

## **Does corporate governance predict firm profitability?**

### **An empirical study in Oman**

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#### **ABSTRACT**

**Purpose** – This research aims to test whether corporate governance (CG) predicts firm profitability in a sample of firms listed in the financial mark in Oman.

**Design/methodology/approach** — This research analyses cross-sectional data across 50 non-financial firms. This study used annual reports for the fiscal year 2018 to analyze the impact of CG on firm profitability. This work tested its hypotheses and analyzing them via the Partial Least Squares (PLS).

**Findings** — The result of this research indicates that a positive link between all the predictors is found: board size, ownership, gender, and audit committee, and firm profitability (financial performance).

**Practical Implications** –

**Originality/value** — This research is the first of its kind via examining the link between this set of predictors of (CG) and firm performance in the Omani context. The present study provides empirical evidence for the researchers, policymakers, and other stakeholders.

**Keywords** Corporate governance, Financial performance, Oman

**Paper Type** Research paper (secondary data)

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## **1. INTRODUCTION**

It is recognized throughout the world that corporate governance (CG) has become one of the essential issues in evaluating a company's strengths and functions (Crifo, Escrig-Olmedo, & Mottis, 2019). It helps in monitoring the performance of the company (Dony, Joseph, & James, 2019). Good corporate governance provides good information and achieve the firm's goals and increase the effectiveness of firm performance. (Rusnah & Adwa, 2014). So, remarkably, we see that corporate governance has increased in the last ten years in most countries around the world (Alabdullah, Ahmed, & Muneerali, 2019). CG could be defined as a process in which firms are overseeing and controlling by legal and other standards (Alabdullah, Yahya, & Ramayah, 2014a). It includes a set of principles and mechanisms that deal with the relationship between management and stakeholders via provides corporate functions such as transparency in a business transaction, legal compliance's, protection of interest of shareholders, and ethical values of the business. Many mechanisms are affected and used to measure corporate governance in any firm. Selected of these mechanisms are board of Directors size, board composition, audit committee, and also CEO status (Homaidi, Almaqtari, Ahmad, & Tabash, 2019).

CG was first known at the beginning of the 19<sup>th</sup> of the last century as mentioned by Alabdullah, Yahya & Ramayah (2014b). Its principles are helpful to link the gap which might happen between the management represented by its managers and the principal of the firm and as a result of undesirable practices by the managers that might harm the firm Al-Matar, Al-Swidi, and Fadzil, (2014). Thus, the CG concept arose to adjust links related to the board, managerial branch managers, and also for the audit committees in the companies in addition to links between stockholders and other interested parties. Finally, CG is currently the essence of the proxy for the work mangers and also regulators around the world mainly after the universal financial global crises (Sun, Stewart, & Pollard, 2011). Poor corporate governance leads to weak outputs in the company's performance and might lead to potential financial crisis and

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even fraud financial crisis and even fraud (Zaitul, Melmusi & Ilona, 2019). Widiatmika and Darma, (2018) show there is a lack in investigating the variables of good CG, motivation, and organizational culture and other variables that might also have an impact on the company's performance. There have been a concern in the literature review towards corporate governance in the last five years but the majority of them have focused on one of the developing economies, namely Jordan (Alabdullah, 2016a, 2016b, 2016c, 2017, 2018, 2020; Alabdullah, Laadjal, Ries, & Al-Asadi, 2018a; Alabdullah, Ries, & Nor, 2019; Alabdullah, Ries, & Thottoli, 2019; Alabdullah, Nor, & Ries, 2018; Alabdullah, Yahya, Nor, & Majeed, 2016; Alabdullah et al., 2014), while there is a need for giving more attention to other countries such as Oman. As for Oman as a context of the current study, based on recent literature, the companies in Oman have faced several difficulties and challenges in different issues in various large, medium, and small companies. For example, Al-Belashi and Bagam, (2017) demonstrated that there is a lack of management skills and poor access with notable negligence to the latest contemporary trends of technology in the majority of Omani companies. Also, a study done by Al-Mataani (2017) mentioned that there are several challenges and vital difficulties in the environmental business in Oman, which represented by the presence of a number of issues, for example, ineffective labor market and immature education for entrepreneurship. More recently, a study was done by AlMaskari, AlMaskari, Alqanoob, and Kunjumuhamed (2019), also they pointed out that the Omani companies are somewhat suffering from some issues, for example, the issue of fear of risks and scarcity in the presence of a mindset in entrepreneurship. Also, they mentioned that in general there is declining in the Middle East's economies, especially in Oman in the last five years that result from the price reduction in crude oil due to the decline in GDP. They recommended that there are notable challenges and problems faced by Omani companies that require attention and intervention by researchers and scholars.

