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Impact of Corporate Governance on Return of Equity: Insights from Muscat Securities Market

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Abstract –

Purpose – To investigate and conclude the impact of corporate governance mechanisms namely board size, concentrated ownership, number of audit committees on the return on equity. The paper focuses on companies listed on Muscat Securities Market.

Research Design – Data for forty-five companies across financial, industrial, and service sectors was collected from Capital Market Authority of Oman for a period of ten years (2010-2019). In total there were 450 observations which were then reduce to 45 observations taking average of ten years. STATA was used for data analytics.

Findings/Takeaways – The research discovered that chosen independent variables had a relation with return on equity. This is consistent with much research particularly in the developing and emerging economies. Board size demonstrated a positive relation, however concentrated ownership and number of audit committees demonstrated a negative relation with return on equity. ROE showed positive correlation with board size and number of audit committee meetings and a negative correlation with concentrated ownership.

Contribution/Value – There have been very less studies investigating the impact and relationship of corporate governance on ROE. Further a study across sector is also not evident. This study present valuable insights from Muscat Securities Market and comparing them with other findings from various parts of the world. The intent for the contribution to filed of academics is to provide valuable findings for various stakeholders in understanding what is corporate governance and how they channelize the framework to improve the return on equity.

Paper Classification – Research Based

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1. INTRODUCTION

The word governance from the concept of steering basically meaning the how to manage and move forward in the chosen direction **(Farrar, 2008)**. The concept of corporate governance and its various mechanisms like ownership structure, board traits, and audit committee characteristics and their impact on the performance on the company is a domain which is of interest to many researcher's across the globe **(Puni & Anlesinya, 2020) (Shahwan & Habib, 2020) (Liedong & Rajwani, 2018).**

The concept of business dates to time immemorial, the basic intent to grow wealth. As the time evolved and owing to globalization the need to have framework of policies and procedures was realized. Thanks to corporate governance which is an interwoven and integrated framework where in different stakeholders are engaged with the common goal to ensure protection, growth and sustainability of business **(Steger, 2015).**

In the new age world of digitalization and globalization where in economies are interrelated and interdependent, corporate governance has emerged as the new religion when it comes to governance of business. Investment is no more the luxury of the affluent class; many mid-level and small investors aspire to derive benefits from investing in different businesses. The awareness and respect for

corporate governance is on an exponential growth **(Bansal & Sharma, 2016).**

Necessity is the mother of innovation; the various scams and financial crisis catalyzed the need for more prudent and stringent controls in the business processes and the way business were governed. Specially after the financial crisis of 2008 which saw many big reputed international financial institutions going bankrupt **(Kirkpatrick, 2009)**. Think global act local; the same is true for corporate governance. The framework considers the local conditions and keeps in perspective the social, cultural, and economic aspects of the country the firm operates in. This dynamism equips the organization with a tool which is practical and implements in various parts of the world to serve as an effective mechanism to respond and resolve challenges faced by the particular firm **(Beckers**, **2017)**.

This paper contributes to the research in the realm of corporate governance. Oman introduced the code of corporate governance in 2002, being the first Gulf nation to do so. This paper analyses the key components of corporate governance framework namely ownership structure, board traits, and audit committee characteristics and its impact on the financial performance of forty-five firms across industrial sector, service sectors and financial sector which are listed on the Muscat Securities Market. The period of study is for ten years from 2010 until 2019. A comprehensive study which will aid in evaluating the effectiveness of corporate governance mechanisms.

2. LITERATURE REVIEW

Gaining legitimacy and sustaining the same is the key to success for any organization, also with dynamically changing world it also important that corporation fulfill their responsibility of being a good corporate citizen. Corporate governance does play a critical role in enabling this objective of the organization **(Rendtorff, 2019)**. Reputation of the brand and firm is key driver in ensuring the business is on the path of growth, it is very critical for organizations to ensure there reputation is maintained thanks to corporate governance role in facilitating this **(Salvioni & Gennari, 2019).**

Lastly, accountability is one of the major factors when it comes to shareholders. They feel with various authorities given to the management the executives need to be accountable for whatever happens in the business. The framework of corporate governance aptly covers this core demand of shareholders **(Al Hammadi & Nobanee, 2019)**.

