

# **Corporate Governance Practices and Firm Performance of Listed Companies Including Islamic Financial Institutions in the United Arab Emirates.**

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## DECLARATION

I, Hani Saker Alagha declare that the DBA thesis entitled Corporate Governance Practices and Firm Performance of Listed Companies Including Islamic Financial Institutions in the United Arab Emirates is no more than 100,000 words in length, exclusive of tables, figures, appendices, references and footnotes. This thesis contains no material that has been submitted previously, in whole or in part, for the award of any other academic degree or diploma. Except where otherwise indicated, this thesis is my own work

03/02/2016

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Hani Saker Alagha

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DATE

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# ABSTRACT

Corporate governance is considered to have significant implications for the growth prospects of an economy. Well-formulated corporate governance mechanisms are regarded as important not only in reducing risk for investors, but also in protecting shareholders' value as well as in improving and enhancing a firm's performance. However, corporate governance mechanisms do vary between countries, as each country is unique in its political, economic, legal, culture and social contexts. Each country has its own corporate governance regulations with respect to various aspects of corporate management, which come under public domain. The United Arab Emirates (UAE) also has its own corporate governance rules introduced in 2010. The results of the study reported here evaluate the consequences of compliance with different components of the rules by UAE firms. The conclusions of the study lead to some recommendations to the UAE regulatory authorities.

The purpose of this study was to investigate the extent of compliance with various components of corporate governance rules of 2010 and their relationship between corporate governance practices and performance of financial and non-financial firms and conventional and Islamic banks in the context of the UAE. The study investigated the impact of the implementation of 2010 corporate governance rules and the extent of changes to corporate governance practices two years later (in 2012). During this period, firms that operated in the UAE were experiencing the impact of the global financial crisis of 2008-2009 and its aftermath.

Agency theory, stewardship theory and Islamic perspectives were used as theoretical foundations of the study. Agency theory advocates separation of leadership roles to minimise agency cost and ensure protection of shareholder interests. Stewardship theory, on the other hand, assumes the governing boards and managers act in the best interests of their principals (shareholders) and hence the leadership roles need not be separated. The Islamic perspective of corporate governance argues that corporate governance is about justice and fair treatment to all related stakeholders, with the objective that everyone has a unity of purpose to serve Allah and accordingly the general community in the best possible way through cooperation and fair treatment of all types of stakeholders, based on Sharia principles. The literature review in relation to corporate governance practices and firm performance revealed mixed findings.

Based on the literature review and the aim of this study, a conceptual framework was proposed. It explains how the board structure and corporate reporting practices of firms in the UAE influenced and affected firm performance. In this framework, corporate governance variables were ownership structure, separate leadership, board composition, board size, audit committee composition and a Sharia Supervisory Board (SSB) for Islamic institutions. Separate leadership refers to the separation of the position of chairperson and CEO. Board composition focuses on the regulatory requirement that a majority of directors should be non-executive directors on the board. Board size refers to the number of board members in the board. Audit committee composition refers to the regulatory requirement of at least one member in the audit committee to be a financial expert. SSB refers to the total number of members in the SSB, the SSB annual report to shareholders, multiple directorships of SSB members, SSB competency, appraisal of SSB, accountability of SSB and frequency of SSB meetings.

The research examined the relationship of these variables to firm performance. Firm performance was measured by using Return on Assets (ROA), Return on Equity (ROE) and Tobin's q as proxies.

This is the first research conducted in the UAE context after the introduction of the 2010 corporate governance rules, the first after declaring Dubai the capital of the Islamic economy and the first after Dubai won the bid to host Expo 2020. As UAE is an emerging market, this study contributes significantly to the body of knowledge on corporate governance in emerging markets and shows how corporate governance influences and impacts on firm performance in an active but sensitive emerging market of the UAE.

The methodology was a comparative analysis that measured the changes to corporate governance practices from 2008-2009 to 2011-2012. The total population of all listed-companies from both Dubai Financial Market (DFM) and Abu Dhabi Stock Exchange (ADX) for the years 2008-2009 and 2011-2012 was used. Data was obtained from compiled annual reports of the companies, and financial market websites. It contained governance and performance information for all listed companies, and specifically identified banks with Islamic and traditional governance structures, and financial and non-financial companies. The data was analysed with SPSS to obtain quantitative measures of descriptive statistics, and analysed using Spearman's correlation, analysis of variance and regression.

Descriptive statistics from the study showed a significant increase in corporate governance practices between 2008-2009 and 2011-2012 for ownership structure, leadership structure, board composition, and audit committee composition of a financial expert. However, the overall results revealed that the implementation of 2010 governance rules made no significant impact on corporate performance. Nevertheless, descriptive statistics for non-financial companies revealed that the governance rules have negatively affected the performance of ROA and ROE of non-financial companies. No impact was observed in relation to financial companies because of the introduction of the governance rules.

The results of the comparative test between conventional and Islamic banks revealed no significant difference between both types of banks in terms of performance and no significant influence observed on both Islamic and conventional banks because of the introduction of the governance rules. Correlation analysis was used to test the relationships between variables in the pre- and post -governance periods. The pre-governance analysis revealed that the proportion of family ownership had a positive correlation with ROA; a negative correlation between the proportion of individual ownership and both ROA and ROE; a negative correlation between non-executive directors on boards and Tobin's q, and a negative correlation between board size and Tobin's q. The correlation test of the post-governance period revealed a positive correlation between the proportion of government ownership and ROE.

The regression model revealed that there is a positive relationship between family ownership and performance; a negative relationship between government ownership and performance; a negative relationship between SSB disclosure on appropriateness of allocation of profit and loss between shareholders and IAH and performance; and a positive relationship between SSB accountability and performance of Islamic banks in the UAE. Thus, the findings of this study showed mixed results of positives, negatives and no relationships between corporate governance practices and firm performance.

Implementations of good governance practices need not necessarily increase or improve firm performance in the short-term as other external economic factors may have a direct impact on corporate performance. As a result, this study has significant implications for the corporate sector, investors, policy makers and international agencies, in particular in relation to IFI, government and stakeholders. The study has important applications due to the importance of protection of corporates, continuity and success of the general economy of the country.

This study makes a number of original contributions. It is one of the first studies of the impact of corporate governance variables and Islamic banking on company performance in an emerging country context of an active sensitive Islamic country, UAE. The study evaluates the effect of compliance levels on the new corporate governance rules by comparing pre and post rule periods. The role of SSB as an Islamic governance practice is assessed against Islamic bank performance and compared with that of conventional banks. The study compares financial with non-financial companies and conventional with Islamic banks in the UAE context, using data on all the listed companies in UAE. The study leads to development of specific recommendations to UAE regulatory authorities. The methods used are applicable in similar contexts to other regions and countries.

There were some limitations for this study. Only two years of compliance was evaluated. This period may be the initial learning phase and hence clear effects on performance may not have been captured by the data. The results could be different in the long term. Only secondary data was used. Addition of some qualitative data on perceptions of corporate leaders, regulatory authorities, SSB members, shareholders and other stakeholders might have been useful to interpret the data. There were only four Islamic banks. This can exaggerate the effects. If there were more Islamic banks, it would have enhanced the reliability of the results.

The conclusions drawn from this study were that good governance practices were important to the performance of any organization. However, for governance practices to have a full impact on firm performance in the UAE, the author recommended that boards should consider structured policies and reforms that extend beyond the focus of adding value to shareholders. Rather, they should include and consider the interests of all stakeholders of the relevant industry. Additionally, as the dominant mechanism, conventional corporate governance paradigms need to be extended to include ethical and self-enforced governance instruments in order for governance mechanisms to achieve the real value for which they were developed and intended.

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# GLOSSARY OF TERMS

ADX	Abu Dhabi Stock Exchange
ANOVA	Analysis of Variance
ASX	Australian Securities Exchange
Bsize	Board Size
CEO	Chief Executive Officer
CGI	Corporate Governance Index
COMM	Board Committees
COMP	Board Composition
DFM	Dubai Financial Market
DIEDC	Dubai Islamic Economy Development Centre
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GFC	Global Finance Crisis
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
LDS	Leadership Structure
MCAP	Market Capitalisation
NONEX	No. of Non-executive Directors
NPV	Net Present Values
OECD	Organization for Economic Co-operation and Development
ROA	Return on Assets
ROE	Return on Equity
SSB	Sharia Supervisory Board
TA	Total Assets
TQ	Tobin's Q
UAE	United Arab Emirates



# CHAPTER 1

## Introduction

### 1.1 Background

Corporate governance is about control, strategies, mechanisms, accountability and distribution of the power by which corporations ensure and maintain balanced relationships not only between different classes of shareholders but also between other interest groups and related stakeholders. It is concerned with the alignment of the interests of the individuals involved in the management and the shareholders of companies (Clarke 2004). Because of its importance in the business world, corporate governance has become a widely discussed topic in both developed and developing countries. The general view of corporate governance among businesses and investors is that it determines and influences firm performance and it protects the interests of shareholders. Therefore corporate governance has become an important and evolving topic among all developed and developing countries.

However, there are no universally agreed upon corporate governance mechanisms, as each country has its own unique economic structure, regulations, social and cultural backgrounds in addition to different geopolitical system. Notably, corporate governance mechanisms vary between developed and developing countries. For instance, companies operating in developed countries have dispersed ownership structure and enjoy a stable political and economic environment, in addition to well-developed regulatory frameworks which have led to effective corporate governance practices. On the other hand, firms that operate in emerging markets such the UAE may be affected by regional political instability and by global economic crises as countries of emerging markets are more sensitive to economic issues than countries of mature markets.

According to (Jinarat & Quang 2003) corporate governance gained real importance as it deals with critical business issues such as managers' behaviour, investors and regulatory agencies. It also relates to the procedural control through which the achievements of corporate long-term objectives are accomplished (Friedman, M. 2007) argued that a corporation's main responsibility is to increase shareholder's value as long as they operate within the legal framework of the business environment. In general, corporate governance

includes codes of best practice and regulations. Corporate management is responsible and accountable for effective management of the businesses, attainment of its business goals and objectives, as well as attainment of its legal obligations and compliances.

In the United States, the Sarbanes-Oxley Act was introduced to improve corporate governance mechanisms in an attempt to help regain market and investors' confidence (Romano 2004). Likewise in Australia CLERP 9 was introduced in response to the collapse of HIH (Knott & Securities 2002). Similarly, the United Arab Emirates (UAE) introduced its mandatory standards through the Ministry of Economics known as Ministerial Resolution No (518) of 2009 Concerning Governance Rules and Corporate Discipline Standards (Al Mansouri 2009). This resolution is prescriptive and is applicable to all non-financial listed corporations in both the Abu Dhabi Securities Market and Dubai Financial Markets. Moreover, the existence of SSB in Islamic banks' board structure is mandatory by Federal Law No 6 of 1985 that clearly stipulates that Islamic banks must comply with Islamic Sharia law (Al Nahyan 1985). In essence, corporate governance reforms are meant not only to protect the rights of shareholders and stakeholders but also to drive and encourage economic growth, produce a safe investment environment and lead to better performance (Jesover & Kirkpatrick 2005)

This study aims to investigate the following corporate governance variables and their relation to firm performance in the context of the UAE: ownership structure, leadership structure, board composition, board size, financial experts in audit committees and SSB in the Islamic banks. The remainder of this chapter is organized as follows: Section 1.2 provides an overview of the context of the study, Section 1.3 explains the relationship of corporate governance practices to firm performance, Section 1.4 presents the aims of the study, Section 1.5 presents and discusses the conceptual framework of the study, Section 1.6 describes the methodology used in the study, Section 1.7 discusses the limitations of existing literature, Section 1.8 outlines the contribution to knowledge and significance of the study and Section 1.9 describes the structure of the thesis.

## **1.2 Context of the Study**

The United Arab Emirates (UAE) stock market is relatively new and small. In the period from 1975 to 1982 UAE's market witnessed the creation of many corporates due to rising oil prices and the strong interest of the Federal Government in building a stable and strong economy. However, the crash of the Kuwaiti stock market (Al-Manakh market) in

1983 and the fall of oil prices in 1986 had a negative impact on the capital market of the UAE. During the period from 1993 to 1997, the UAE's capital market rose again due to the establishment of many new corporates. Again, during the summer of 1998, the UAE's capital market experienced a sharp decline, caused by factors such as negative speculative trading, lack of regulation, manipulation of the market by block traders and professional investors, the drop in oil prices and lack of financial disclosure and transparency (Moustafa 2004). As a result of the 1998 market crisis, the UAE government officially reorganised its stock market by establishing the Emirates Securities and Commodities Authority (ES&CA) on 1 February 2000 pursuant to Federal Law No 4 of 2000 under the chairmanship of the Minister of Economy and Commerce. Its function is to regulate and develop the primary and secondary markets, monitor the market and promote a safe and favourable environment for investors. The Dubai Financial Market (DFM) was officially established in March 2000 as the first organized stock market in UAE, and the Abu Dhabi Securities Market (ADSM) started operating in November 2000. ADSM is larger than DFM. In 2001 ES&CA launched an official capital-weighted average market index with 1000 points, called Emirates index, consisting of all listed stocks. ES&CA enacted a set of statutory orders and regulations that relate to arbitration, listing, practice, brokers' transparency and disclosure, financial markets operations, trading, clearance and depository (Moustafa 2004). These enactments were the starting point of better corporate governance in the UAE capital market.