The set of challenges and problems above represents a call for researchers to study the business environment in Omani companies and the necessity of searching issues that help enhance the companies' performance in Omani because such enhancement is ultimate leads to improving the economic performance of the country as a whole. Thus, the present study is a response to what was discussed in previous studies

therefore it aims at testing the link between CG and companies' performance in Muscat Securities Market (MSM) in Oman.

## **2. LITERATURE REVIEW**

The current study focused on the most recent works related to CG and firm financial performance, specifically it focused on the studies that have been done in the last five years. CG deals with the setup mechanisms that the company's activities and actions are managed, to maximizing principal value via the duty of directors and enhance the company's performance (Alabdullah, 2018). The role of CG in enhancing companies' performance was tested in the literature review based on agency theory as a key dependent variable which might achieve and strengthened as a significant goal as mentioned by Alabdullah, 2016d; Alfadhl and Alabdullah, 2013; Alabdullah, et al., 2014b. Duong, Evans, and Truong (2020) study the impact of senior Australian CFOs to represent managerial ownership of on company earnings and performance in light of agency theory and found that companies with financial managers as experts from within the company performance of the company and the quality of profits is much lower. In companies with strong CEOs, the negative effect of FCA membership increases the quality of earnings. They found that CFOs experience in the firms lowers the quality of both earnings and profitability. Moreover, they revealed the negative effect of CFO on both earnings and profitability. Pandey and Hassan, (2020) tested the link between the board of directors and features of company level and the Product responsibility (PR) ratings of companies and their findings were steady by the agency theory notion and in sharp contrast to the United States market and revenue, size of the board, and diversity of the board are positively effect on ratings of the PR. Kivaya, Kemboi, and Odunga, (2020) investigated the moderator role of the size of the firm on the link between CG and performance of micro-finance Institutions in Nairobi County and found both boards of directors size, board duality has a negatively associated with the firm performance of micro-finance institutions. Board composition has a positive and significant association with the financial performance of microfinance institutions. Bahoo, Ahmed, Shoukat and Ahmad, (2019) were tested are CG and management ownership related to the firm performance and found that multiple techniques in this work suggested an approach of the broader to the empirical studies of financial

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performance and the impact of CG and management ownership in firm performance. Munir, Khan, Usman, and Khuram, (2019) in their study focused to investigate one important question as if the sound CG enhances the sustainability of the firm performance or not they found that testing in good CG and better sustainability is essential for creating long-term value. The purpose of this work is to analyze the role of transparency, accountability, responsibility, independence, fairness, work motivation, organization culture, and good corporate governance towards financial performance. Widiatmika and Darma, (2018) were analyzed the effect of transparency, accountability, responsibility, independence, fairness, work motivation, organization culture and good corporate governance towards financial performance and were found that the application of GCG principles, work motivation, and organizational culture very influential on the financial performance of rural banks in Badung Regency. Susanti, Andhani, and Zulaihati, (2019) have tested the effect of intellectual capital and good corporate governance (GCG) on performance in the financial sector and found that good Corporate Governance indicates that GCG is positively affected companies' performance. Appiah et al. (2017) in their research they tested the role of CG on banks' performance. They find a negative link between the composition of the board and performance, except the return on equity of those banks. Fiandrino, Devalle, and Cantino (2019) were reconciled on the link between CG, corporate performance, and CSR by testing how firms link with CSR and argued that CG and CFP have an effect on CSR due to they significantly affect environmental practices. Wang and Sarkis, (2017) were suggested if firms implement CSR positively to generate good outcomes of the CSR, this plays a significant role in influencing firms' financial performance. As a result, it provides an illustration of the mediation impact of actual outcomes of the CSR to the previous findings of heterogeneous on CSR and its financial return links. Yilmaz (2018) in his analysis try to explain that CG plays a vital role in financial ratios and expressed that overall link CG and financial ratios show a weak in Oman context. Patel, (2018) analyzed corporate governance firms link and found that the directors' ownership increases the performance of the companies goes down and found a negative link, which may be due to the inability of the independent directors to perform efficiently, effectively and independently in the existing local and cultural context. Somani and Bhatia (2018) aims to see the significant