Corporate Governance Systems

The finer modalities in the framework of corporate governance would differ from country to country as consequence of the legal framework and socio-economic environment. Broadly one can classify the systems in two categories. First one is the Anglo Saxon System, this type of system is more prevalent in the developed economies wherein the ownership pattern is more dispersed **(Mueller, 2006)**. Second system is known as the Communitarian System more prevalent in the developing economies and it is more associated where ownership is more concentrated **(Jungmann, 2006).** However there is also another system specifically categorized for the emerging economies like India and China; the key characteristic being board positions held by large shareholders **(Sethi et al., 2006)**.

Performance of Firm and Corporate Governance

CG framework has two dimension internal and external. As the name suggests the internal mechanisms are more in control of the organization and external mechanisms are the one which are dynamic and the firms needs to adapt its process and strategies to the same **(Bushman & Smith, 2001) (Cremers et al., 2005) (Gillan, 2006)**.

Ownership is one of the main internal CG mechanisms, it is one of key component when it come to steering the firms' objectives, vision and strategies adopted to achieve the objectives. A dispersed ownership patter does negatively impact the achievement of business objectives **(Andersson & Maher, 1999)**. Concentrated ownership has been extensively researched in various parts of the world. An extensive research of over five thousand firms over a period of ten years concluded that concentrated ownership gives these owners a much higher say when it come to liquidating their ownerships **(Xuan-Quang & Zhong-Xin, 2013)**. A study of thirty one companies from Tunisia revealed that concentrated ownership performs more of a monitoring role and they have a say in the same **(Halioui & Jerbi, 2012)**. An investigation of companies from Spain revealed that owing to prospects of collusion specially if the concentrated ownership is with banks it can lead to detrimental impact on the firm performance **(Tribo Gine & Martinez, 2010)**. Management is well aware of the controlling powers the concentrated owners have and cannot avoid their queries on different matters sought from management, further management proposals are subjected to close scrutiny of the owners which are often in the form of private meetings **(Cuomo et al., 2016)**. Collective voting rights give the owners an upper edge when it comes to matters specially related to corporate governance and their influencing position is certainly the key component in CG framework **(Laeven & Levine, 2008)**.

Board Size is another internal CG mechanism which basically guides the company direction in terms of its vision and business strategies. The size of board basically is the number of directors on the board, a negative relationship was found when it come to the effect on the return on equity **(Pathan & Faff, 2013).**

A smaller board size was found to be faster when it comes to decision making regarding various strategies of the business, there was less bureaucracy and differences of opinion were almost insignificant. Apart from the quicker decision making it also ensured that c-suite powers were controlled **(Linck et al., 2008).** On the contrary researchers in Australia argued that large number of directors or in other words bigger board size have a positive impact on firm performance. They attributed this to the networking of the directors and believed in business world networking plays an important roles in growth and sustainability of the firm **(Kiel & Nicholson, 2003)**. There is ample research in this area wherein the board size bet fit depends on the type of industry its size and its presence across the globe. One cannot have a predetermined level of number of directors as this entirely depends on the business and the environment the business operates in. Faster decision making and avoidance of conflicts and difference of opinion is the most common researched argument **(Malik et al., 2014).** Other researchers based on their findings have recommended larger board sizes, the basis of their argument is that in todays dynamic business world the board needs to operate with specific committees complementing its role, to aid in various committees it is vital to have more board members with varied skills and expertise so t they can contribute effectively and efficiently as members of the various board committees **(Alfraih, 2016).**