The Federal Law No 4 of 2000, concerning the ES&CMA was amended by a Ministerial Resolution No 518 of 2009 concerned with Governance Rules and Corporate Discipline Standards. The amendment was aimed at achieving corporate discipline in the management of companies in accordance with international standards and approaches. The new regulations dealt with determination of responsibilities and duties of members of boards of directors and the executive management of companies taking into consideration protection of shareholders' and stakeholders' equity (Al Mansouri 2009). These new governance rules were effective from 30 April 2010 and are applicable to all companies listed in DFM and/or ADSM. Almost five years after its introduction, it is now the appropriate time to review the consequences of the new rules in terms of extent of compliance by firms and its impact on performance. This is the context of the study reported here.

## **1.3 The relationship between corporate governance practices and firm performance**

Although many rules can be framed to prescribe and regulate corporate governance, unless it can be shown to be related to firm performance, firms will not be keen to comply with them. Some of the relevant literature is briefly discussed below.

There have been many previous studies on the relationship between corporate governance variables and its performance. The variables studied include: board sub-committees, independent directors, single or dual leadership for CEO and chairperson and board size (Christensen, Kent & Stewart 2010); board size, firm size and insider directors (Kiel & Nicholson 2003); board independence and size, insiders' shareholdings and outsiders' shareholdings (Pham, Suchard & Zein 2007); the association between primary stakeholders and management (Galbreath 2006); ownership structure (Welch 2003); independent directors, size of the board, and shareholding of institutional investors and mutual funds; duality of CEO and chairperson, residence, age and tenure of the CEO (Vintila & Gherghina 2012); board characteristics, including shareholder accountability, quality of directors and board independence (Ragothaman & Gollakota 2009); and stock ownership of board members, CEO-chair separation and board independence (Bhagat, Sanjai & Bolton 2008). Significant positive correlation was obtained for board independence during the pre and post Sarbanes-Oxley Act and the stock ownership of directors in the USA (Bhagat, S. & Bolton 2009). Empirical evidence provided by (Beiner et al. 2004; Brown & Caylor 2004; Yermack 1996; Zeckhauser & Pound 1990) confirms a positive relationship between good corporate governance practices and corporate performance. Due to their importance on performance, ownership structure and board composition were considered in this study.

### **Ownership Structure**

Large publicly listed companies are commonly managed by professional managers and not by their owners. These professional managers are appointed to work and manage the company's assets using their skills and professionalism. However, according to agency theory, their appointment would create a potential conflict of interest between shareholders and managers as their agents. The dispersed nature of shareholding of large publicly listed companies would create the need for companies to establish and structure a control mechanism monitoring corporate management because no one shareholder has the incentive

to monitor management on his/her own. As a result of separation between ownership and management and the incentives to managers in the form of shares to align their interests with those of the shareholders, agency costs are created as well as monitoring costs (Jensen & Meckling 1976).

Welch (2003) Agreed on the importance of ownership stature on performance but did not find any empirical relationship between the two variables. However, the study found a positive relationship between ownership structure and the size of the firm. Craswell, Taylor and Saywell (1997) and (Demsetz, Harold & Villalonga 2001) found no clear relationship between ownership structure and firm performance. On the other hand, Zeckhauser and Pound (1990) asserted that there is a relationship between large shareholders and future performance and that a large body of shareholders can be seen as an indicator of positive future performance.

## **Leadership structure**

One of the issues that the UAE governance rules required for better corporate governance was the separation of the top two positions of the board (CEO and chairperson). According to (Tin Yan & Shu Kam 2008), combining the roles of the CEO and the chairperson can result in a dominant CEO which will lead to ineffective monitoring of the management by the board. On the other hand, (Davis, Schoorman & Donaldson 1997) contended that combining the two roles will enable companies to decrease the cost of monitoring, bonding and incentives leading to improved company performance. However, leadership structure need not always reflect in firm performance as indicated in several studies (Daily, Catherine M & Dalton 1992; Kiel & Nicholson 2003; Vafeas & Theodorou 1998; Weir, Laing & McKnight 2002). Brickley, Coles and Jarrell (1997) found that CEO duality did not reduce performance, while (Boyd 1995; Sanda, Mikailu & Garba 2005) found a positive relationship between company performance and the separation of CEO and chairperson roles. (Dehaene, De Vuyst & Ooghe 2001) found higher return on assets when the two roles were combined.

Thus, no conclusive evidence exists on leadership structure. In the case of UAE, both common and Islamic rules apply to corporate governance and hence it is appropriate to examine this effect in UAE context. Therefore leadership structure was included as a component of this study.

## **Board composition**

Most international corporate governance codes and rules require boards of directors of publicly-listed corporations to have a combined form of insider and outsider directors (Al Mansouri 2009; Council, ACG 2007; McKnight & Weir 2009; Valenti 2008b).

This rule indicates the importance of corporate board structure and mechanisms in terms of their impact on performance as well as their functionalities in different environmental settings. Boards of directors are the final decision-making authority over top management and set the company policies and strategies. Therefore, the structure of a board is an essential part of the governance mechanism (Jensen 1993). Liang and Li (1999) observed higher return on investment and (Dehaene, De Vuyst & Ooghe 2001) obtained higher return on equity due to the presence of outside directors in the board. (Jackling & Johl 2009) found that the greater the proportion of outside directors, the higher the improvement in the firm's performance. The outside directors act independently as monitors to protect the interest of shareholders in situations where conflict of interest occurs with firm managers (Fama, EFa & Jensen 1983). In addition, Baysinger and Butler (1985b) found that corporations perform better if the board includes more outsider directors. On the other hand, Klein (1998) found a positive relationship between insider directors and firm performance. This indicates that valuable knowledge and information regarding the firms' investments decision could be provided by insider directors (Agrawal & Knoeber 1996). Moreover, Krivogorsky (2006) found a strong positive relationship between the proportion of independent directors on the board and profitability ratio and no strong relationship between the proportion of inside directors and profitability.

Overall, there are positive indications of higher firm performance when independent directors are in the board. UAE rules stipulate that the majority of board members must be independent directors. However, there is inadequate data regarding this relationship in the case of UAE and the specific dimension of Islamic rules can influence the relationship in certain ways. Hence, these aspects were included in this study.

## **Board Size**

Board size is an important construct of a good corporate governance mechanism. The impact of board size is evident with respect to its engagement and involvement in corporate activities and affairs. Together with the structure, the size of the board indicates its ability and efficiency in directing and guiding corporations. This is supported by a number of studies.

Small-sized boards were favoured in the findings of (Jensen 1993; Singh & Davidson III 2003; Yermack 1996)

and (Lipton & Lorsch 1992) and through decreased agency cost (McKnight & Weir 2009). On the other hand, Kiel and Nicholson (2003) found a positive correlation between board size and firm performance. Pearce and Zahra (1991) pointed out that a large board is more powerful and assists in building relationships and corporate identity. According to Jensen (1993), boards are subject to high levels of conflicts as a result of a less cohesive relationship and understanding among the board members. (Conger & Lawler 2009) argued that there is no magical or ideal size for a board and it is about the time it takes to form the right mix of skills, knowledge and leadership to effectively add value to the company.

This raises a question: what should be the size of the board? In the UAE context, Islamic rules also apply and hence board size is governed by having a required number of Islamic scholars on the board. Will it add to the size? This is a major theme to be researched in the UAE context and is therefore included in this study.

### **Audit Committees Composition – Financial Expert**

Audit committees are particularly important for better corporate governance, especially for monitoring and assessing the reliability of financial reporting of companies (McMullen 1996). Boards of directors and audit committees are established to monitor management's behaviour and to ensure that managers act in the best interests of the shareholders and not for their own personal interest (Fama, EFa & Jensen 1983; Jensen & Meckling 1976). This represents the agency theory perspective that audit committees can reduce the conflict of interest between shareholders and managers. The significance of audit committees, their role and contribution to corporate governance structure is evident in corporate governance mechanisms of different countries. For example, in the USA under sections 301 and 402 of the Sarbanes-Oxley Act, an audit committee is required to be established and should have at least one financial expert (Hoi, Robin & Tessori 2007) . Australian Stock Exchange guidelines Recommendation 4 require the establishment of audit committees with guidelines about their composition, operation and responsibilities (Council, ACG 2007). In the UAE under Article 6 of the ministerial resolution, audit committees are required to be established and should include at least one financial expert (Al Mansouri 2009).

Empirical evidence on the presence of financial experts in audit committees and the performance of firms showed a significant positive relationship between the appointment of independent financial experts in the audit committee and stock return (DeFond, Hann & Hu 2005). The importance of having experts in areas such as law, accounting and auditing in an audit committee was highlighted by a positive relationship between the presence of financial experts and financial reporting quality obtained by (DeZoort 1997), McDaniel, Martin and Maines (2002) and Qin (2007). Krishnan (2005) concluded, that companies with financial experts and independent audit committees are less likely to have internal control problems.

## **Islamic Corporate Governance**

According to Choudhury and Hoque (2006) Islamic corporate governance is a faith-based theoretical decision-making process that uses Islamic socio-scientific principles related to the epistemology of *Tawhead*: oneness of God. The Islamic view of corporate governance is useful for minimising transaction costs in decision-making environments and achieving the objectives of the corporation within the framework of Sharia law or the Islamic rules and principles (Choudhury & Hoque 2006).

Consistent with Sharia principles, Islamic corporate governance has a wide commission with obligations covering and extending to suppliers, customers, competitors and employees, and embracing the spiritual as well as the temporal needs of the community (Lewis 2005). Thus the Islamic perspective of corporate governance is both a responsibility and an obligation not only on a corporate level but also more on the individual level. It extends beyond the interests of shareholder value to reach the community in general and the environment (Abu-Tapanjeh 2009). Islamic corporate governance is based on fairness to all stakeholders (Ghayad 2008).

Others such as Kasri (2009) state that the main differences between conventional and Islamic perspectives of corporate governance relate to philosophical aspects, the aims and objectives of corporations, the types of contracts involved and the key players in governance practice, in addition to the relationships between the players. The difference lies in the Islamic perspective of corporate governance practice as a Muslim's commitment, obligation and responsibility to God. It leads to an implicit contract with God and an explicit contract with humans. Ultimately, God and Islam are placed as key players in the corporate governance practice. This is in contrast to the conventional view point that focuses on physical and material aspects (Kasri 2009).



In practice, most of the Islamic organisations use conventional corporate governance standards which may not be in accordance or consistent with Islamic values. In the field of governance, the tools and mechanisms are relatively the same and differences are minor (Kasri 2009). The main distinguishing attribute of Islamic corporate governance is the mandatory presence of a Sharia Supervisory Board (SSB) since all business transactions have to be Sharia compliant (Alman 2012; Ghayad 2008; Kasri 2009; Safieddine 2009). The UAE issued Federal Law No 6 of 1985 that clearly stipulates compliance of Islamic banks with Islamic Sharia law (Al Nahyan 1985). It is also evident in the code of corporate governance of the Dubai Islamic Bank, the oldest and the largest Islamic bank in the UAE. This bank has its code of corporate governance benchmarked with global best practice (Dubai Islamic Bank 2010). In an empirical study of corporate governance and performance of Islamic banks, Bukhari, Awan and Ahmed (2013) found that the most significant dimensions which affect corporate governance in Islamic banks are the board of directors and the Sharia Supervisory Board. Alman (2012) Found that risk-taking in loan portfolios of Islamic banks is positively influenced by the increased size of the SSB.

## **1.4 The aims of the study**

The introduction of corporate governance practices in the UAE is aimed at providing a mechanism to establish and improve investors' confidence, to establish trust in management and to promote economic development of the country. However, the efficiency of corporate governance structures and practices on companies operating in the emerging sensitive market of the UAE has not been adequately investigated using specific governance variables. It is also necessary to study the corporate governance practices that enhance the value of listed companies in the UAE.

Based on the above background, the following research question was devised for this study:

### **Research Question**

What is the impact of the new corporate governance rules introduced in 2010 on corporate governance variables and the performance of non-financial and financial firms and Islamic and conventional banks listed on the DFM and ADX?

The aim of this study was to find an answer to the above research question.

In this study, an investigation was undertaken of the relationship between corporate governance practices consisting of ownership structure and components of board structure — leadership structure, board composition, board size, audit committee and Sharia Supervisory Board in the Islamic banks — and performance of listed companies in the UAE. As the effect of adoption of new codes was being assessed, the extent of changes between two years before adoption (pre-governance period: 2008-2009) and two years after adoption (post-governance period: 2011-2012) were compared.

