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The Impact of Corporate Governance on Firm Performance: Evidence from the UAE

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Abstract
This study seeks to examine the relationship between corporate governance and firm performance of companies listed in Abu Dhabi stock exchange. It is argued in this paper that strong corporate governance mechanisms are expected to have a positive impact on performance measures.
The dataset is drawn from the Abu Dhabi exchange Shareholding Company’s guide for years 2007-2011.The study uses pooled regression analysis on 281 firm/year observations.In this regard, two measures of firm performance are used; Tobin’s Q score and Return on Assets (ROA), on the other hand independent variables include institutional ownership, governmental ownership, board size, and audit quality. The study controls for the relationship between the dependent and independent variables by including firm size, debt ratio, dividend yield, and age as control variables.
Results showed significant positive impact of corporate governance measures on firm performance (except for Audit quality). Results obtained inthis research paper provide further evidence on the importance of corporate governance mechanisms on stock market participants’ valuation of listed companies. In addition, it makes us understand to some extent the attitudes of shareholders toward good corporate governance practices.The importance of this research paper stems from the fact that it is conducted in an emerging economy which has recently adopted a corporate governance code. In this regard, the UAE has put into action the new corporate governance code on 2007 and made it mandatory on all listed companies as on 2010, the current study focus on this period. As far as the current researcher is aware of, prior studies conducted in the UAE context were cross-sectional in nature and conducted before the implementation of the new code.
Key words: Corporate Governance, Firm Performance, Ownership Structure, Emerging Markets.
Paper type: Research Paper

1. Introduction:

In the past two decades attention toward issues related to corporate governance has been increasing as a result of a series of financial and economic events occurring around the world. In this regard, high profile financial scandals, financial crisis, and unexpected corporate failure have driven countries to strengthen their corporate laws in order to increase the confidence in financial markets (Solomon, 2010). As one of the most newly established financial markets in the Middle East, the United Arab Emirates has always considered the importance of keeping its financial markets (Dubai Financial Market and Abu Dhabi Financial Market) to be viewed by the stock market participants as safe, stable, transparent, and protected by the law. One of these laws is related to corporate governance.

Corporate governance might be viewed as the relationship between a company’s management and shareholders. It is defined as “the system by which business corporations are directed and controlled” (Rankin, et al.2012: 188).It is widely believed that the implementation of a good corporate governance framework presents companies a structured path to better management practices, effective oversight and control mechanisms which lead to opportunities for growth, financing and improved performance (Solomon, 2010). In this regard, countries with newly established, yet promising, financial markets such as the UAE consider the adoption of corporate governance code as a must in order to build up a confidence and to attract and sustain investments. The implementation of corporate governance code is seen by the UAE government as a priority when enhancing its financial markets.

As it is discussed later in this paper, the UAE corporate governance code was issued in 2007 and was mandatory on all listed companies in 2010. As far as the current researcher is aware of, only one study in the UAE context was conducted to examine the impact of corporate governance on firm performance. However,Aljifri and Moustafa (2007) conducted their study by covering cross-sectional data in the year 2004 when the UAE corporate law was silent regarding corporate governance issues. The current study extends what was investigated by Aljifri and Moustafa (2007) by examining the period of implementing the new UAE corporate governance code (i.e. 2007-2011).

2. UAE corporate governance regime:

The economy of the United Arab Emirates is the second largest in the Arab world (after Saudi Arabia), with a gross domestic product(GDP) of $377 billion (AED1.38 trillion) in 2012. Since the independence in 1971,

UAE's economy has grown by nearly 231 times to AED1.45 trillion in 2013 (John, 2013).Although The United Arab Emirates is considered as one of the largest exports of Oil and Gas in the world, the general trend and vision in the UAE economy is to reduce its dependency on oil exports by diversifying the economy, particularly in the financial, tourism and construction sectors. This has been reflected by the founding father of the UAE the Late Sheikh Zayed Bin Sultan:

> *"We must not rely on oil alone as the main source of our national income. We have to diversify the sources of our revenue and construct economic projects that will ensure a free, stable and dignified life for the people"*

As a response, the UAE which is seeking to enhance its economic competitiveness by diversifying its resources and by building a knowledge-based economy has taken crucial steps in making the country to be viewed as an attractive environment for investments. One of these steps is to strengthen its financial market through ensuring that the investing environment in the UAE is safe, stable, protected by the law, and transparent. One of these steps is related to the implementation of a corporate governance code on companies listed in the UAE financial markets.