Audit Committees are on of most critical pillar of internal corporate governance framework. They facilitate the board by ensuring a close watch on the business processes and internal controls of the organization. Their main role is to ensure the auditing ecosystem in intact be it for the internal audit or the external audit **(Anderson et al., 2004).** Keeping in mind the monitoring and supervisor role of the audit committees it is of utmost importance that audit committee meets at frequent intervals. These meetings would aid the process more rationally and formally wherein the discussions, observations and non-compliance are recorded, discussed and future preventive and predictive measures are discussed and aligned **(Abbott et al., 2004).** Different researchers have come to a common finding that number of time the audit committee meets matters most given their role wherein they review, monitor and develop policies and procedures for the organization **(Soliman & Ragab, 2014).** It is further argued that meetings should be conducted in compliance to the local regulation as required for the corporate governance framework and should play the role as designed to complement and comfort the board with financial scrutiny of the organization **(Huang & Thiruvadi, 2010) (Mohammad et al., 2016).**

Return on Equity [ROE] is a measure to analyze the effectiveness of equity investment in the asset and measure the returns. It gives the investor a clear idea on what returns are available from after netting off all associated business costs **(Damodaran, 2007).** Though ROE is not a ratio to judge the profitability and understand all aspect impacting the same, however it a great measure for comparison and benchmarking **(Ichsani & Suhardi, 2015).**

Research Gap leading to development of Hypotheses

Much research in corporate governance is evident from the developed countries and in case of emerging markets. Researchers in Gulf countries have just started taking the lead to discover the impact of corporate governance on various aspects of firm performance. In case on Oman there is very limited literature on studying the relationship between specific firm performance variable and different corporate governance mechanism. This paper aims at addressing the same. Three areas of corporate governance are taken as part of the study for this paper:

- Concentrated Ownership
- Board Size
- Number of Audit Committee Meetings

Concentrated Ownership and its impact on ROE: The paper takes 20% or more shareholding as the benchmark for concentrated ownership. The null hypotheses taken is:

Ho1: Concentrated Ownership has no relation to Return on Equity.

Some of the previous research in the same domain from other countries are cited. A positive relation was found in studies conducted in 2000 in case of banks in Germany **(Gorton & Schmid, 2000).** In United Sates of America and Japan (2005) no relation was discovered based on the studies between ownership pattern and ROE (Seifert et al., **2005)**.

Board Size and its impact on ROE: the paper investigates the number of board directors on the board and its influence of ROE. The null hypotheses taken is:

Ho2: Board Size has no relation to Return on Equity.

Some of the previous research in the same domain from other countries are cited. In 2011 in case of Turkish firms it was found that board size has no relation on ROE **(Topak, 2011)**. In case on Lebanese banks in 2011 they found a positive relationship between board size and ROE **(Chahine & Safieddine, 2011)**.

Number of Audit Committee meetings and its impact on ROE- The number of meetings during a calendar year have been taken. The null hypotheses taken is:

Ho3: Number of Audit Committee Meetings has no relation to Return on Equity.

Some of the previous research in the same domain from other countries are cited. In 2016 in case of Indian firms it was found that number of audit committee meetings had no relation to the return on equity (**Bansal & Sharma, 2016**). On the contrary in 2016 postive relation was discovered among the two in case of companies researched in the United Kingdom (**Zábojníková, 2016**).

3. RESEARCH METHODOLOGY

This sections answers what the methodology for this study and the rationale on various components of the research design.

Sample Size – Forty-Five companies from three sectors namely financial, industrial, and service sector have been chosen for this study. The chosen companies are listed on the Muscat Securities Market (MSM). The data is collected for a period of ten years from 2010 until 2019. Ten observations per firm, making it Four Hundred and Fifty observations in total. The source of data was primarily the annual reports and corporate governance of the firms which are available on the MSM portal.

Variables – as part of this study. Three variable categories have been chosen. The same are listed below along with their measurement mechanism.

I. **Dependent Variable-** Return on Equity (ROE) is the dependent variable as part of the study. It is measured as a percentile of net returns that the firm has made in a financial year in relation to the equity capital of the company.