The specific objectives of the study were:

1. To determine to what extent do the corporate governance rules of United Arabs Emirates have an impact on the overall corporate performance
2. To identify the differences and the similarities between Islamic and conventional corporate governance perspectives within the scope and framework of this study
3. The impact of Islamic corporate governance practices on Islamic firm performance and whether such impact differs from conventional corporate governance practices with respect to firm performance
4. The degree of influence of the corporate governance rules on Islamic and conventional banks in terms of performance, ownership structure, board composition and audit committee composition.
5. To determine the relationship between corporate governance practices such as board leadership structure, board composition, ownership structure, board size, and existence of a financial expert on audit committees and firm performance
6. To examine the impact of SSB of Islamic firms on performance through the following variables: board size of SSB, SSB annual report, experiences, knowledge and qualifications of SSB members, appraisal of SSB, accountability of SSB and frequencies of SSB meetings
7. To investigate the extent to which the companies have adopted corporate governance practices
8. To determine through a comparative analysis, the changes, impact and influence of corporate governance practices on performance in the period before and after the introduction of the governance rules of the following sectors:
  - Non-financial companies
  - Financial companies
  - Financial companies compared to non-financial companies

- Islamic banks
  - Conventional banks
  - Sharia versus conventional banks
  - Dubai FM compared to Abu Dhabi DX; and
9. To propose recommendations on corporate governance codes and practices to regulatory agencies based on the findings of this study.

## **1.5 The conceptual framework of the study**

On the basis of the relevant literature review, this study investigated corporate governance practices and firm performance in the UAE business context. This section presents a theoretical framework suited to the context of the UAE based on agency, stewardship and Islamic perspectives of corporate governance in relation to firm performance. In this framework of corporate governance variables, ownership structure is employed as an influential construct and leadership structure, board composition, board size, audit committee and SSB are the monitoring mechanisms of the board. Accountability to shareholders and other stakeholders is assessed through performance, calculated in terms of accounting and market-based measures.

The financial performance measures used in the study are: return on equity (ROE), return on assets (ROA) and Tobin's Q as these are considered as proxies for accounting returns and market returns. ROE is an accounting measure used to assess rates of return on shareholders' equity and has been used to measure firm performance (Epps & Cereola 2008; Leng 2004) while ROA, which is also an accounting measure, is used to assess the efficiency of assets employed in order to measure firm performance (Abdullah 2004b; Bonn, Yoshikawa & Phan 2004; Haniffa, R & Hudaib 2006). Tobin's Q is a market-based performance measure which compares the value of a company as given by financial markets with the value of the company's assets (Tobin (1969).

## **1.6 The methodology used in the study**

To examine the relationship between corporate governance practices and firm performance in the UAE, this study used methodologies adopted in previous studies of this area of corporate governance. Most studies which have examined these relationships have used a positivist research paradigm of a deduction method and quantitative techniques for the analysis of data collected from secondary sources. To investigate the extent to which the

listed companies in the UAE adopted the corporate governance rules of 2010 and the changes to corporate governance practices and impact on performance, a four years comparative analysis was conducted for the pre-governance period of 2008-2009 and post-governance period of 2011-2012.

Analyses were conducted using the SPSS software package. Descriptive statistics were used to calculate the mean difference for the years 2008, 2009 and 2011, 2012. T-tests were conducted to determine the significance of the differences between the means of 2008-2009 and 2011-2012. Correlation analysis was conducted to find out if there is an association between governance variables and firm performance for the pre and post-governance periods.

Finally, a regression test was conducted for the four years to find the relationship between corporate governance variables and firm performance. A regulatory index was developed for sub-variables used for SSB, treatments were given and variables were transformed by taking a natural logarithm. Data was collected from secondary sources including company's annual reports, journals, and the websites of DFM, ASX, UAE's S&CA and the central banks. Total populations of all listed companies in both DFM and ASX for years 2008, 2009, 2011 and 2012 were collected and tested.

## **1.7 The limitation of existing literature**

Although there is a growing body of literature on corporate governance practices and firm performance, there was a diversity of results in the existing literature on corporate governance and performance because of the different theoretical perspectives, variables and methods of measurement. Moreover, the board engagement in the process of decision making and the contextual nature of each individual firm are different (Korac-Kakabadse, Kakabadse and Kouzmin (2001). Furthermore, most corporate governance studies were conducted in the developed markets. There have been few empirical studies with specific variables, theories and perspectives that have investigated the impact of corporate governance rules and guidelines on the corporate performance of an emerging economy like the UAE and compared implementation of governance mechanisms with the performance of conventional and Islamic banks. In addition there have been few empirical studies that have examined the extent to which conventional corporate governance mechanisms are similar to or differ from Islamic corporate governance mechanisms and perspectives in an emerging, active and sensitive market like the UAE.

Islamic finance is a fast-growing sector not only in the Middle East and South-East Asia, but also internationally. UAE, the context of this study, is the host country of the Islamic capital Dubai which makes this study unique and of special value. The UK, China and Hong Kong have Islamic finance centres and services and as such Islamic corporate governance is required to be implemented in these international markets. This study is expected to produce interesting results to fill the gap in knowledge of not only the relationship between corporate governance practices and firm performance, but also reduce the gap if any between Islamic and conventional corporate governance practices. It will also help in better understanding market differences and building on similarities for better governance.

## **1.8 Contribution to knowledge and significance of the study**

This study will positively contribute to and enrich the existing literature on corporate governance and performance. More specifically, the research will add real value to the little literature available on corporate governance and performance in the UAE context, by investigating the corporate governance structures of the UAE and how they can reflect the accountability of the board to shareholders and other stakeholders through firm performance.

Existing research has examined corporate governance variables of ownership structure and performance, board composition and performance, SSB in Islamic banks and performance. However, these studies have examined the corporate governance variables separately and in different contexts. In addition, this study investigated the relevance of various corporate governance theories in discussing and explaining the differences in these relationships. This study has examined the impact and the influence of the corporate governance rules implemented by listed companies in the UAE market. It has also examined the similarities and differences between conventional and Islamic governance requirements and their impact and influence on firm performance which have not previously been examined. Thus this study will contribute to knowledge in several ways:

1. It is the first to examine the impact and influence of the corporate governance rules of 2010 on firm performance of non-financial and financial companies including Islamic and conventional banks.

2. It is the first to investigate the differences and similarities between conventional and Islamic corporate governance practices in the UAE on the board structure and whether the differences have any impact on firm performance.
3. It is the first to investigate the impact of the SSB on Islamic bank performance employing specific and most valid variables and sub-variables in the relevant literature, such as board size of SSB, SSB annual report, experiences, knowledge and qualifications of SSB members, appraisal of SSB, and accountability of SSB and frequencies of SSB meetings.
4. It is the first to investigate the extent to which the companies have adopted corporate governance practices stipulated in the governance rules of 2010.
5. It is the first to investigate in aggregate the performance of the companies listed on the ASX and the performance of the companies listed on the DFM and the extent to which both markets vary.
6. Firm performance could be improved by using the final recommendations presented in chapter 8 of this study which are missing in the existing literature.
7. This research also contributes to stewardship and agency theories and an Islamic perspective of corporate governance in relation to the accountability of the board to shareholders and other stakeholders of companies operating in an emerging, active but sensitive market.
8. Investigating both conventional and Islamic corporate governance practices is of significance not only to the UAE market as it is the hub and the capital of the Islamic economy, but also to all GCC regions and other international markets such as the UK, China and Hong Kong that have shown interest and initiated Islamic financial services in their markets.
9. This study will not only benefit the corporate sector of the UAE, but it will also be of significance for other GCC countries that are culturally and politically similar to the UAE. In addition it will benefit regulators, investors, researchers, academics and decision makers, as well as assisting policy-makers in improving better governance standards.

## 1.9 Structure of the thesis.

The thesis comprises eight chapters, commencing with Chapter 1 which introduces the topic and provides the background to the study as well as identifying gaps in the literature.

Chapter 2 provides a literature review on both conventional and Islamic corporate governance practices and firm performance. Chapter 3 explains the economic and political environment of the UAE, as well as its historical development in corporate governance, corporate governance reforms and development of both the Dubai Financial Market and Abu Dhabi Stock Exchange.

Chapter 4 presents the conceptual framework of corporate governance and firm performance. The literature in the conceptual framework illustrates the relationship between those concepts. This chapter discusses theoretical perspectives of the conceptual framework, on the basis of which the hypothesis is developed to test the model of corporate governance constructs.

Chapter 5 explains the methodology of the study and includes the discussion of the variables used in the model for corporate governance and firm performance. It includes the data collection methods, measurement used and the conceptualisation and operationalisation of the hypothesis. The statistical techniques employed to analyse the data used for the study are explained.

Chapter 6 discusses the results of the statistical analysis of the data. The descriptive statistics compare the compliance of corporate governance practices in the UAE. Correlation used to measure the strength of association and an analysis of variance tests the hypothesis of the study and explains the interaction between the corporate and firm performance variables. In addition, the importance of individual governance variables in affecting firm performance variables is also discussed.

Chapter 7 discusses the implications of the statistical analyses of the results relating to the relationship of governance and firm performance variables. This discussion incorporates theoretical and empirical evidence from the literature on corporate governance and firm performance, including the impact on the role of individual variables. This chapter further provides empirical evidence to accept or reject the hypothesis of the study.

Chapter 8 presents the summary and conclusion of the study. In particular, it provides an overview of the analysis of the relationship between corporate governance practices and firm performance. It also discusses the findings, implications, limitations, recommendations and suggestions for future research directions.



# **CHAPTER 2**

## **Corporate Governance and Firm Performance**

### **2.1 Introduction**

The purpose of this chapter is to critically analyse the corporate governance theories used in the study as well as their application to the corporates. Effective corporate governance results in the efficient use of the resources of a company, thereby underpinning growth (OECD 2004). Corporate governance is a checks and balances system that ensures the focus on many corporate perspectives and constituencies such as proper resource allocation and delegation of power and decision-making authority and responsibility of making corporate changes with regard to strategic directions (Thorne, Ferrell & Ferrell 2011). Strategic direction means planning for growth and targeted performance to increase shareholder value. Corporate governance is an important topic that has attracted public attention because of its relationship to the economic health of companies and its effect on society in general (Rezaee 2009). The real importance of corporate governance lies in its ability, efficiency and effectiveness to deal with critical business issues such as behaviour of managers, investors and regulatory agencies and its relationship to the procedural control and monitoring through which the achievement of corporate long-term objectives is accomplished (Jinarat and Quang (2003). Therefore, increased monitoring by the institutional investors, mounting pressure for international standards of corporate governance in the emerging markets (Clarke 2004) have helped in corporate governance reforms and to attract investors. The principles of corporate governance reforms are meant to improve performance.

### **2.2 Corporate Governance and Definitions**

In general corporate governance includes codes of best practice and regulations to which corporate management is responsible and accountable.

Corporate governance is a system that includes strategies, mechanisms, accountability and distribution of the power by which corporations ensure and maintain balanced

relationships not only between different classes of shareholders but also between other interest groups and related stakeholders to maintain appropriate and sustainable corporate performance. Various definitions are reviewed below to arrive at a definition suitable for this study.

According to Cadbury, A (1992) corporate governance is ‘the system by which companies are directed and controlled’. This definition emphasizes that the board of directors is responsible for corporate governance and the shareholders’ responsibility is to appoint the board members as well as the external auditors to ensure effective corporate governance.

The Organisation for Economic Co-operation and Development (OECD (2004) defines corporate governance as a set of relationships between a company’s management, its board, its shareholders and other stakeholders.

Another definition a (Banks 2004) sees governance as ‘the structure and function of a corporation in relation to its stakeholders generally, and its shareholders specifically’; in other words, relationships between and among corporate management and all its related players in a market.

Agency theory focuses on the conflict of interest in the relationship between the principal (shareholder) and the manager (agent) (Clarke 2004) and not on the wider range of related stakeholders.

McColgan (2001) defines corporate governance as a conflict of interest between various parties who are usually involved in contractual relationships and other commercial arrangements with corporations, and also between shareholders, debt holders and corporate managers. An effective corporate governance mechanism needs to be designed and articulated to ensure that the gap between the interests of managers and shareholders is narrowed and the mechanism has a positive impact on corporate performance. Friedman, Milton (1970) argued that a corporation’s main responsibility is to increase shareholder’s value as long as they operate within the legal framework of the business environment. However, the modern concept of corporate governance includes the interests of all stakeholders.

Shleifer and Vishny (1997) related corporate governance to the return on investment. This naturally benefits only shareholder interests, as it is a way for these suppliers of finance to corporations to assure themselves of getting a return on their investment. It is clear that, on the basis of agency theory, corporate governance mechanisms play a key role in the capital

market, especially when used to assure investors that their investment managers are being monitored and motivated to increase shareholder value through high return on their investments.

Tirole (2001) defined corporate governance as ‘the design of institutions that induce or force management to internalize the welfare of stakeholders’. Mitton (2002) defined corporate governance as a way by which minority shareholders are protected from expropriation by controlling shareholders like managers. (Clarke 2007) defined corporate governance as “balancing complex interests in the pursuit of value creation for the benefit of a wide constituency”, thus broadening the scope from shareholder interests to the importance of wider stakeholder interest, stressing also social and environmental sustainability as the final business goal.

The above definitions generally focus on the manner in which corporates are controlled, managed and directed to ensure that they are operating within legal boundaries and adequately maintain the interests and the needs of all types of shareholders as well as the relevant stakeholders. Solomon and Solomon (2004) suggested that ‘corporate governance is the system of checks and balances, both internal and external to companies, which ensures that Companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business activity’.

## **2.3 Corporate Governance Differences**

According to Roche (2005) corporate governance is an evolving subject and is not easy to define; definitions vary according to their context, according to Armstrong and Sweeney (2002), and the perspectives of different researchers. There is no single acceptable definition of corporate governance.