link between CG and Financial profitability and were concluded a positive association of CG and performance among Cement firms in India. The specific aims of the work included; the impact of board size on the performance of NSE firms; to create the influence the duality of CEO on the performance of NSE firms, and to evaluate the effect of board composition on the performance of NSE listed commercial and services firms. NSE listed firms should seek to ensure a greater diversity of non-executive board members and continuous supervision of the executive board to reduce the risk of the firm through rigorous checks and balances. Njenga, (2018) were investigated the role of CG on the performance of (NSE) listed commercial and services firms they have tested the role of board size on firm performance of NSE listed firms; to establish the influence of CEO duality on the performance of NSE listed firms; and to evaluate the impact of board composition on firm performance of NSE listed firms and in their opinion, three CG practices (board size, CEO nonduality, and composition ) adopted significantly influence the performance of NSE listed firms. Haq, Zhao, and Rehman, (2020) examined the role of the CG on performance in India. Different measures of CG like the Board size and its independency and Board directors were studied in the Indian firms and it was found by them that there was a positive link between Board size, Board independence and performance of Indian firms. Al-Matar, et al., (2014) the goal of their research is to check the link between the features of the board, features of the audit committee, and the features of the executive committee and how it is achieved in Omani firms. The results specific a significant positive link between board volume, board gathering, audit committee, and the independence of the administrative committee, and Tobin's Q. Besides, independence of the board and legal counsel both are safely but negatively linked to Tobin Q. In addition, a positive link is a set of CEO tenure, preparation of CEO, volume, of the audit committee, and finally company profitability.

### **3. METHODOLOGY**

This work comprised firms listed in MSM for 117 firms. The sample of this research is represented by 50 companies listed in MSM for the year 2019. This research uses secondary data based on annual reports.

An analysis of the quantitative data was then made using PLS technique' regression.

### 3.1 Variables of the research and its measurements

This work utilized measurements with an extensive range as measurements of CG and firm performance. An explanation is explained below:

Table 1, measurements of the variables:

Variables	Acronym	Measurement
Return on Assets (as a percentage)	ROA	It is measured by divided net income on total assets
Return on Equity (as a percentage)	ROE	It is measured by divided net income on common equity
Board Size (number)	BOD	It is represented by the number of managers exist in the board of directors
Managerial Ownership (as a percentage)	M-Owner	It is a total share held by a firm's managers
Gender	Gender	0 Male, 1 Female
Audit Committee	Audit Com	Dichotomous; 1 if committee members above the 3, 0 otherwise

## 4. Results

This work tested the impact of CG as a predictor of performance in a sample of non-financial listed firms in Oman. In the previous literature review, this research determines three major variables for performance: board size, ownership, and gender with influencing the firm performance relationship. Therefore, from all dimensions of variables that are identified, hypotheses were formed to inquire about the objectives.

#### 4.1 Assessment of Measurement Model

It is known that discriminant validity is the extent that implies that a construct is distinguished from other different constructs (Hair, Black, Babin, & Anderson, 2010). It shows a correlation of unavoidable low between interest measurements and other measurements that are probably as mentioned by Heeler, & Ray (1972) is not measuring the same variable. In PLS for testing the discriminant validity, there are standards applied. The square-root of every AVE for every construct must have a high correlation level including the other constructs. Thus, to deal with discriminant validity, as mentioned by Fornell & Larcker (1981), the square root of each construct in its AVE has to be compared versus the constructs' correlations for all other constructs.

Table 2: Discriminant Validity Constructs

Variables	Audit-Com	Bord-Z	Gender	M-Ownership	ROA	ROE
Audit-Com	1.000					
Bord-Z	0.089	1.000				
Gender	-0.086	0.614	1.000			
M-Ownersh	0.090	0.201	0.220	1.000		
ROA	-0.109	-0.154	-0.125	0.041	1.000	
ROE	-0.101	-0.159	-0.125	0.030	0.972	1.000

Evaluation for the Structural-model was done after measurement-model analysis and it has passed all criteria. An examination of the determination coefficient ( $R^2$ ) is done. In this work, a variable which is the endogenous show to have  $R^2$  value 0.44 (ROA), 0.41 (ROE) (substantial) suggesting that 44%, 41% of the variance in financial performance (ROA and ROE) can be explained by the predictors: board size, ownership, and gender.