Corporate Governance has been regulated in the UAE through a number of years by the UAE Securities and Commodities Authority (SCA). In early 2007, the SCA introduced the UAE code of corporate governance (SCA Decision R/32 of 2007). The code detailed the corporate governance requirements that companies should comply with. According to the code, listed companies are required to include in their annual reports a "corporate governance report" which should contain information about Board Structure and Directors duties and liabilities. Also, the corporate governance report should outline information about board committees, Directors' remuneration, internal control, risk management, and the external auditor. In October 2009, a new code concerning Corporate Governance was issued by the UAE Ministry of Economy which amended the old code. The ministerial resolution No. 518 of 2009 refined, clarified, and updated the old code and made it clear that corporate governance disclosures are mandatory on companies listed in the UAE securities market. In this regard, Companies listed in the UAE securities market were given a grace period of three years starting from 2007 to comply with the code (no later than 30 April 2010).

The new code places more emphasis on oversight of the management and functions of the board of directors by appointing more independent members and non-executive directors, forming committees and having external auditor who is neutral and independent to companies activities. Going beyond what is required by the previous Code, the External auditor is prohibited to perform any technical, administrative or consultation services or any services that may affect its independence.The duties of directors have been further enhanced in accordance with international standards. According to the code, the position of chairman of the board of directors and managing director should not be held by the same person different individuals. Also, the existence of non-executive directors has been increased and as a requirement, the board of any company should at least setup an audit committee, a nomination committee and remuneration committee. The audit, nomination and remuneration committees must comprise of not less than three non-executive directors, of whom at least two members shall be independent members and shall be chaired by either independent members. In this regard,these committees are entitled to submit written reports to ensure greater transparency of the procedures, results and recommendations that the committee reaches.

In Addition, thenew code also requires listed companies to have a code of conduct along with other corporate internal policies and standards. It requires the board of directors to establish a specific internal control system, to assess risk management and ensure a thoroughexecution of the governance rules. Most importantly, the new code also requireslisted companies to apply environmental and social policies requiring greater corporate social responsibility.

3. Literature Review and hypotheses development

Corporate governance literature is originally linked to the pioneer work of Jensen and Meckling (1976). According to the agency theory as presented by Jensen and Meckling (1976), agency problems occur when the interests of agents are not aligned with those of principals. Depending on the parties involved in conflicts, agency problems can be categorized as: managerial agency (between stockholders and management); debt agency (between stockholders and bondholders); social agency (between private and public sectors); and political agency (between agents of the public sector and the rest of society or taxpayers). According to Jensen and Meckling (1976), shareholders are the residual claimants after other parties, and thus shareholders' rights are the weakest. Corporate governance is therefore mainly designed to protect and promote the interests of shareholders. This paper will focus on the agency-principal problems between managers and stockholders.

The following section is designed to provide a discussion regarding hypothesis development of the study.

3.1. Government Ownership

The direction of the relationship between government ownership and firm performance in prior literature was not conclusive. One school of thoughts suggested a negative relationshipbetween government ownership and firm performance (Miggenson and Netter, 2001; Xu and Wang, 1999; Mak and Li, 2001). Generally, these studies argued that privately owned firms are more efficient and more profitable than state owned firms. Mak and Li (2001) explained that government tends to be less active in monitoring its investments. They claim the weaker accountability and monitoring of state-owned firms' financial performance, as well as easier access to financing, are likely to reduce the incentives of such firms to adopt strong governance mechanisms.

However, the negative relationship between government ownership and firm performance should not be generalized. Prior literature indicated that the direction of the relationship depends on the country under examination. While the study conducted by Xu and Wang (1999) in the Chinese context indicated a negative relationship, studies conducted in Kuwait, UAE, Malaysia, and Singapore found a significant positive relationship between government ownership and firm performance (Aljifri and Moustafa, 2007; Najid and Abdul Rahman, 2001; Ang and Ding, 2006; and Alfaraih, et. al., 2012). In this regard, Eng and Mack (2003) explained that government owned firms tend to mitigate the problem of asymmetric information that results from imperfect information about the value of the firms given to investors and that such firms are also generally able to gain easier access to different sources of financing as compared with other firms. In addition, government owned firms may face less pressure to comply with financial reporting regulations, which might motivate management to select accounting choices that improve firms' performance (Aljifri and Moustafa, 2007).