There are two contradictory arguments regarding the objective of a firm. One group of researchers argues that the corporate objective is mainly to increase shareholders’ value (Friedman, Milton 1970; Sundaram & Inkpen 2004). The other group argues that a firm’s commitment and obligations are beyond its shareholders and should be extended to include its entire stakeholders (Donaldson, T & Preston 1995; Freeman 2010). The overall objective of corporate governance is similar. However, differences arise among individual companies in the practical implementation and governance mechanisms that are put in place. Corporate

boards of different companies are represented by individuals with different perspectives of corporate governance as well as different leadership styles.

The main mission of listed corporates is to create long-term value, normally achieved through corporate governance structures and mechanisms.

Corporate mission has two important roles: one is to create value and the other is to protect the value. Value creation means increasing the long-term value of shareholders by putting in place business strategies through which corporates could ensure continuous improvement of their performance. With regard to protection of value, corporates focus on the monitoring and accountability of management to ensure that shareholders' —as well as the relevant stakeholders'— interests are protected and not being abused (Rezaee 2009).

## **2.4 Principles of Corporate Governance**

As a result of different countries having different regulatory environments and legal systems, principles of corporate governance have been developed for use as guidance rather than rules by companies in different business environment (Fremond & Capaul 2002; Gul & Tsui 2004). La Porta et al. (1997) indicated that the operation of a country's capital markets depends on the legal system and environment.

The OECD was the first organisation to offer an international code of corporate governance principles, issued in May 1999 and was revised in 2004 (Mallin 2010). Both versions (OECD 1999, 2004) provide guidelines and recommendations on corporate governance practices with emphasis on the rights and equitable treatment of shareholders, roles of stakeholders, disclosure and transparency, and the responsibilities of the board. The OECD Principles of Corporate Governance enrich the scope of corporate governance by acknowledging not only the rights of shareholders but also of stakeholders. Nevertheless, the OECD principles place no obligations on the members of the organisation (Fremond & Capaul 2002).

The OECD principles focus on governance problems that result from the separation of ownership and control. They are intended to assist OECD and non-OECD governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries and to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance. The principles provide an instrument that offers non-

binding standards and good practices, as well as guidance on implementation, which can be adapted to the specific circumstances of individual countries and regions (OECD 2004).

The OECD also encourages companies to establish mechanisms not only to monitor and control managers, but also mechanisms by which management could establish balanced and reasonable compensation and incentives schemes to ensure that managers are motivated and the investors have confidence in economic growth and return (OECD 2004). Iskander and Chamlou (2000) proposed a framework in which corporate governance can be viewed as the dynamic interplay of internal and external incentives that affect the performance of all corporations, whether private, publicly traded, or state-owned.

In the United Kingdom (UK) the financial reporting council established the UK corporate governance code, first introduced by Cadbury committee in 1992 to facilitate effective, entrepreneurial and prudent management that can deliver long-term success for a company. The latest changes and updates of the code were in September 2012 (Council, FR 2010). The UK code of corporate governance is intended as a guide to the key components of effective board practice. It is based on the fundamental principles of good governance such as transparency, accountability, probity and sustainable achievement of an entity over the longer term. The code is flexible in that it reflects the changing economic and social business environment. It pays special attention to better involvement and interaction of the shareholders with the board of directors, as well as the importance of the board leadership and behaviour (Council, FR 2010). The principles ensure the effectiveness of the “comply or explain approach” of UK corporate governance.

The five main principles of the code are: the leadership; leadership separation and responsibility of the chairperson with regard to the long-term success of the company; effectiveness; the board and its committees with the appropriate balance of skills, experience, independence and knowledge of the company; and accountability. The board should present a fair, balanced and understandable assessment of the company’s position and prospects. Furthermore, sufficient, reasonable and balanced remuneration should be in place to attract, retain and motivate directors of that quality required to run the company successfully. Relations with shareholders should be through continuing discussion and dialogue based on the mutual interests and understanding of objectives (Council, FR 2010).

In Australia, the Australian Securities Exchange (ASX) Corporate Governance Council (ASX CGC) was founded in August 2002 by 21 groups of different backgrounds,

including business, investment and shareholder groups (Council, ACG 2007). The Council's mission is to develop and deliver a practical industry-wide, supported framework of corporate governance that can be used as a guideline by listed companies, shareholders, the market and the Australian community. The Council, ACG (2007) states that corporate governance is the framework of rules, relationships, systems and processes within and by which authority is exercised and controlled in corporations. This framework includes the mechanisms by which those in control of corporates and others are held to account. Corporate governance influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimised. Among the eight corporate governance principles developed by the Council, the main focus is on the functions of the board and the senior executives, board composition, size and effectiveness. The majority of the board should be independent members and the roles of the chair and the chief executive officer should be separated. An audit committee should be established with majority independent and non-executive directors. Respect for the rights of shareholders, risk management and a remuneration committee are also included (Council, ACG 2007). According to Beck (2008) the ASX Corporate Governance Council encourages adoption of good corporate governance practices and standards by all publicly-listed corporates through its Corporate Governance Principles and Recommendations and thereby contributes significantly to ensuring that corporates have an efficient and effective framework to design a governance mechanism for their specific requirements which meets the expectations of market, legislators, regulators and the general public.

## **2.5 Importance of Corporate Governance**

Principles of corporate governance are important and the degree of implementation of these principles and codes are critical to an effective corporate governance mechanism. Governance principles are meant not only to protect and increase shareholders' value but also to ensure that the interests of all stakeholders are considered, conflict of interest is eliminated, and enforcement of accountability and transparency function properly in the interests of the wider economy.

Corporate governance focuses on the strategic-level of accountability and control leading to effective performance of all organisational types. It is a checks and balances system that concentrates on many corporate perspectives and constituencies such as proper resource allocation and delegation of power and decision-making authority and responsibility

in accordance with strategic directions (Thorne, Ferrell & Ferrell 2011). Effective corporate governance results in the efficient use of the company's resources, thereby underpinning growth (OECD 2004). There is evidence in the literature of a positive relationship between good corporate governance and corporate performance (Beiner et al. 2004; Brown & Caylor 2004; Yermack 1996; Zeckhauser & Pound 1990).

Good governance benefits corporates through better cash flow which enables access to low cost capital. Good corporate governance improves corporate standards regarding credit ratings which facilitate financing opportunities at low rate. Corporates with good corporate governance are more likely to have proper control mechanisms as well as proper allocation of resources which ultimately contribute to their growth and prosperity and improve economic and financial stability in local and global financial markets (Banks 2004).

## **2.6. Theories and Perspective of Corporate Governance**

Some theories and perspectives are relevant to this study of the relationship between corporate governance and performance of publicly-listed companies. They are based on the governance structures, and processes and practices that affect the performance of publicly-listed corporates.

These are agency theory, stewardship theory and Islamic perspective of corporate governance and are reviewed in the following sections.

### **2.6.1 Agency Theory**

Many corporate governance studies are derived from or guided by agency theory. According to the agency theory, corporate governance is necessary for corporates in order to ensure that the principal-agent risks and problems are mitigated (Berle & Means 1932; Donaldson, L & Davis 1991; Eisenhardt 1989a). An agent is someone who takes responsibility to perform certain work on behalf of another individual (the principal). Essentially agency theory examines the relationships and the work of the individuals (Managers) contracted to work for the interests of the shareholders (principles) and how the conflict of interests arises. Daily, Catherine M, Dalton and Cannella (2003) pointed out that humans are not willing to sacrifice their personal interests for the best interests of others. The theory proposes that each individual in an organisation is motivated to increase his/her own

interests. This proposition of self-interest is the key argument of agency theorists. The separation between management as the control and shareholders as owners is a common practice in the corporate structure (Clarke 2004), as a response to the nature of the modern corporations which have a dispersed ownership structure. Berle and Means (1932) regarded corporate governance as a mechanism by which the board of directors would monitor and minimise the conflict of interest and the managers-owners' problems. Jensen and Meckling (1976) described the firm as a nexus of contracts among individual factors of production resulting in the emergence of the agency theory. The firm is a separate legal entity and not an individual, where conflicts of interests and objectives of individuals exist. They are always governed by contractual arrangements to bring such conflicting issues into equilibrium. Contractual arrangements and relationships are entered into between and among many businesses related parties including shareholders, managers, customers, suppliers, creditors and employers (Jensen & Meckling 1976). These contracts are articulated to maintain and safeguard the right of each individual involved and to maximize the value of their organizations. Minimising agency costs and implementing accounting methods to most efficiently reflect their own performance are two methods to achieve this (Deegan 2006).

Agency theory puts forward a set of assumptions for governing corporations which normally consist of a large number of shareholders. These shareholders delegate to managers responsibility to control and manage their investments for the purpose of generating future profit and subsequently increase their wealth. These managers may not always own shares in the corporation, but may possess a high level of knowledge and experiences in managing the corporation in the best possible manner (Aintablian & Boustany 2008). The solution suggested by the theory to minimise such conflict of interests between managers and shareholders is to align the interests of both the principal and the agent in one direction. Corporate governance is fundamentally about concern of misuse of shareholders' resources by their managers (Clarke 2004). Therefore agency costs occur as a result of misalignment of interest between the owner and the agent (Ang, Cole & Lin 2000).

According to Jensen and Meckling (1976) agency cost has three components: monitoring, bonding and residual loss. Monitoring cost is the cost incurred by the principal to mitigate the uncertain behaviour of the agent. Bonding cost is the cost incurred to ensure that managers' decisions are taken for the interest and benefits of the principals. Residual loss is a cost incurred when both the monitoring and bonding costs have failed to control the assumed opposing and divergent behaviour of managers. Based on these effects on the agency cost and



internal inefficiencies, agency theory proposes that corporate governance mechanisms are the tool to ensure that their investments are protected and their values are increased by monitoring and controlling behaviour and decisions of managers (Jensen & Meckling 1976). On the other hand Turnbull (1997) concluded, using agency theory, that shareholder value cannot be increased, because managers and executives enjoy the discretion which allows them to divert shareholder values for their own personal benefits.

Agency theory suggests facts about human behaviour applied to the behaviour of managers and executives and guides not only investors, but also corporate regulatory bodies through frameworks developed by its assumptions. Using the assumptions of agency theory, analysis as well as structure of corporate management can be reasonably formed and articulated for the benefit of shareholders, corporate entities and the business environment mainly by providing investment protection.

### **2.6.2 Stewardship Theory**

Contrary to agency theory which focuses on managerial opportunistic individualism, stewardship theory suggests that executive managers are intrinsically trustworthy individuals.

Stewardship theory assumes that managers are stewards and their actions and interests are aligned with the objectives of their organisation. The theory puts forward the argument that managers are motivated by the success of their organizations and hence are interested in achieving high performance due to their desire to accomplish recognition from peers (Donaldson, L & Davis 1991). Stewardship theory focuses on leadership and how a leader of an organisation is a trustworthy person whose behaviour is aligned with the interest of the organisation and its owners. Therefore an organisational structure needs to be formulated in a manner that allows a leader such as a chief executive officer to have duality of roles as CEO and as chairperson (Davis, Schoorman & Donaldson 1997). The argument is that, as a result of leadership duality, companies will benefit from the unified and strong control and command to produce effectiveness for high return to shareholders (Donaldson, L & Davis 1991). The theory also argues that a steward should be given the power and discretion to utilise his/her authority over the organization's resources and decision-making as he/she is trusted to work in the interest of the organisation and its shareholders. By so doing the organisation will be able to diminish the cost of monitoring, bonding and incentives, which are the agency costs (Davis, Schoorman & Donaldson 1997).

The theory also assumes that top managers and executives usually devote their entire working lives to the company they direct and govern; they are more likely to understand the operation and the business environment than outside directors. The theory also assumes that managers and executives would have better knowledge and information than outside directors which would ensure that they take the best decisions for the company they manage (Donaldson, L & Davis 1991). Proponents of stewardship theory believe that financial performance is likely to be better with internal mechanisms of corporate governance and practices as it grants greater authority and power to executives and managers. Therefore, combining the roles of CEO and the chairman is beneficial (Davis, Schoorman & Donaldson 1997; Donaldson, L & Davis 1991, 1994).

The argument is that executives and managers are inherently and naturally trustworthy and therefore there is no agency conflict or agency cost associated with executives and managers. Stewardship theory favours specialist board members rather than independent outside directors as proposed by agency theory.

Nonetheless Turnbull (1997) claims that a steward or self-serving agent may be contingent on the cultural and institutional environment in which the company operates and therefore differences in corporate governance mechanisms and behaviour of managers need to be considered according to different contexts.

### **2.6.3 Islamic Perspective of Corporate Governance**

According to Choudhury and Hoque (2006) Islamic corporate governance is a faith-based theoretical framework that relates to the process of decision-making using the principles of the Islamic socio-scientific epistemology of *Tawhead* oneness of God. The usefulness of the influence of the Islamic view of corporate governance is its effect on minimisation of transaction costs in decision-making environments and achieving the objectives of the corporation within the framework of the Islamic rules and principles, otherwise called Sharia law (Choudhury & Hoque 2006).