II. **Independent Variables-** Concentrated Ownership (CO) which is measured as the percentile of shareholding of a family or company in the firm. To quantification, a threshold of minimum twenty percent was taken to qualify for a concentrated ownership. The value assigned of statistical computation was One and in case where the concentrated ownership was below twenty percent the value assigned was zero. Board Size (BS) represent the main trait of a board. It is measured as sum of all directors nominated in the board, the total number of directors constitute executive and non-executive directors. Number of audit committee meetings (ACM) the audit committee which is a committee that aids boards is constituted by board members, the number of meetings held in a financial year were taken as the total number of audit committees meeting held.

III. **Control Variables-** As part of this study Four variables have considered which act as control variables. Firm size is one of the critical and important variables, it has two aspects thereby resulting in two variables. First one being (S1) where in the firm size is a consequence of its revenue measured as a natural log of the revenue. Second control variable of firm size (S2) is measured as investment in the total assets of the firm also measured as a natural log value. Age of the firm is another control variable, measured as number of years the firm has existed since its listing on the stock market. Leverage the last variable is measured as the extent to which the firm is leveraged, measured as the percentile of debt in relation to its assets.

IV. **Analysis of Data –** STATA has been used to analyze the data. Various statistical techniques were applied to facilitate findings and arrive at conclusions. OLS regression along with descriptive statistics and other test such as VIF, omitted variables tests have been conducted to ensure data robustness.

4. FINDINGS

To start with the basic descriptive statistics was carried for all forty-five companies including all variables as part of this study.

Table 1: Descriptive Statistics

variable	Obs	Mean	Std. Dev.	Min	Max
roe	45	.1168667	.0657051	.004	.347
bs	45	7.428889	1.41351	5	11
co	45	.8911111	.3117562	0	1
acm	45	4.797778	1.147624	0	7
firms1	45	16.67467	1.89192	9.89	20.13
firms2	45	15.514	2.463682	9.55	19.22
lev	45	.4673333	.2466908	.09	.89
age	45	24.54444	9.27351	8.5	42.5

Key Findings: As evident from the above the above table, the average ROE for 45 companies was at around 11.6%, however the minimum value observed was as low as 0.4% and maximum value being 34.7%. Number of directors constituting the board was between 5 to 11 directors. Close to 90% of the companies showed a concentrated ownership indicating alignment with Anglo Saxon corporate governance system where in the shareholding patters are not widely dispersed. It was inferred around 5 audit committees were held on an average by the companies as against a minimum legally compliance of 4 meetings one each quarter. On an average the age that is number of years the companies have been listed on the securities market was around 24 plus years. The average leverage of firms stood at around 46%.

Table 2: Influence of Board Size along with Control Variables on ROE

. regress roe bs firms1 firms2 lev age

Source	SS	df	MS
Model	.058813078	5	.011762616
Residual	.131142123	39	.003362619
Total	.189955202	44	.004317164

Statistic	Value
Number of obs =	45
F(5, 39) =	3.50
Prob > F =	0.0104
R-squared =	0.3096
Adj R-squared =	0.2211
Root MSE =	.05799

roe	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
bs	.0037691	.0074537	0.51	0.616	-.0113074	.0188457
firms1	.0195083	.0058953	3.31	0.002	.007584	.0314326
firms2	-.0033818	.0036112	-0.94	0.355	-.0106862	.0039225
lev	-.0498033	.0410509	-1.21	0.232	-.1328367	.03323
age	.0007108	.0009704	0.73	0.468	-.001252	.0026736
_cons	-.178133	.1002223	-1.78	0.083	-.3808516	.0245857

Key Findings: The standard error being 0.007 and value of R square at 31% indicate that independent variable has an explanatory capability in terms of changes in dependent variable. The prob>F being less than 0.05 implies rejection of the null hypothesis. The key finding being that board size has relation with ROE.