Based on the above arguments, it is expected in the UAE environment that the relationship between government ownership and firm performance will have a positive direction due to the fact that the UAE government is continuously and heavily supporting initiatives and laws that ensures investors protection in the UAE financial markets. Also, the UAE government is acting as a role model for other businesses in terms of transparency corporate monitoring. So it is expected that the UAE Government ownership in listed companies will act as a CG mechanism and is expected to have a positive impact on firm performance.

H1: Ceteris paribus there is a significant positive relationship between Government ownership and firm value

Institutional Ownership

The involvement of institutional investors has emerged as a vital force in corporate monitoring and as a mechanism to protect the interest of minority shareholders. The term institutions refer to the ownership stake in a company that is held by large financial organizations, insurance companies corporate pension funds, college endowments, commercial banks, hedge funds, mutual funds, and boutique asset management firms (Al-Malkawi and Pillai, 2012).

Prior studies have produced mixed results. Chaganti and Damanpour (1991) and Lowenstein (1991), for instance, find little evidence that institutional ownership is correlated with firm performance.

On the other hand, Demsetz (1983), Shliefer and Vishney (1986), McConnell and Servaes (1990), Lehmann and Weigand (2000), Larcker et al. (2004) and Hashim and Devi (2004) report that there is a positive relation between firm value and ownership by institutional investors. In the UAE context and on a cross-sectional study conducted in 2004 covering 51 firms,Aljifiri and Moustafa (2007) found a positive relationship between institutional ownership and firm performance.

H2: Ceteris paribus there is a significant positive relationship between Institutional ownership and firm value

3.3. Board Size

With regard to a relationship between the size of a board and a firm's performance, there are two distinct schools of thoughts. The first school of thought argues that a smaller board size will contribute more to the success of a firm (Lipton and Lorsch, 1992; Jensen, 1993; Yermack, 1996). However, the second school of thought considers that a large board size will improve a firm's performance (Pfeffer, 1972; Klein, 1998; Coles et. al., 2008). These studies indicate that a large board will support and advise firm management more effectively because of a complex of business environment and an organizational culture (Klein, 1998). Moreover, a large board size will gather much more information. As a result, a large board size appears to be better for firm performance (Dalton et. al., 1999).

H3: Ceteris paribus, there is a significant positive relationship between Board size and firm performance.

3.4 Audit Type

Agency theory and information suppression hypothesis state that there is a relationship between auditor type and firm performance and. It is suggested that the higher audit quality may control opportunistic management behaviors, reduce agency costs and, consequently, increase the firm value in the marketplace. In consistent with this argument, Aljifiri and Moustafa (2007) find empirically a significant positive relationship between auditor type and firm performance. Thus, the expected sign for the effect of external auditor type on firm performance is positive.

H4: Ceteris paribus, there is a positive association between auditor type and firm performance.

4. Data and Methodology

This study seeks to examine the impact of Corporate Governance on firm performance in emerging markets using UAE listed companies as a sample. The dataset is drawn from the Abu Dhabi company guide for years 2007-2011 as published by Abu Dhabi Securities Exchange (ADX). From this dataset companies that failed to report financial information and companies whose shares were not traded in the ADX during the examined period were excluded from the study. Based on that, 281 firm/year observations were included in the analysis.
Table 1 below provides information related to number of firms included in the study per year. As mentioned earlier, total number of observations is 281 firm/year observations. This covers years 2007-2011.

Table 1
Sample of the study

	2007	2008	2009	2010	2011	total
Number of listed companies	64	65	67	64	67	327
Number of companies excluded	10	7	9	11	9	46
Companies included in the sample	54	58	58	53	58	281

Pooled OLS regression models are applied for the 281 firm/year observations. The following two modelsare used:

Model (1)

Tobin's Q = α + β1 (GOV) + β2 (INST) + β3 (BSize) + β4 (AUDIT) + β5 (LnTA) + β6 (DRATIO) + β7 (DYLD) + β8 (AGE) + εit

Model (2)

ROA = α + β1 (GOV) + β2 (INST) + β3 (BSize) + β4 (AUDIT) + β5 (LnTA) + β6 (DRATIO) + β7 (DYLD) + β8 (AGE) + εit

Where:

The dependent variable is firm performance measured as:
Tobin’s Q = (firm market value – book value of debt)/total assets
And
ROA = return on assets ratio; net income/total assets
α = intercept coefficient of firm i, β = row vector of slope coefficients of regressors;
(GOV) = proportion of government ownership in the firm
(INST) = proportion of Institutional ownership in the firm
(AUDIT) = external auditor type; 1 if the company's accounts are audited by a bug four auditing firm, 0 otherwise.
(BSize) = Board size
(LnTA) = natural logarithm of total assets
(DRATIO) = Debt Ratio; total debt/total assets.
(DYLD) = Dividends Yield;
(AGE) = number of years since establishment
εit = residual error of firm I in year t.