Consistent with Sharia principles, Islamic corporate governance has a wide commission, with obligations covering and extending to suppliers, customers, competitors and employees, embracing the spiritual as well as the temporal needs of the community (Lewis 2005). This clearly indicates that the Islamic perspective of corporate governance is a responsibility and obligation not only on a corporate level but also on the individual level and extending beyond the interests of shareholder value (Abu-Tapanjeh 2009), as held in the

conventional view (Lewis 2005), to reach the community and the environment (Abu-Tapanjeh 2009). Islamic corporate governance is about fairness to all stakeholders, a view that most of the conventional contributors would hardly accept as they limit the aim of governance to corporate management and control in order to obtain long-term firm value (Ghayad 2008).

Kasri (2009) asserts that the main difference between conventional and Islamic perspectives of corporate governance is the philosophical aspect, comprising aims and objectives of corporations, the types of contracts involved, and key players in governance practice, in addition to the relationships between the players. In the Islamic perspective, corporate governance practice is a Muslim's commitment, obligation and responsibility to the God. Therefore, this leads to an implicit contract with God and an explicit contract with humans. Ultimately, God and Islam are the key players in corporate governance practice. This contrasts to the conventional view that focuses on the physical and material aspects of governance (Kasri 2009).

In practice, most of the Islamic organisations use western corporate governance standards which may not be in accordance with Islamic values. However, the governance tools and mechanisms are similar for both and the differences are minor (Kasri 2009). For example, the UAE Central Bank as the governance regulatory body of all Islamic and conventional financial institutions encourages the use of the OECD's international corporate governance practices (AlSuwaidi 2006). Moreover, the code of corporate governance of the Dubai Islamic Bank, the oldest and the largest Islamic bank in the UAE, is benchmarked with global best practice (Dubai Islamic Bank 2010). The main distinguishing feature of Islamic corporate governance is the mandatory presence of a Sharia Supervisory Board (SSB) as all business transactions have to be Sharia compliant (Alman 2012; Ghayad 2008; Kasri 2009; Safieddine 2009). The UAE issued a federal Law No 6 of 1985 that clearly stipulated Islamic banks must comply with Islamic Sharia law (Al Nahyan 1985). Although the codes of the UAE Central Bank and Dubai Islamic Bank contain best corporate governance practices, they are also strictly compliant with the Sharia laws. This indicates that in practice the main difference between conventional and Islamic corporate governance at the organisational level is the mandatory presence of a SSB in the Islamic institutions, in addition to other contractual arrangements on the operational level.

There are few empirical studies that have addressed the corporate governance and performance of Islamic banks. Bukhari, Awan and Ahmed (2013) found that the most

significant dimensions which affect corporate governance in Islamic banks are the Board of Directors and the Sharia Supervisory Board. Alman (2012) found evidence that the loan portfolio risk-taking of Islamic banks is positively influenced by increasing the size of the SSB.

## **2.7. Corporate Ownership Structure and Firm Performance**

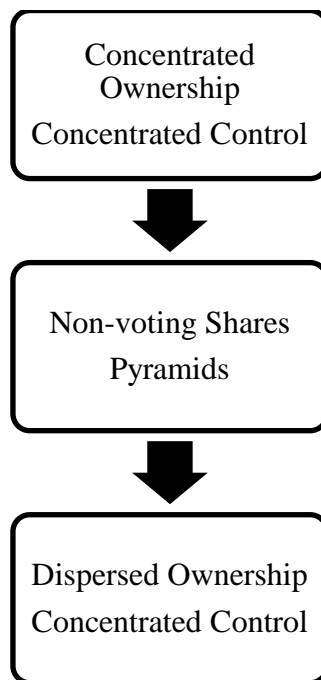
Large publicly listed companies are commonly managed by professional managers rather than owners.

However the appointment of these professional managers on the basis of agency theory would create a potential conflict of interest between shareholders and their agents. The dispersed nature of shareholding of large publicly listed companies would require companies to establish and structure a control mechanism for the purpose of monitoring corporate management because no one shareholder has the incentive to monitor management on his/her own.

According to (Mayer 2000) there are two models of ownership structure: one is the Insider System and the other is the Market-based System. The insider system is used in Continental European countries such as Germany, and in Japan and Asian countries, while the Market-based system is used by Anglo-American corporations in the US and the UK (Bebchuk 1999; Mayer 2000).

In both models, a company would start as a private company owned, controlled and managed by its founder. It requires capital and therefore issues shares. In the insider system it can raise these funds in the form of non-voting equity, sell shares to related firms and ensure that control remains in the hands of a small number of parties. As the company grows and expands, new large investors purchase stakes, minority stakes are sold off to companies that are purchased and the complex network and pyramids of the insider ownership structure system starts to emerge. The whole process is explained in Fig 2.1.

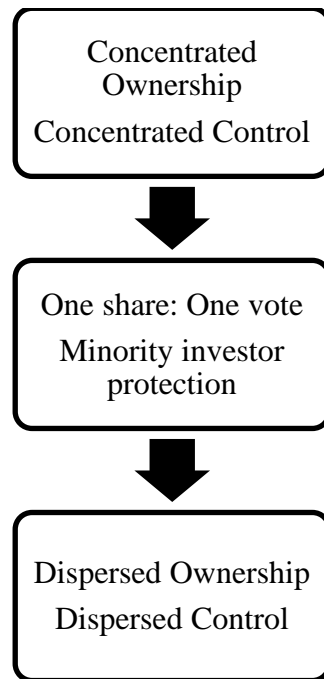
*Figure 2.1: Continental Europe Evolution of Control - Insider Ownership System*



Source: (Mayer 2000)

In the Anglo-American corporations, particularly in the UK, a company sells equity on the stock market and when more than 50 per cent of the voting rights are sold, control is transferred to the market. Other companies cannot purchase stakes of more than 30 per cent in the company without making full bids. Share blocks are therefore sold off and both ownership and control become dispersed in the hands of outside individuals and financial institutions (Figure 2.2)

*Figure 2.2: Anglo-American Evolution of Control - Outsider Ownership System*



Source: (Mayer 2000)

In the "Insider System", control is concentrated in the hands of a small number of individual investors with differences of interests and agendas. In the "Outsider System", shareholdings are dispersed and voting is not concentrated in a few hands. In the "Insider System", firm control is concentrated in the hands of a small number of individual shareholders. Such ownership structure demonstrates two different theoretical arguments which have an impact on the firm.

One argument, based on agency theory, is that such organisational setups would positively impact on corporate performance through a reduction in the agency cost. Managers have a tendency to work towards their own personal best interests by way of allocating firms' resources towards themselves and that may conflict with those interests of outside shareholders (Jensen & Meckling 1976). Furthermore (Baysinger & Butler 1985a; Berle & Means 1932; Fama, EFa & Jensen 1983; Gompers 2003; Jensen & Meckling 1976; Shleifer & Vishny 1986), managers are motivated by the widely dispersed ownership structure to dispossess corporate shares in a way that negatively affects the wealth of shareholders (Core, Holthausen & Larcker 1999; Berle & Means 1932; Fama, EFa & Jensen 1983; Jensen & Meckling 1976; Shleifer & Vishny 1986)

On the other hand, the existence of large shareholders with large equity stakes or controlling shareholders is assumed to negatively harm a firm because the controlling shareholders' interests may not align with those of non-controlling shareholders (Porta, Lopez-De-Silanes & Shleifer 1999; Shleifer & Vishny 1997).

Controlling shareholders may use a company's resources for their own interests, such as paying themselves unnecessary high salaries and dividends or appointing their family members in top executives positions and in the board of directors without considering their competencies and other relevant factors (Wiwattanakantang 2001). (Demsetz, H 1983) was the first to challenge the assumptions of agency theory, arguing that there should be no relationship between ownership structure and company performance, and that ownership structure should be considered as an endogenous outcome of decisions that reflect the level of influence of shareholders. Demsetz, Harold and Lehn (1985a) also did not find any relationship between profit rates and various measures of ownership concentration in a sample of 511 US firms. Demsetz, H (1983) suggested that diffusion of ownership structure provides a better chance for corporations to survive when they are under pressure for large equity capital, but that there is no particular equity/ownership structure that is optimal to increase the performance. On the contrary (Shleifer & Vishny 1997) observed the significant role of large shareholders and its positive impact on the share prices of firms.

Mehran (1995) established that there was a positive relationship between managerial equity ownership and company performance, while Zeckhauser and Pound (1990) observed a relationship between large shareholders and future performance and suggested that a large body of shareholders can be an indicator of positive future performance. Conversely, (Porta, Lopez-De-Silanes & Shleifer 1999) found that when the majority shareholders effectively control a corporation, their policy may result in expropriation of minority shareholders by not paying dividends and transferring profits to companies that they own and control. Morck, Shleifer and Vishny (1988b) examined the relationship between ownership structure and firm performance using Tobin's q as a performance measure and obtained a non-linear relationship between insider ownership and firm performance. The study found a positive relationship between ownership structure and Tobin's q between 0 and 5 per cent of board ownership, a negative relationship between 5 and 25 per cent, and a positive relationship thereafter. Nevertheless these findings are not confirmed by accounting-based measures. (McConnell & Servaes 1990) investigated the relationship between Tobin's q and the structure of equity ownership and found a significant curvilinear relationship between Tobin's q and the

fraction of common stock owned by corporate insiders between 0 to the range of 40-50 per cent and a negative relationship when exceeding 50 per cent. The study also found a positive relationship between Tobin's q and the fraction of shares owned by institutional investors.

Zeitun and Tian (2007) found empirical evidence of positive effects of ownership concentration on company performance in terms of both accounting-based measures and market-based measure using a sample of publicly-listed companies in Jordan. The positive effect of ownership concentration had a stronger influence on the accounting-based measure of performance than on the market-based measure of performance. In a study of 249 large banks in 20 countries in the Middle East and North Africa (MENA), (Kobeissi 2004) found a positive relationship between ownership concentration and performance in the banking sector.

Ownership structure is an important factor in corporations and that is evident by the empirical evidence from studies conducted in different contexts using different variables and measurement tools. However there has been no consensus on the relationship between ownership structure and performance, which keeps the door wide open for future research. According to Tricker and Bob (1998), ownership structures of publicly-listed corporates around the globe are often complex and to understand their corporate governance it is important to understand the ownership structure, which will indicate their potential to exercise power and influence. This suggests the significance of ownership structure in terms of shareholders and the role they can play in the company's affairs. Shareholders can appoint board members, and oversee and appoint managers (agents) to run the company which would have an impact on its performance.

## **2.8 Board Structure**

### **2.8.1 Leadership Structure and Performance**

Duality or separation of chairperson and chief executive officer roles is a board structure construct that has the potential of increasing or decreasing agency conflict. This construct refers to aboard leadership structure in which one person performs both the roles of chairperson (control) and chief executive officer (CEO – management) of the board (Cadbury, SA 2000). The chairperson of the board is responsible for managing the board. The role includes the nomination of new board members, setting agendas for board meetings, reviewing the performance of senior management, and resolving conflicts which may arise



within the board (Laing & Weir 1999). In contrast, the CEO's responsibility is to manage the day-to-day operations of the company including implementation of the board decisions.

The agency theory perspective advocates that proper control mechanisms and monitoring are required in order to protect shareholders from the agency cost of modern capitalism (Fama, EFa & Jensen 1983) which results from separation of ownership and management (Berle & Means 1932). This is monitored and controlled by an independent and active board, in addition to manager's incentives and compensation (Amable 2005). Separation of the role of CEO and chairperson is mainly based on agency theory (Dalton et al. 1998), as the main role of the board of directors is to monitor management, including the CEO, to make sure that shareholders' interests are protected (Fama, EFa & Jensen 1983). Combining the roles of CEO and chairperson will result in a dominant CEO which will lead to ineffective monitoring of the management by the board (Tin Yan & Shu Kam 2008).

Duality of CEO and chairperson is one of the specific governance mechanisms identified in many internal corporate governance mechanisms, such as the Australian corporate governance principles guidelines (Council, ACG 2007), the US Sarbanes-Oxley Act (Valenti 2008b) and in the combined code of the UK (McKnight & Weir 2009). In the United Arab Emirates corporate governance rules recommend that separation of the roles of CEO and chairperson might enhance corporate performance and reduce agency conflict/cost (Al Mansouri 2009).

According to (Jensen 1993), duality of the CEO and chairperson would impair control over top management decisions and reduce the board's effectiveness and performance. Agency problems seem to be greater when one person holds both positions. (Jensen 1993) asserts that duality of the roles increases agency problems by compromising the board's effectiveness in monitoring the CEO performance. As a result, pro-agency theory researchers argue that separating the two roles will increase board independence by providing effective checks and balances over managerial behaviour (Haniffa, RM & Cooke 2002; Lipton & Lorsch 1992). Separating the two roles makes it easier for the board of directors to remove a non-performing CEO (Jensen 1993). These practices would protect shareholder value from being misused by managers.

But supporters of the stewardship theory argue that managers are inherently trustworthy and are good stewards of company resources and work to achieve a higher level of corporate profits (Donaldson, L & Davis 1991, 1994). Combining the roles in an

organisation will enable companies to minimise the cost of monitoring, bonding and incentives (Davis, Schoorman & Donaldson 1997) which will improve company performance.

Studies on this issue have yielded mixed findings. (Daily, Catherine M & Dalton 1992; Vafeas & Theodorou 1998; Weir, Laing & McKnight 2002) found no relationship between duality of roles and performance. Brickley, Coles and Jarrell (1997) found that role duality did not reduce performance, (Boyd 1995; Rechner & Dalton 1991; Sanda, Mikailu & Garba 2005) found positive relationships between company performance and separating the roles of CEO and chairperson.

