markets are experiencing the growing success of Islamic finance, which follows a unique form of investment related to Muslim values (i.e. limitation of interest bearing loan) regarding socially responsible investing. In this study, we examine the role of top managers in financial decisions at sharia-compliant firms in Pakistan and the UK. For each firm in the sample, a manager-firm matched panel has been constructed to identify the top managers across the sharia compliant firms over the time. After accounting for the observable and unobservable heterogeneity, we identify the observable differences in firms' financing decisions that are attributable to managers' fixed effects. We also examine the difference in the styles among managers who move between firms that are sharia-compliant and those that are not sharia-compliant. Results of the study show that the managers exert significantly important influence over leveraging, the dividend policy, and working capital decisions. The decisions of managers who come from non-sharia-compliant firms are significantly different from those who come from sharia-compliant firms. Moreover, the policies regarding leveraging, dividend payouts, and working capital at sharia-compliant firms differ significantly from those at non-sharia-compliant firms. Furthermore, discriminating the differences between the importance of managerial financial styles of top officials in sharia and non-sharia companies helps managers make strategic plans in terms of their financial decisions.

1. Introduction

The question of whether top managers influence financial decisions at a firm has been a topic of much debate in the literature (Rotemberg and Saloner, 2000; Van den Steen, 2004). The most prominent view is that top managers are a very important ingredient in corporate practices and policies. Some studies also confirm that differences in managers' idiosyncratic styles are reflected in cross-sectional differences in capital structure and dividend payout decisions. Several studies (Bamber et al., 2010; Bertrand and Schoar, 2003; Dyreng et al., 2010; Frank and Goyal, 2007) explore the influence of managers' style on various corporate polices—such as investing and financing, corporate leverage, voluntary corporate disclosure,

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and corporate tax avoidance—and find that managers' styles play a significant role in these policies. Questions concerning managers' financial styles have subsequently sparked considerable debate among researchers (see, e.g., Fee et al., 2011). According to Bertrand and Schoar (2003), top executives are the key ingredient in the determination of corporate policy and play a significant role in company performance, financing, investing, and operating decisions.

These studies are, however, limited in scope with respect to geographic and economic context, subject matter, and the nature of business conduct. For example, studies are conducted only for developed countries (a limitation with respect to geographic and economic context). The economy in developing countries differs substantially from that in developed countries in terms of political stability, law and order, technological development, the use of information technology, financial structure, income level, and education, and so on. Therefore, the validation of an economic and financial concept demands its testing in different geographic and economic contexts. Further, the existing literature on managers' financial styles ignores the managers' impact on dividend policy and working capital decisions (a limitation with respect to subject matter). Since managers influence other areas of decision making in finance, it can be logically inferred that they also affect dividend and working capital policies.

Moreover, the current literature on managers' effects does not account for the philosophy under which business is conducted (a limitation with respect to the nature of business conduct). For example, (sharia-compliant) SC and (non-sharia-compliant) NSC firms operate under different sets of principles and rules. These different business philosophies may have an important bearing on managers' styles; this aspect has been neglected in the literature on managers' styles.

Over the past few years, there has been an increasing trend toward investment in SC financial products. For example, the market for SC financial products in the UK grew at about 15–20% in the past two years specifically, 2012. According to a recent report, SC assets worldwide are worth US$2 trillion (TheCityUK, 2013).[1] The distinction between sharia- and NSC business is whether Islamic law should be the source of decisions that firms make and whether in the event of a conflict between the two, Islamic law should take precedence over the usual economic rationale. Islamic finance, which follows a unique form of investment based on Muslim values regarding socially responsible investing, has had growing success on financial markets. However, according to Fox (2004) socially responsible investment incorporates the concept of social and environmental concerns, whereas SC equities must follow Islamic laws and rules.

The principles of Islamic finance originate in sharia, Islamic law, which is based on *hadith*/*sunnah* (saying attributed to Prophet PBUH) of the Prophet Muhammad (Prophet Peace Be upon Him) and the Quran, which directs all aspects of personal and social life for Muslims. One unique element of Islamic finance is that it prohibits interest, whether it is nominal or excessive, simple or compound, fixed or floating. To obey the rules of sharia, investments must not involve interest (*riba*). Islamic finance has a strong financial and institutional network all over the world. There is now a Dow Jones Islamic Index, which tracks almost 600 companies.[2]

According to Robinson (2007), world financial markets have experienced extraordinary growth in Islamic finance since 9/11. Islamic finance is considered the main feature of any decision made by SC firms. A majority of reluctant Muslim investors have started to invest in the stock market because of greater emphasis on religion (Omran and Pointon, 2004). Previously, Muslim investors considered investment in a stock market a form of gambling and tried to avoid investing in it. We believe that these sharia-conscious or religious investors constitute important clientele for SC firms. Most of these investors use mutual funds and other institutional investors to invest their capital in SC assets. We argue that these new clientele of investors act as a monitoring device. Brickley et al. (1988) note that institutional investors, such as mutual funds, are effective monitors. As a result, the governance environment of SC firms is better than that of their NSC counterparts (Farooq and AbdelBari, 2015).

According to Sole (2007), Islamic institutions, which now are present in over 51 countries, have substantially grown over past few years. According to Michael (2007), the Islamic Bank of Britain was created in 2004 as a retail Islamic bank in the UK, and the Bank of London was launched in July 2007. The UK has 21 conventional institutions that provide Islamic financial services for its 1.8 million Muslims.

Two criteria are used to decide whether a firm is sharia compliant: (1) financial ratios and (2) industry or sector screening. According to the financial criterion, firms that are heavily leveraged, with earnings that depend upon excessive interest, are considered noncompliant. According to the criteria of the Dow Jones Islamic Index, firms whose borrowing exceeds one-third of their market capitalization are also noncompliant, as are companies that earn one-third of their income from interest, which is the case for most conventional banks.[3] In case of industry or sector screening, those firms that are unacceptable as SC firms are involved in the brewing, distilling, production, and distribution of alcoholic beverages, the production and distribution of pork, gambling and casino operations, and media companies whose output includes pornography.[4] In this study, we address the research gap in the literature on corporate finance and sharia and examine the impact of managers' styles on

[1] For further details, see Dewandaru et al. (2014).

[2] The Dow Jones Islamic Market Indexes, introduced in 1999, were the first indexes of sharia-compliant firms. Now the listed indexes number more than 70 and are included in Islamic market indicators such as global indexes, regional indexes, individual countries, and individual industries. Among all these, the most important are the Dow Jones Islamic Market Titans 100 index, the indicator of the 100 largest companies compatible with the dictates of sharia, the Dow Jones Islamic Index (Dow Jones selection made with Islamic criteria), and the Dow Jones Islamic Market Asia/Pacific Titans 25 Index (the 25 largest companies in Asia and the Pacific). Another important group of indices is the FTSE Global Islamic Index Series, an indicator for those who wish to invest in global equity in line with Islamic laws and rules.

[3] For further details, see Indexes (2009).

[4] For more information, see Wilson (2004).

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