Table 3: Influence of Concentrated Ownership along with Control Variables on ROE

. regress roe co firms1 firms2 lev age

Source	SS	df	MS
Model	.072807878	5	.014561576
Residual	.117147324	39	.003003778
Total	.189955202	44	.004317164

Statistic	Value
Number of obs =	45
F(5, 39) =	4.85
Prob > F =	0.0015
R-squared =	0.3833
Adj R-squared =	0.3042
Root MSE =	.05481

roe	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
co	-.0596138	.0268071	-2.22	0.032	-.1138363	-.0053914
firms1	.021012	.0049657	4.23	0.000	.010968	.0310559
firms2	-.0032663	.0034125	-0.96	0.344	-.0101687	.0036361
lev	-.0445443	.0384909	-1.16	0.254	-.1223994	.0333109
age	.0005265	.000908	0.58	0.565	-.0013102	.0023632
_cons	-.1218096	.0976265	-1.25	0.220	-.3192779	.0756587

Key Findings: The standard error being 0.026 and value of R square at 38% indicate that independent variable has an explanatory capability in terms of changes in dependent variable. The prob>F being less than 0.05 implies rejection of the null hypothesis. The key finding being that concentrated ownership has relation with ROE.

Table 4: Influence of Number of audit committee meetings along with Control Variables on ROE

. regress roe acm firms1 firms2 lev age

Source	SS	df	MS
Model	.074022197	5	.014804439
Residual	.115933005	39	.002972641
Total	.189955202	44	.004317164

Statistic	Value
Number of obs =	45
F(5, 39) =	4.98
Prob > F =	0.0013
R-squared =	0.3897
Adj R-squared =	0.3114
Root MSE =	.05452

roe	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
acm	-.0210059	.0090348	-2.32	0.025	-.0392806	-.0027313
firms1	.0280874	.0058359	4.81	0.000	.0162831	.0398917
firms2	-.0028655	.0034027	-0.84	0.405	-.0097482	.0040172
lev	-.0398134	.0384023	-1.04	0.306	-.1174894	.0378627
Age	.0007411	.000895	0.83	0.413	-.0010692	.0025514
_cons	-.2058275	.0950038	-2.17	0.036	-.3979908	-.0136643

Key Findings: The standard error being 0.009 and value of R square at 39% indicate that independent variable has an explanatory capability in terms of changes in dependent variable. The prob>F being less than 0.05 implies rejection of the null hypothesis. The key finding being that number of audit committee meetings has relation with ROE.

Various other tests were performed to check and ensure the robustness of the data and give strength to the findings.

Table 5: Breusch-Pagan / Cook-Weisberg test for heteroskedasticity

Breusch-Pagan / Cook-Weisberg test for heteroskedasticity
Ho: Constant variance
Variables: fitted values of roe

chi2(1) = 3.31
Prob > chi2 = 0.0688

Key Findings: All variable be it dependent, independent and control variables were taken to investigate if any heteroskedasticity exists in the data collected. Since chi2 value obtained is greater than 0.05 it clearly suggests that there is no heteroskedasticity and the data collected is homogeneous.

Table 6: Variance Inflations Factor Test

. vif

Variable	VIF	1/VIF
firms1	2.09	0.479544
acm	1.68	0.595718
bs	1.61	0.619840
lev	1.35	0.742292
co	1.15	0.873057
age	1.11	0.904846
firms2	1.04	0.959227
Mean VIF	1.43	

It is important to evaluate that is any multi-collinearity exists between the variables. As multiple liner relationships between variables could impact the key findings. However, from the table it evident that the variable doesn't show a presence of multi collinearity as the mean VIF value is below 10. Also, none of the variable had a value of VIF which is greater than 10.

Table 7: Variance Inflations Factor Test

. ovtest

Ramsey RESET test using powers of the fitted values of roe
Ho: model has no omitted variables
F(3, 35) = 2.24
Prob > F = 0.1011

Checking for Omitted variables is another test to be considered. Since the obtained value of Prob>F is higher than 0.05 it implies no variable has been omitted or deleted as part of this study.