Specific effects on certain performance variables were reported by some authors. Dehaene, De Vuyst and Ooghe (2001) found that the return of assets (ROA) is higher when the roles of chief executive and chairperson are combined. Higher ROA on ROE were reported by (Donaldson, L & Davis 1991) in 31 of 321 US-based companies between 1985 and 1987 companies which had the two roles combined. This result supports stewardship theory. In an Australian study on 348 publicly listed large corporate (Kiel & Nicholson 2003) found that duality of the roles impacted positively on Tobin's q. In a study of the performance of a sample of 192 of US-Based Corporate from 12 different industries from 1980 through to 1984, (Boyd 1995) observed higher ROI when the roles were combined. A similar result was reported by (Donaldson, L & Davis 1991). These findings support stewardship theory.

On the other hand, (Rechner & Dalton 1991) using a sample of 141 large US-based corporations from 1978 to 1983 observed higher ROI, ROE and profit margins in companies with separated roles. Nevertheless this result has been criticized because the sample was large US-based corporates, only accounting-based variables were measured and corporate specific characteristics such as firm size and industry effects were not controlled (Rechner & Dalton 1991). Similarly, (Haniffa, R & Hudaib 2006) in a sample of 347 Malaysian listed companies obtained increased ROA in the case of companies that separated the two roles compared to those that combined them. Yermack (1996) argued that companies with separate positions of CEO and chairperson are more highly valued than companies with duality of the two roles.

These conflicting results raise the question of the level of practicality and viability of such arguments. The varied results may be due to different contexts with diverse environmental and social settings.

## 2.8.2 Board Composition and Performance

Most international corporate governance codes and rules require boards of directors of publicly-listed corporations to have a combined form of insider and outsider directors (Al Mansouri 2009; Council, ACG 2007; McKnight & Weir 2009; Valenti 2008b). Such specific rules and codes indicate the importance of corporate board composition and mechanisms in term of their impact on monitoring, control, independence, effectiveness and performance in different environmental settings. Boards of directors play a crucial role in corporate governance of companies and the composition of a board is an essential part of the governance mechanism (Jensen 1993), as the first line of monitoring in an organisation. The most recent study conducted by the GCC Board Directors Institute revealed that greater skill, diversity, contribution and evaluation were required to enhance board effectiveness in the GCC region (Institute (2015)). The key findings of the study were inadequate skills and knowledge among directors, limited adoption of self-evaluation processes among boards and ineffective board dynamics. About 69 per cent of the respondents cited corporate governance and compliance rules, when asked where they would like to see more expertise on their boards. Also, boards of directors in the GCC lacked the essential elements to ensure an effective board which may have a negative impact on corporate performance. Liang and Li (1999) identified a positive relationship between the presence of outside directors and return on investment, while Dehaene, De Vuyst and Ooghe (2001) found a positive relationship between outside directors and return on equity. Jackling and Johl (2009) noted that a greater proportion of outside directors are associated with improved firm performance. Baysinger and Butler (1985b) also observed that corporations perform better if the board includes more outside directors. In the UK context, (Weir, Laing & McKnight 2002) observed in a study of 311 publicly-listed companies from 1994 to 1996 an increase in Tobin's q with an increased proportion of independent directors in the board. In South African (Musa & Eddie 2008) noted better performance of boards dominated by non-executive directors compared to those with less non-executive directors. In Continental Europe (Krivogorsky 2006), using a sample of 87 companies between 2000 and 2001, also found a positive relationship between the proportion of independent directors on boards and profitability ratios. These findings support the agency perspective that outside directors act independently as monitors to protect the interest of shareholders in situations where conflicts occurs with firms managers (Fama, EFa & Jensen 1983).

According to (Fama, EF 1980; Fama, EFa & Jensen 1983), outside directors are critical in the internal control mechanism because they are more prepared to perform a monitoring role in an organisation. Firstenberg and Malkiel (1980) advocated a majority of outside directors on corporate boards.

Australian Corporate Governance principles recommend that the majority of the board should be independent non-exertive members (Council, ASXCG & Exchange 2007), to contribute to board effectiveness. Similarly the Dubai Islamic Bank code of corporate governance stipulates a majority of non-executive directors on bank boards (Dubai Islamic Bank 2010), consistent with the direction of UAE Ministerial Resolution No. 518 of 2009 Concerning Governance Rules and Corporate Standards (Al Mansouri 2009).

However, (Agrawal & Knoeber 1996; Bhagat, Sanjai & Black 2000; Yermack 1996); and (Laing & Weir 1999) in the UK found a negative relationship between non-executive director representation and corporate performance. These findings support stewardship theory which contends that insider directors are better equipped to understand and deal with complexities of business operations than outsider directors. Such findings also suggest that though independent and non-executive directors can bring objectivity and independence to the board room, they may also stifle management decisions and business opportunities through excessive monitoring and control.

In a study using a sample of 485 S&P 500 firms for 1992 and 486 for 1993, Klein (1998) obtained a significantly positive relationship for the percentage of inside directors on finance and investment committees with accounting and stock market performance measures. This indicates that outside directors can provide valuable knowledge and information for effective investments decisions (Agrawal & Knoeber 1996). (Fama, EFa & Jensen 1983) assert that inside directors provide valuable information to boards about long-term investment decisions.

No impact on corporate performance was observed by (Hermalin, Benjamin E. & Weisbach 1991) in a sample of 142 US-based publicly-listed companies and by (Haniffa, R & Hudaib 2006) in a sample of 347 Malaysian publicly-listed companies.

These diverse empirical findings suggest that there is no agreement on any specific effect or the applicability of a specific theoretical assumption. The board composition and performance relationship seems to be quite complex, particularly in large publicly-listed corporates (Dalton & Kesner 1983) which most of these studies used for their samples.

### 2.8.3 Board Size and Performance

Board size is an important construct of a good corporate governance mechanism. The impact of the board size is expressed in the engagement and involvement of boards in corporate activities and affairs. In addition to the structure, the size of the board indicates its ability and efficiency in directing and guiding corporations. A group of researchers reported better performance for smaller boards (Eisenberg, Sundgren & Wells 1998; Hermalin, Benjamin E & Weisbach 2001; Jensen 1993; Singh & Davidson III 2003; Yermack 1996) and (Lipton & Lorsch 1992). It seems that the smaller the size, the lower the agency cost (McKnight & Weir 2009).

Tobin's q was higher for smaller boards in (Yermack 1996) study of a sample of 452 of US-based large public companies between 1984 and 1991. This effect was attributed to poor communication and coordination among board members which leads to negative monitoring. According to (Jensen 1993), increased board size may destroy the firm's value because of the board's reduced ability to function effectively with regard to communication, coordination and monitoring. He argued that agent/managers would increase board size beyond its value-maximizing level. Large boards are less cohesive and poor in understanding among the board members. The agency theory model assumes that because agents/managers generate large boards which are ineffective, board size and performance are negatively linked. Jensen (1993) also proposed an optimal board size of ten or fewer. (Lipton & Lorsch 1992) argued that when board size exceeded seven or eight people, its functional effectiveness is affected, but (Conger & Lawler 2009) argued that there is no magical or ideal size for a board the more important consideration is the time it takes to form the right mix of skills, knowledge and leadership to effectively add value to the company. (Guest 2009) also found a negative impact of board size on Tobin's q and ROE in a large sample of UK firms; The larger the size, the greater the effect.

Hillman, Keim and Luce (2001) (Hillman, Keim & Luce 2001; Pfeffer 1972a) observed that the larger the board size, the better for the company as it will help to supply valuable resources..

This relationship is based on the view that board size is associated with the company's capability and ability to access significant resources and the external environment through its larger board membership (Dalton et al. 1999; Hillman & Dalziel 2003). (Kiel & Nicholson 2003) using a sample of 348 of Australia's largest publicly listed companies found a

significant correlation between board size and Tobin's Q. (Pearce & Zahra 1991) pointed out that a larger board is more powerful and assists in building relationships and corporate identity. In a study on the banking industry conducted by (Andres & Vallelado 2008), larger board size was related to directors' ability to monitor and advise management, and that larger boards might demonstrate more efficiency in monitoring and advising functions and create more value for a company.

Connelly and Limpaphayom (2004) reported that board size does not have any relationship to company performance. A United Arab Emirates-based study by (Aljifri & Moustafa 2007) reported that board size had an insignificant impact on firm performance in the UAE.

The above mixed results regarding the relationship between board size and company performance establish that there is no agreement about the optimal board size (Dalton et al. 2003). From a theoretical perspective, (Kiel & Nicholson 2003) argued there is no single theory that offers a broad explanation and justification of the corporate governance-corporate performance relationship. However each theory has elements which can be applied in different settings. Board size could have an impact on the evolving nature of a company or result in poor performance of a company, although poor performance could also be related to composition of a board (Eisenberg, Sundgren & Wells 1998). This indicates that different circumstances can have different impacts on the governance-performance relationship debate, including the board size construct.

#### **2.8.4 Audit Committee Composition and Performance**

Audit committees are of particular importance in improving corporate governance, more specifically in monitoring and assessing the financial reporting reliability of companies (McMullen 1996). Boards of directors and audit committees are established to monitor management's behaviour and to ensure that managers act in the best interests of the shareholders rather than their own personal interests (Fama, EFa & Jensen 1983; Jensen & Meckling 1976). This represents the agency theory perspective of audit committees being established to reduce the level of conflict between shareholders and managers. The significance of audit committees, their role and contribution to corporate governance structure is evident in different corporate governance mechanisms. In the US sections 301 and 402 of the Sarbanes-Oxley Act require an audit committee to be established (Hoi, Robin & Tessori 2007). The Australian Stock Exchange guidelines recommends the establishment

of audit committees with guidelines about their composition, operation and responsibilities (Council, ACG 2007). In the UAE, Article 6 of the ministerial resolution requires audit committees to be established (Al Mansouri 2009).

DeFond, Hann and Hu (2005) found a significant positive relationship between the appointment of independent financial experts in the audit committee and stock return. The importance of having experts in law, accounting and auditing in audit committees is evident in the findings of DeZoort (1997) which also indicate that internal control evaluation is the most important responsibility of an audit committee. This finding drew attention to audit committee members needing to be carefully selected or appointed and have experience in accounting and finance to enable them to evaluate companies' internal controls. McDaniel, Martin and Maines (2002) established a positive relationship between the presence of financial experts within audit committees and the quality of financial reporting. Such empirical results demonstrate the important role a financial expert can play within an audit committee.

A financial expert can articulate a value-adding framework which an audit committee would discuss, evaluate and take effective decisions, with regards to the responsibility and priority of an audit committee functions within a firm as well as improving the overall effectiveness of its oversight (McDaniel, Martin & Maines 2002).

Qin (2007) reported positive relationship between the presence of a financial expert in an audit committee and the quality of reported earnings. Krishnan (2005) observed that companies with financial experts and independent audit committees are less likely to have internal control problems. These results confirm not only the importance of audit committees within organisations, but also the importance of the characteristics of the audit committee members. There have been many incidents where audit committees members were found to be incompetent and did not understand their roles, duties and responsibilities (DeZoort 1997).

In a study using a sample of 119 Australian publicly-listed firms between 1999 and 2007, Azam, Hoque and Yeasmin (2010) observed a positive relationship between the frequency of audit committee meetings and equity return (ROE). A negative association between the size of audit committees and an earning restatement was noted by (Lin, Li & Yang 2006). This indicated that the smaller the size of an audit committee the better the oversight of financial reporting processes. The same study also revealed that the

independence, financial expertise, activity, and stock ownership of audit committees did not have a significant impact on the quality of reported earnings.

(DeFond, Hann & Hu 2005) reported a positive market reaction to the appointment of financial expertise to audit committees. It is imperative that audit committees members possess the right financial literacy and experience as well as the relevant qualifications if they are to improve the audit committee oversight function and establish an effective monitoring mechanism. Such requirements enable audit committees to not only protect shareholders interests, but also to add value through improving companies' operational and financial functions.

### **2.8.5 Islamic Corporate Governance (Sharia Supervisory Board and Performance)**

According to Choudhury and Hoque (2006) Islamic corporate governance is a faith-based theoretical framework that is regarded as a theory that relates to the process of decision-making using the principles of the Islamic socio-scientific epistemology of *Tawhead*, oneness of God. The influence of the Islamic view of corporate governance is significant, particularly when related to transaction cost minimization in decision-making environments and achievement of the objectives of the corporation within the framework of Sharia law and Islamic rules and principles (Choudhury & Hoque 2006).

Consistent with Sharia principles, Islamic corporate governance has a wide commission, with obligations covering and extending to suppliers, customers, competitors and employees, embracing the spiritual as well as the temporal needs of the community (Lewis 2005). Thus, the Islamic perspective of corporate governance is a responsibility and obligation not only on a corporate level but more on the individual level and extending beyond the interests of shareholders' value (Abu-Tapanjeh 2009) as held in the conventional view (Lewis 2005) and to reach into the community and the environment (Abu-Tapanjeh 2009). Islamic corporate governance is about fairness to all stakeholders, a view that most of the Western contributors would hardly accept, as they limit the aim of governance to obtaining long-term firm value (Ghayad 2008).