Table 3: Explanation of the Variance

Endogenous Construct	Explanation of the Variance (R <sup>2</sup> )
Exogenous Variables -> Endogenous (ROA)	0,44
Exogenous Variables -> Endogenous (ROE)	0.41

The Structural model clarifies the link between latent variables which hypothesized in the model. Because the main aim of PLS is forecasting as shown by Hair et al. (2010), the quality of the model from a theoretical aspect is, decided by the endogenous constructs via its variance explained (R<sup>2</sup>) and the magnitude of all the path estimates (Chin, 2010). Therefore, it might conclude that the current work highly meets the criterion. The variance shown for endogenous is revealed in the above Table 3. In this work, Independent variables that are the size of board, ownership, gander, and audit committee, tested using Variance inflation factors (VIF) and condition indices to understand multicollinearity problems.

#### 4.2 Hypotheses Testing

Lohmoller (1989) shows that the coefficient range must be more than 0.1 in order to consider as acceptable. Path estimates need to be computed from the initial set, 3 that showed as significant, and also 1 not significant: the findings related to this test will be presented next.

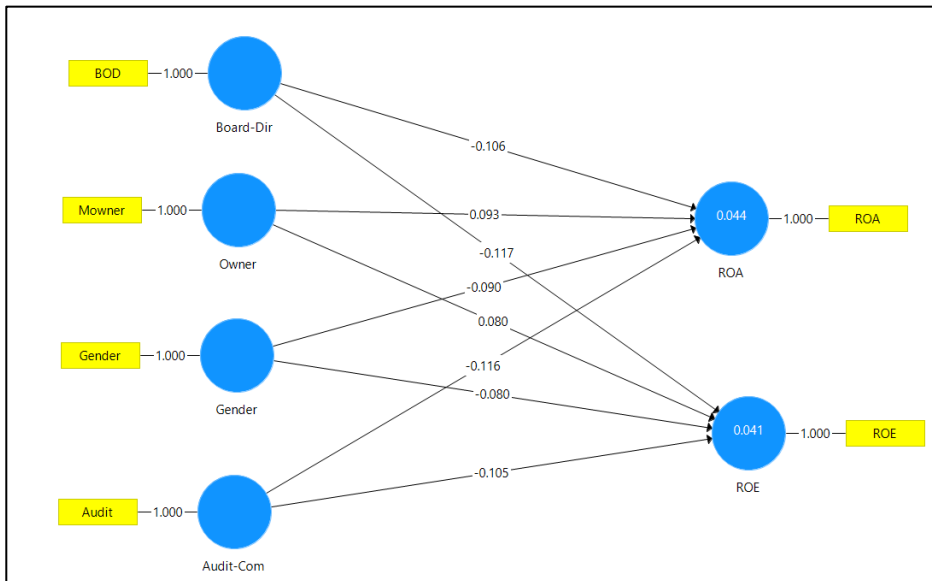
Table 4, reviews the findings related to testing the hypothesis. The findings revealed that the audit committee negatively significant with a financial performance where it was  $P < 0.05$ ,  $t = 1.710$ . This result indicates that the audit committee has a significant impact on financial performance. The results showed that board size has a significant negative relationship with a financial performance where it was  $P < 0.05$ ,  $t = 2.307$ . This result shows board size has a significant effect on performance. The findings showed that managerial ownership is positively related to a financial performance where it was  $P < 0.05$ ,  $t = 1.644$ . This result indicates that managerial ownership is positively

affected financial performance. Overall, three results have revealed supporting that the majority of factors do affect financial performance.