Table 8: Correlation among the various variables

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. correlate roe bs co acm firms1 firms2 lev age
(obs=45)
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	roe	bs	co	acm	firms1	firms2	lev	age
roe	1.0000							
bs	0.3267	1.0000						
co	-0.2753	0.2440	1.0000					
acm	0.0589	0.4299	0.1848	1.0000				
firms1	0.5085	0.5221	0.0450	0.6038	1.0000			
firms2	-0.1013	-0.0371	0.0050	0.0354	-0.0159	1.0000		
lev	0.1139	0.3375	0.0508	0.3337	0.4683	-0.1549	1.0000	
age	0.0593	0.1065	-0.1429	-0.0841	-0.1000	0.0844	-0.0918	1.0000

From the above table one can infer that ROE which is taken as dependent variable as part of this study demonstrates a positive correlation with two of the independent variables. The extent of positive correlation with board size is 32.6%, with audit committee meetings it was around 6%. However, with concentrated ownership it showed a negative correlation at 27%.

5. DISCUSSION AND CONCLUSIONS

The findings of this study in terms of impact of corporate governance mechanisms on return on equity have been compare with previous studies across different markets. Below are cases where the current study is in alignment with other studied conducted elsewhere.

The research discovered a positive relation between the board size and ROE. Implying that larger the board the better returns is generates for the firm. This is consistent with studies in case of banks in Lebanon in 2011 **(Chahine & Safieddine, 2011);**However studies on similar subject in United Kingdom **(Guest, 2009)** and India **(Kalsie & Shrivastav, 2016)** found a negative relationship.

Oman being a small economy, the findings does point to the fact the larger board size the key advantage being the individual networking of the directors. More number of directors does give the company an added advantage in terms of getting a chance into bidding and increasing the probability of wining the tenders and contracts though being competitive. Furter, it can be also argued that larger board sizes do increase the skill inventory as every director brings along with him an expertise and experience which is useful for the company to introspect on its macro business strategies.

The research discovered a negative relation between the concentrated ownership and ROE. Implying that concentrated ownership limits the potential of the firms in its ability to generate returns. This is consistent with studies in case of Western European firms **(Laeven & Levine, 2008)** and companies operating in Tunisia **(Turki & Sedrine, 2012);** However studies on similar subject in Gulf Countries **(Arouri et al., 2014)** and German Banks **(Gorton & Schmid, 2000)** found a positive relationship.

Based on the research it was observed that around 90% of the companies in Oman had concentrated ownership. A phenomenon which is a consequence of family run business getting listed on the stock exchange. Further many government agencies have huge holdings in the company like pension funds. This does negatively impact the company's ability to rationally explore areas of growth and improvement. Further, lack of diversity in shareholding limits new and innovative ideas being generated. The capital market authority in Oman can certainly take a note of this finding and find ways to make the shareholding more dispersed, this is healthy from a macro economic point of view. Ordinary people becoming shareholders and investing stock markets do ensure growth and sustainability of the stock markets. We can see the phenomenon in case of developed countries.

The research discovered a negative relation between the number of audit committee meetings and ROE. This is consistent with studies in case of banks in Ghana **(Awinbugri & Prince, 2019)** and firms in Bangladesh **(Rahman et al., 2019);** However studies on similar subject in United Kingdom **(Zábojníková, 2016)** and firms in Jordan **(Mohammed & Hmed, 2018)** found a positive relationship.

The finding does open a pandora box, as one would think a greater number of meetings should ideally mean adequate time is given towards the reviewing and monitoring process. However, finding stating a negative relationship does bring to the fore the point is the content and intent of the meetings. Its also forces one to introspect the skills and expertise of audit committee members. As audit committee is an important tool in the entire framework of corporate governance.

The paper acts as valuable feedback for the various stakeholders. From the perspective of the regulators, Capital Market Authority needs to further investigate the findings where in negative relationship is discovered, find the root causes of the same. Further implement suitable amendments to bring about the desirable changes. The companies also look at the paper and evaluate their own firm and compare with the overall finding. The paper does bring in value to field of literature by enhancing the scarce literature in this area.

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