5. Statistical analyses

Descriptive statistics of the variables included in the study are presented inTable 2 below.

Table 2
Descriptive statistics

	Mean	Median	SD	Min	Max
Tobin's Q	0.880	0.725	0.915	-0.748	5.571
ROA	0.029	0.046	0.106	-0.586	0.439
GOV	0.0472	0.000	0.105	0.000	0.912
INST	0.302	0.256	0.242	0.000	0.998
BSIZE	8.4	8	0.232	5	13
DRATIO	0.312	0.301	0.189	0.007	0.957
DYLD	0.021	0.000	0.052	0.000	0.721
AGE	21.22	15	14.437	1	44
LnTA	16.52	16.34	1.25	13.83	20.58

Table 3 presents the results of the pooled regression analysis covering the two dependent variables (Tobin’s Q and ROA). As seen in the table, the two regression models achieved significant F statistic values and the adjusted R square values were 30.7% and 39.7% respectively.

Results of the regression analysis indicate a significant positive relationship between firm performance and Government Ownership, Institutional Ownership and Board Size. These results provide supporting evidence of hypotheses H1, H2, and H3 and consistent with prior studies conducted by Aljifri and Moustafa (2007) Najid and Abdul Rahman (2001) Ang and Ding (2006) and Alfaraih, et. al. (2012). Hence, corporate governance mechanisms related to ownership structure and board size have significant positive impact on firm performance in the UAE context. However, Audit type appears to have no significant impact on firm performance. As a result, hypothesis H4 is not supported.On the other hand, Size and dividend yield are found to have significant positive impact on firm performance while debt ratio reported a significant negative effect.

Table 3
Results of the pooled OLS regression

	Dependent Variable= Tobin's Q		Dependent Variable= ROA		
F Statistics	17.445		25.473		
P value	0.000		0.000		
Adjusted R	0.307		0.397		
DW	1.938		1.743		
Independent Variables	Coefficient	P-Value	Coefficient	P-Value	VIF
GOV	**0.138**	**0.076***	0.084	0.245	1.25
INST	**0.108**	**0.066***	**0.128**	**0.020****	1.19
BSIZE	**0.124**	**0.071***	**0.134**	**0.040****	1.21
AUDIT	0.138	0.269	0.072	0.534	1.36
LnTA	**0.104**	**0.078***	**0.236**	**0.000*****	1.29
DRTIO	**-0.508**	**0.000*****	**-0.114**	**0.023****	1.07
DYLD	**0.170**	**0.013****	**0.613**	**0.000*****	1.13
AGE	0.014	0.814	-0.052	0.348	1.32

*significant ay the 10% level, **significant at the 5% level, *** significant at the 1% level

6. Summary, Conclusion, and recommendations for further studies

This study aimed at examining the impact of corporate governance on firm performance in emerging economies by focusing on the UAE context. Pooled regression analysis was conducted on a sample of 283 companies listed in the Abu Dhabi Stock Exchange covering the period between 2007-2011. Two measures of the dependent variable (i.e. Firm performance) were used: Tobin’s Q and ROA. On the other hand, independent variables related to corporate governance were measured in terms of four variables, these are: institutional ownership, government ownership, board size, and audit type. Moreover, the relationship between the dependent variable and the independent variables was controlled by including size, leverage, dividends payout, and age.

Results of the pooled regression analysis indicated a significant positive impact of corporate governance measures (Institutional ownership, Government ownership, and board size) on firm performance. This provides two indications, the first is related to positive impact on company’s stock market prices and the other is related to company’s profitability. Accordingly, results indicate that companies with strong corporate governance mechanisms are perceived positively by the financial market participants which are reflected, in turns, on companies’ stock market prices. Also, results of this study indicate that strong corporate governance mechanisms influence company performance in terms of generating profits.

Nevertheless, the issue of corporate governance still needs more investigations in the context of emerging economies, especially the UAE. As far as the current researcher is aware of, qualitative studies examining attitudes and perceptions regarding corporate governance still to be conducted in emerging economies. Also, it is recommended to build up a corporate governance index to assess good corporate governance practice.

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