Table 4: Path Coefficients

Path	Path Coefficient	t-value
Audit-Com -> ROA	-0.116	*1.710
Bord-Z-> ROA	-0.106	*2.307
M-Owner ->ROA	0.090	0.388
Gender->ROA	-0.090	0.363
Audit-Com -> ROE	0.105	1.324
Bord-Z-> ROE	-0.117	0.212
M-Owner ->ROE	0.080	*1.644
Gender->ROE	-0.080	0.545

Note: Significance levels: \*\*\* P < 0. 001 (t >3.33), \*\*p < 0. 01 (t >2.33), \*p < 0.05 (t >1.605) (based in one-tailed test)



## **5. The Impact of CG mechanisms on financial performance**

The researchers investigate the effects of factors CG on firm performance relationships in some of the companies in MSM in Oman. In the previous literature review, this research determines three major variables for firm performance viz, the board size, ownership & gender with influencing the firm financial performance relationship. Therefore, from all dimensions of variables that are identified, hypotheses were formed to inquire about the objectives.

The present work used secondary data to be obtained from the firms' websites of listed companies in MSM for the fiscal year, 2019. A total of 50 out of 117 companies were successfully collected in this research.

The first independent variable of CG tested in current research is the board of Directors' size. Following Oman's code of CG, the board of directors is mainly referred to one of the important tools of CG that control the management behavior. In order to be guaranteed that the managers' action is towards the enhancement of the shareholders' interests and the firm's business is appropriately conducted by the managers of the company. The case of board size has a vital role to enhance companies' firm performance. Scholars assert and focus on the essential function and the effect of the size on company performance (Alabdullah et al., 2014a). The findings in the regression analysis shown in Table 4 that revealed a significant and positive link between the size board and performance ( $P < 0.05$ ,  $t = 2.307$ ). The finding shows a significant negative link between larger board size and performance. This indicates that the higher the board size, the higher the firm performance of Omani listed firms. This shows that the directors' board used good CG that makes the directors use to tend to higher firm performance.

The second independent variable used in the present work is managerial ownership. The result shows a positive link between management ownership and firm performance ( $p < 0.05$ ,  $t = 1.644$ ). This reflects that in case the managers own some shares of the firm, they use to have higher firm performance. Such finding is steady with some literature that tested the link between management ownership and performance.

Regarding the third independent variable of CG investigated in the current research, it is the audit committee. The finding reveals there is a significant link among the audit committee and firm performance ( $\beta = -.085$ , and  $p > .1$ ). One probable cause for such finding is the audit committee in Omani listed firms in MSM simply matters due to as argued by Al Matar, et al., (2014); Al Matari, Al Swidi, Fadzal and Hand Al Mataari, (2012), independence of audit committee provides that might be significant to appoint well expertise and experienced individuals in order to assure and value creation in a firm. However, a probable cause for a significant finding of the audit committee on financial performance is that audit committees of Omani companies are taken as important as compared with audit committees of other companies in the world. This finding lines the significant findings on the audit committee indicating the effect of certain specific board practices aspects in non-developed countries of companies' profitability is appeared in the case of Oman.

## **6. CONCLUSION**

The main aim of the current work is to test the role of CG mechanisms; board size, ownership, gender, and audit committee on the firm performance (ROA and ROE) in Muscat Securities Market (MSM) for the year 2019. After doing the analysis, the current work got the following main matters:

- (1) The size of the board has shown a negative effect on performance in listed firms in Oman. This in agreement with the idea of agency theory. The concept behind agency theory is that small board size is positive affects performance.
- (2) The present research also showed there is an adverse and significant link among managerial ownership and firm performance, which also is in line with the idea of Agency theory.
- (3) The present research revealed there is an insignificant link among audit committees and performance. It expresses the link between this mechanism of CG and its link with firm performance is clearly insignificant.

Because there is a gap in the literature and a lack in testing some corporate governance mechanisms in developing countries especially in Oman, the present work contributes by adding knowledge and thoughts to the existent literature in Oman and other developing countries.

Second, regarding listed companies in Oman, the present work reflects that the agency theory able to clarify the link among both sizes of the board and management ownership, and performance. It is further support for the agency theory notion which is clear that it is compatible with the Omani context. The researchers suggest that firms and their managements focus on such mechanisms for enhancing performance in Omani companies. Therefore, the present research provides an understanding of CG tools that affect firm performance, especially in Oman firms are characterizes by its well-defined culture and environment. The overall results reveal that Omani firms are showing well performance as per the indication of their financial performance. The present research has strongly supported that the corporate governance mechanism has a significant role in firms' performance. Further, the research indicates that proper implementation of the CG mechanism leads to improves the firm's financial performance. Thus, this improved performance will positively improve the economy of the country in the long run.

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