Others such as Kasri (2009) state that the main difference between conventional and Islamic perspective of corporate governance relates to philosophical aspects, comprising aims and objectives of corporations, the types of contracts involved, and key players in governance practice in addition to the relationships between the players. The difference relates to the



Islamic perspective of corporate governance practice as a Muslim's commitment, obligation, and responsibility to God. Therefore, this leads to an implicit contract with God and an explicit contract with humans. Ultimately, it places God and Islam itself as key players in corporate governance practice, whereas the conventional view focuses on the physical and material aspects (Kasri 2009).

A major philosophical difference between conventional and Islamic perspectives is that the objectives of companies in the conventional model are to maximise profit of shareholders or maximise the wealth of the stakeholders. But the Islamic perspective is that the prime objective is unity of purpose of everyone to serve Almighty Allah (God) SWT (*Subhanahu Wa Ta'ala*). Such belief and action will result in an Islamic society that can avoid conflicting interests among its members (Kasri 2009).

In Islam, moral behaviour is considered to be part and parcel of worship and submission to God. This belief would lead to members of society cooperating rather than competing to achieve the ultimate objective and success in life. This is considered to please God (Ahmad 2003). Such philosophical considerations do not exist in the conventional literature.

Islamic corporate governance is about fulfilling the contractual commitments and obligations towards all relevant and related parties, stakeholders, the environment and the general public. It is about trust and integrity and about being intellectually and intentionally honest and transparent. Such normative attributes can only be possessed by individuals whose ultimate goal is to please almighty God through being complaint with the Divine Law of Sharia (Kasri 2009). Foundation of the Sharia is a covenant between God and man which imposes on man the duty of being faithful to his Lord. Failure to fulfil these obligations means he or she has breached the Divine contract, thus equivalent to betrayal with all the resulting consequences in this world and beyond.

In practice, most of the Islamic organisations use western corporate governance standards which may not be in accordance with Islamic values. However, in the area of the governance tools and mechanisms, both are relatively the same and differences are minor (Kasri 2009). (Al-Tamimi 2012) found little difference between conventional national banks and Islamic banks in the UAE when investigating corporate governance practices. Furthermore (Ghayad 2008) acknowledged that Islamic banks have the same purpose as conventional banks except that Islamic banks operate according to the Sharia ruling which is

known as Fiqh al-Muamalat (Islamic rules on transactions that include not to deal or operate with interest but with profit/loss sharing principles ). (Metwally 2012) reported in his study of fifteen interest-free banks (Islamic banks) and fifteen conventional banks (interest-based banks), that the two groups may be differentiated in terms of liquidity, leverage and credit risk, but not profitability and efficiency. Islamic banks lean towards conservative methods in utilizing funds for lending and were disadvantaged in their investment opportunities. This finding suggests that operational differences may exist between both type of banks, particularly in terms of liquidity, leverage and credit risk. These relate to the use of Sharia Islamic rules by Islamic banks.

However, the main distinguishing attributes of Islamic corporate governance is the mandatory presence of a Sharia Supervisory Board (SSB) as all business transactions have to be Sharia compliant (Al-Tamimi, Lafi & Uddin 2009; Alman 2012; Ghayad 2008; Haron, Ahmad & Planisek 1994; Kasri 2009; Majid, Sulaiman & Ariffin 2011; Safieddine 2009) .

The Sharia Supervisory Board constitutes a key instrument of governance in an Islamic Bank (Ghayad 2008). The UAE Federal Law No 6 of 1985 clearly stipulates that Islamic banks must comply with Islamic Sharia law (Al Nahyan 1985). Incorporation of SSB into conventional governance systems is widely practised. The UAE Central Bank as the governance regulatory body of all Islamic and conventional financial institutions encourages the use of the OECD's international corporate governance practices (AlSuwaidi 2006). It is also evident in the code of corporate Governance of the Dubai Islamic Bank, the oldest and the largest Islamic bank in the UAE which indicates that its code of corporate governance is benchmarked with global best practices (Dubai Islamic Bank 2010). Thus the main practical difference between conventional and Islamic corporate governance on the organisational level is the mandatory presence of SSB in Islamic institutions in addition to other contractual arrangements on the operational level. For example, when lending money, participation in partnership business is the main function of Islamic banks, whereas lending money and getting it back with compound interest is the business goal of conventional banks (Al-Tamimi, Lafi & Uddin 2009).

There are few empirical studies that have addressed the corporate governance and performance of Islamic banks. Bukhari, Awan and Ahmed (2013) found that the most significant dimensions which affect corporate governance in Islamic banks are the Board of Directors and the Sharia Supervisory Board. Alman (2012) found that the loan portfolio risk-taking of Islamic banks is positively influenced by increasing the size of the SSB. (Al-

Tamimi, Lafi & Uddin 2009) reported that most UAE bank customers preferred banking with Islamic banks, even though they were not satisfied with the types of services and products that they provide. The same study also reported a significant difference between how customers perceived UAE Islamic banks versus conventional banks. This perhaps related to the fact that most UAE citizens are Muslims and therefore choose or prefer to bank with Islamic banks, because Islamic banks tailor their products and services on the principles of Islamic religion.

A Malaysian study by Haron, Ahmad and Planisek (1994) found that 39 per cent of Muslim respondents believed religion is the only reason people patronize Islamic banks. Furthermore, a Jordanian study reported that 65 per cent of people banked with the Islamic bank because it not only provided conventional banking but also observed Sharia rules and principles (Naser, Jamal & Al-Khatib 1999). Based on these results, it can be argued that the performance of Islamic banks is largely driven by its Muslim customers-base, which wishes to conduct business transactions in accordance with Islamic sharia law, particularly in Muslims countries. However, Haron, Ahmad and Planisek (1994) found that both Muslims and non-Muslims who patronized commercial banks had a common perception in selecting their banks and therefore Islamic banks should not emphasise religion (Sharia principles) as a strategy in an effort to attract more customers.

Bin Hasan (2011) reported in his study of Islamic financial institutions (IFIs) in Malaysia and the Gulf Cooperation Council GCC which includes the UAE and the UK of perceptions of the roles and functions of the Sharia Supervisory Board in accountability, organizational communication, Sharia non-compliance risk, Islamic ethics and values, and Sharia control processes. In the Malaysian context IFIs were generally satisfied with the performance of the Sharia Supervisory Board, Similarly, IFIs in the UK were satisfied with the performance of their Sharia Supervisory boards. In the GCC, while most IFIs agreed on the positive performance of the Sharia Supervisory Board, a few IFIs were dissatisfied with its performance. Some IFIs in GCC acknowledged that their Sharia Supervisory Board has ignored some important aspects of Islamic Sharia governance, particularly with respect to the effectiveness of organizational communication, identifying Sharia non-compliance risk, contributing to Islamic ethics and values, and Sharia control processes (Bin Hasan 2011). It should be noted that the evaluation and assessment of the performance of Sharia Supervisory board's is crucial not only to better governance but also to the success of IFIs. Rammal (2010) revealed that there was a worldwide shortage of competent Sharia advisors in the

Islamic finance sector, resulting in SSB employees being hired to work for more than one SSB, which raises a concern about conflict of interest (Bin Hasan 2011). Unal (2009) using network analysis techniques in his survey of SSB scholars and their involvement in multiple SSB positions, found that the top 10 scholars (who held 15 or more positions) share 253 positions, an average of 25.3 positions per scholar. Such findings may indicate that some governance practices in relation to SSB needed to be addressed. They include accountability of SSB, confidentiality, ineffective monitoring, and lack of competence as a result of a shortage of qualified individuals.

There may be some benefits in engaging in multiple Sharia boards, as SSB members may gain increased experience and knowledge. However excessive Sharia board positions at one particular time in many Islamic Financial Institutions could negatively affect the efficiency of SSB scholars and consequently their performance as well as potentially raising an issue regarding agency problems and conflict of interest.

According to the Auditing and Accounting Organisation for Islamic Financial Institutions (AAOIFI)

A Sharia supervisory board is an independent body of specialised jurists in *fiqhalmua'malat* (Islamic commercial jurisprudence). However, the Sharia supervisory board may include a member other than those specialised in *fiqhalmua'malat*, but who should be an expert in the field of Islamic financial institutions and with knowledge of *fiqhalmua'malat*. The Sharia supervisory board is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic Sharia Rules and Principles. The fatwas, and rulings of the Sharia supervisory board shall be binding on the Islamic financial institution (AAOIFI 1991).

This definition seems to ignore the general business competencies and the linkage between Islamic Sharia Law and current market requirements in a globalized economy. SSB members need to possess relevant business competencies so they can innovate and develop new products and drive Islamic bank performance forward in order to increase their market share.

With regard to specific business competencies of the Sharia Supervisory Board (Bin Hasan 2011) reported that only 51.4 per cent of Islamic Financial Institutions provided professional training to their Sharia Supervisory Board, especially in matters of finance and

banking,. He also reported that 43 per cent of Islamic Financial Institutions in Malaysia, the Gulf Cooperation Council and the UK did not assess or evaluate their Sharia Supervisory Board's performance. This indicated that a large number of IFIs did not know the impact of the Sharia Supervisory Board on their performance which may be a critical issue in Islamic corporate governance. Ghayad (2008) asserted that Sharia members must have a qualification and professional training in finance and commerce to ensure better quality of supervision and consultation. Otherwise, there will be a risk that for short term profits or gains the shareholders and board of directors may be willing to compromise Sharia principles (Akhtar 2006b). It is critical for a Sharia Supervisory Board to maintain Sharia compliance and use its Sharia knowledge to develop new Sharia-compliant products to enable Islamic banks to enhance their performance, compete with conventional banks, and remain viable.

The role of the Sharia Supervisory Board varies depending on the nature, extent and degree of Sharia compliance. Inspired by its foundational principles and stakeholder value orientation, the Sharia board has fiduciary duties and obligations to all stakeholders of the IFIs. Moreover; the integrity of Islamic Financial Institutions is greatly dependant on the status of Sharia compliance, the impact of products, professional competence and observance of Sharia norms (Muhammad 2008).

The Sharia Supervisory Boards are an essential part of Islamic financial institutions, as they are responsible for monitoring the compliance of Sharia rules in their transactions and issuance of Sharia products. In addition, the Sharia Supervisory Board has the authority to issue Fatwas (rulings) regarding the Islamic bank's products and practices (Wardhany & Arshad 2012). According to the Islamic Financial Services Board:

Sharia Governance Framework refers to the set of institutional and organisational arrangements through which an IFI ensures that there is effective independent oversight of Sharia compliance over each of the following structures and processes (1) the issuance of relevant Sharia pronouncement/resolutions; (2) dissemination of information on such Sharia resolutions to the operative personnel of the IFI; (3) an internal Sharia compliance review or audit; (4) to an annual Sharia compliance review or audit for verifying the internal Sharia review.

The Sharia Governance System requires the establishment of a Sharia Supervisory Board to ensure that Islamic banking products and operations match Sharia principles (Prudential & Compilation 2007; Wardhany & Arshad 2012). Ghayad (2008) describes the

role of the Sharia Supervisory Board as both supervisory and consultative in ensuring that Islamic banking adheres strictly to Sharia rules and principles in its operations.

Islamic finance and Sharia-compliant governance have developed in different ways. For example, in the member states of Gulf Cooperation Council (GCC), the SSB governance structure is ruled independently at an institutional level, while in Malaysia the SSB was established and organised at a state level with other members in Islamic financial institutions (Bin Hasan 2011; Warde 2010). The centralized SSB structure in Malaysia seems to focus more on Sharia compliance and does not allow individual Islamic banks to take their own decisions regarding Sharia products and compliance, while the decentralized approach in the GCC is more market-oriented and therefore banks have the freedom to make decisions at the individual level.

## **2.9 Capital Markets and Corporate Governance**

The capital markets play an essential role in the global economy. They provide the means for individuals and organizations to access capital and to enhance and improve return on their businesses and investments. Financial instruments also allow investors to manage risk through transferring certain risks to another participant in the business transaction who might be more willing to manage or capitalize on such risk. Many enterprises including banks, brokers engaged in securities and derivatives transactions, and government-related entities facilitate capital market involvement (Ferris, Jagannathan & Pritchard 2003). Disruption in the financial markets can be troubling to global economies as these markets provide the opportunity for an organisation to access capital. To prevent systemic failure, regulators and governing bodies legislate goals of fostering an environment to maintain sustainable growth and stability of the capital market (Ferris, Jagannathan & Pritchard 2003).

The life blood of capital markets is the capital provided by investors that must be protected through appropriate regulations and effective corporate governance mechanisms (Rezaee 2009). A significant driver of economic growth is the investors' confidence in the capital markets (Rezaee 2009). Stock markets can be directly affected by the type and efficiency of published information which can impact on the allocation of funds to investments that result in a higher return with adjustments to related risk factors (Alexander, Murray & Houghton 1994).

Publicly listed companies play a crucial role in the capital market and therefore investors' confidence is significant in maintaining market activity and growth, which requires accurate financial reports for investors to make informed business decisions (Rezaee 2009). To maintain efficiency a capital market requires financial related information to be provided in a reliable, accurate and transparent manner as this will positively affect the capital market. Therefore, financial reports need to be audited and published in compliance with the rules of the relevant governance regulatory authorities. Public investors can use these reports to assess and evaluate their information to help them make the appropriate investment decision. Audited financial statements are particularly significant for capital markets and relevant interest groups (Rezaee 2009).

## **2.10 Performance Measures and Firm Value**

Research indicates that corporate governance affects firm value through reduced expropriation by insiders and improvement in the expected returns of cash flows that can be distributed to shareholders (Black, Jang & Kim 2006; Claessens & Fan 2002; Klapper & Love 2004; Yermack 1996). Black, Jang and Kim (2006) report a causal relationship between an overall corporate governance index and higher share prices in emerging markets.

According to Ferris, Jagannathan and Pritchard (2003), the value of a firm is determined by the future expected cash flow discounted at a rate that reflects the its riskiness. The important factor to valuation is therefore an assessment of the likely future cash flows, and the application of the appropriate rate of discount to establish present value (Abdul Rahman 1998). Good corporate governance is an essential factor in improving the value of a firm in capital markets of both the developing and developed countries (Rashid 2008).

Oakland (1989) argues that in order to evaluate a firm's performance, it is essential to determine the elements of good performance using performance indicators that are measurable, relevant, and meaningful, and the cost of obtaining and collecting the information must not be greater than its value (Oakland 1989).

Firm performance can be measured using many. Empirical studies on corporate governance use financial measures for firm performance which are either accounting-based or market-based measures (Kiel & Nicholson 2003). Commonly used accounting-based measures are the Return on Equity (ROE)(Baysinger & Butler 1985b) and Return on Assets (ROA)(Kiel & Nicholson 2003) and earnings per share. The market-based measures that are

mostly used in literature are the market to book value ratio and the Tobin's q (Claessens & Fan 2002). Accounting-based measures are usually criticised when compared to current market-based measures. Management can use its authority to manipulate accounting methods which may result in a change of accounting policies, accruals and estimates that will be difficult to interpret and understand across industries. In addition, accounting-based information used to measure performance is historical and focuses on past transactions and events (Kiel & Nicholson 2003). Moreover, accounting-based reports do not include relevant risk factors and do not consider the time value of money principle (Klapper & Love 2004). In contrast, market-based measures are established on the real value of companies' common stock and a management cannot manipulate or have an impact on this method of performance measure. Market-based measures reflect risk adjusted performance (Dalton et al. 1998) and are considered to be forward looking and reflect organisational strategies (Kiel & Nicholson 2003).

Prior empirical studies have used both accounting-based and market-based methods to investigate the relationship between corporate governance practices and firm performance in many different contexts and the results have been mixed. According to a meta-analytic review of corporate governance literature conducted by Dalton et al. (1998), there seems to be no agreed view on what are the best methods as both relied on to investigate performance-related matters. This study used both market-based measures represented by Tobin's q and accounting-based measures represented by Return on Assets (ROA) and Return on Equity (ROE).

## **2.11 Corporate Governance in Emerging Markets**

Emerging markets need to consider better corporate governance in order to gain investor confidence and promote foreign and domestic investment which results in a safe economic environment (Qureshi 2007). The financial crisis that hit the South East Asian markets in 1997 and 1998 was partly attributed to weak corporate governance, this urged governments to consider ways to improve governance practices and structures (Oakland 1989). The action by governments in making governance reforms in the developing markets was aimed at restoring investor confidence through establishing a safe institutional platform in investment markets (Archer, Karim & Al-Deehani 1998). Nevertheless, the corporate sector in emerging markets appears to lag behind the standards for sound corporate governance (Oakland 1989).



The establishment of codes of corporate governance in emerging markets were aimed at promoting a continuing flow of funds and increasing investor confidence in their capital markets (Haniffa, R & Hudaib 2006). Corporates in emerging markets may be aware of the concept of corporate governance, but the issue has been the effective implementation of corporate governance practices (Oakland 1989). This indicated the weakness of legal institutions for corporate governance in emerging markets and the negative impact on the stock market, leading to the Asian crisis (Kiel & Nicholson 2006). However, countries need to consider their unique environmental settings, culture and social factors to develop a corporate governance mechanism that suits their markets and national interests to reform their governance systems (Haniffa, R & Hudaib 2006).

Klapper and Love (2002) indicated that large shareholders might exploit minority shareholders in emerging markets. The regulatory agencies are weak in emerging markets and improvement in the firm's internal governance mechanism can improve their performance to a higher level compared to firms in a developed market.

## **2.12 Conclusion**

This chapter critically analysed the assumptions and arguments of theories of corporate governance as well as its application to modern corporations. It also critically analysed literature in relation to the concept of Islamic corporate governance to emphasise the differences and similarities between the Western and the Islamic corporate governance mechanisms. The review of the literature focused on the relationship between corporate governance and firm performance. It indicated that analysing the performance of corporates is complex and the effect on performance measures depends on the intended objectives of each corporate. This study is to fill the gap in the literature on corporate governance by answering the research question on the impact of the new corporate governance rules introduced in 2010 on corporate governance variables and firm performance of non-financial and financial firms and Islamic and conventional banks listed on the DFM and ADX.

The review of literature will help to develop the study's conceptual framework and to build the hypotheses that determine the relationship between corporate governance and firm performance in the UAE context.



# **CHAPTER 3**

## **Economic Environment, Corporate Governance and Development of Capital Markets in the United Arab Emirates**

### **3.1 Introduction**

Unique among the Gulf Cooperation Council (GCC) states, the United Arab Emirates (UAE) is a federation of seven largely autonomous emirates that joined together in 1971 after independence. They vary significantly in size, population, economic structure and hydrocarbon resources. Abu Dhabi has a leading role as it holds most of the UAE's oil and gas reserves, as well as 87 per cent of the land area and 43 per cent of citizens. Abu Dhabi's hydrocarbon revenue per annum is US\$232,000, the highest in the GCC. As a result, Abu Dhabi has a per capita GDP of US\$82,000. Dubai still has significant hydrocarbon reserves and revenue, relative to its population, but its production has declined since the late 1990s. In response to this decline, Dubai has invested heavily in its development infrastructure and diversifying its economy. It drew on a long tradition of international commerce to create an unrivalled regional hub for trade and manufacturing, focused on the Jebel Ali port and free zone, as well as a broader services economy. As a result, it has achieved a similar level of development to Abu Dhabi and a per capita GDP more than twice as high as the other five northern emirates. Although it was weakened by a debt and real estate crisis in 2009, its economy is now recovering.

Sharjah is the third largest emirate and has some oil and gas reserves, although production is down sharply from the peak. It is situated next to Dubai and, along with Ajman, is the smallest but most densely populated emirate, and forms part of a continuous coastal metropolis. Relatively affordable rents in these emirates mean that hundreds of thousands of workers commute from there into Dubai daily. The other three emirates, Umm al-Quain, Ras al-Khaimah and Fujairah have smaller expatriate populations. They are subsidized by revenue transfers from the federal government.

Umm al-Quain, the smallest emirate, has recently begun producing gas from a small offshore field. Ras al-Khaimah, at the UAE's northern tip, it is the fourth largest emirate, with a little offshore gas, although its Saleh field has been largely depleted.

Finally, Fujairah is the only emirate situated on the east coast. It is growing in importance as the terminus of a strategic new pipeline by-passing the Straits of Hormuz and associated downstream industries (Grant, Golawala & McKechnie 2007; QNB 2013)

## **3. 2 Overview of Economic Environment of UAE**

The UAE has an open economy with a high per capita income and a sizable annual trade surplus. Successful efforts at economic diversification have reduced the percentage of GDP based on oil and gas output to 25 per cent. Since the discovery of oil in the UAE more than 30 years ago, the country has undergone a profound transformation from an underprivileged region of small desert principalities to a modern state with a high standard of living. The government has increased spending on job creation and infrastructure expansion and is opening up utilities to greater private sector involvement. The country's Free Trade Zones - offering 100 per cent foreign ownership and zero taxes - are attracting foreign investors. The global financial crisis and tight international credit constricted the economy in 2009. UAE authorities increased spending to boost liquidity in the banking sector to overcome the impact of the global financial crisis. Through its rich reserves and exportation of oil and gas, it was able to recover. The UAE's strategic plan for the next few years focuses on diversification and creating more opportunities for nationals through improved education and increased private sector employment (The World Factbook 2011)

The UAE gross domestic product (GDP) reached AED 981 Billion in 2011 at a growth rate of 4.2 per cent compared to AED 942 Billion in 2010 at a growth rate of 1.3 per cent, while the real growth of the non-oil sector was about 3.1 per cent in 2011. These growth rates, despite the global financial crisis, confirm the continued success of the policy of diversifying the sources of income and at the same time reducing reliance on oil.

Oil prices remained high, with an average price per barrel reaching 107 dollars in 2011 which increased government revenues and provided resources that were reflected in public spending and investment stimulation and consequently contributed to the development of other sectors of the national economy. The most important sectors have been alternative and renewable energy and the peaceful use of nuclear energy for maintaining non-renewable

oil resources of the state, thus safeguarding the rights of the coming generations and maintaining an environment free from pollution (Economy 2012). These economic developments, evident by economic growth year over year, reflect the UAE leadership vision of maintaining not only continued economic development, but also developing an innovative and progressive knowledge-based economic approach to ensuring the country's economic resources are sustainable and diversified.

Following the boom years, economic growth in the UAE turned negative in 2009 (-4.8 per cent) as indicated in table 3.1. This was due mainly to a drop in trade of 8.0 per cent, oil and natural gas of 8.5 per cent, the real estate sector of 13.2 per cent, and manufacturing of 14.1 per cent. (Table 3.1)

*Table 3.1: GDP growth in the UAE (2007-2011)*

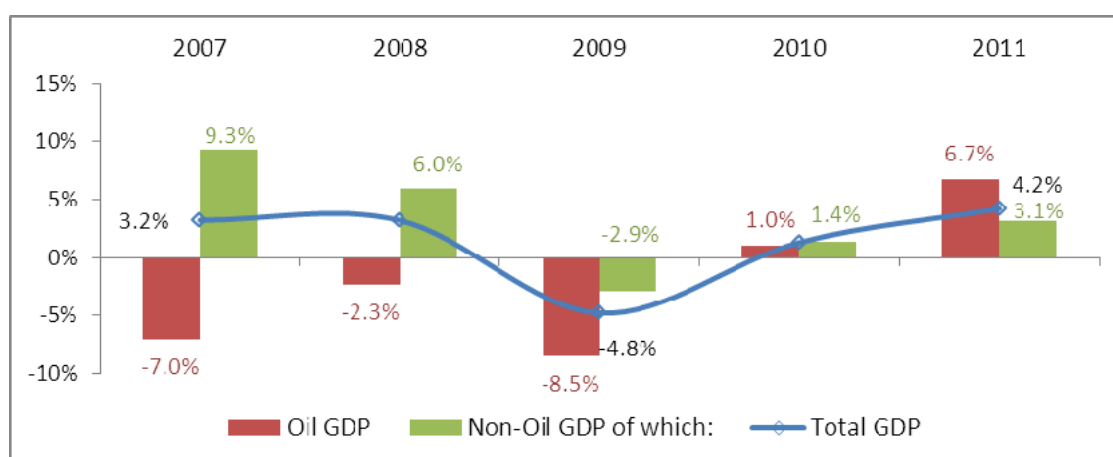
<b>Year</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>
<b>Total GDP</b>	3.2%	3.2%	-4.8%	1.3%	4.2%
<b>Oil GDP</b>	-7.0%	-2.3%	-8.5%	1.0%	6.7%
<b>Non-Oil GDP of which:</b>	9.3%	6.0%	-2.9%	1.4%	3.1%
Manufacturing	1.9%	10.3%	-14.1%	6.9%	3.0%
Construction	10.0%	10.3%	1.7%	2.4%	3.2%
Wholesale Retail & Trade	5.9%	2.7%	-8.0%	3.1%	2.8%
Real Estate	16.1%	2.6%	13.2%	0.1%	0.7%
Transport & Communication	17.9%	11.8%	3.0%	-3.3%	4.0%

Source: Central Bank of the UAE, Financial Stability Report 2012.

The economic recovery started in the following year, with GDP increasing by 1.3 per cent. The economic sectors that registered positive growth included construction at a rate of 2.4 per cent, the real estate sector 0.1 per cent, manufacturing 6.9 per cent and trade 3.1 per cent. Economic recovery further consolidated in 2011, with GDP growing by 4.2 per cent due to a 6.7 per cent growth in oil GDP and a 3.1 per cent growth in non-oil GDP.

Figure 3.1 illustrates the annual growth in both oil and non-oil GDP.

*Figure 3.1: UAE GDP Growth (in %)*



Source: Central Bank of UAE, Financial Stability Report 2012.

## Oil Prices

Despite successful diversification of the economy, oil-GDP at current prices represented 26.4 per cent of total GDP in the UAE in 2009, 30.9 per cent in 2010 and 38.4 per cent in 2011. Higher oil prices impact on other activities as part of the oil income is brought back into the domestic banking system, depending on the government's needs. As a result, resident deposits increased which allowed banks to provide more credit. Brent oil prices decreased by 36.6 per cent in 2009. This was followed by an increase of 28.7 per cent in 2010 and 39.4 per cent in 2011, reaching an average of \$111.0 per barrel in 2011.

## Foreign Investment

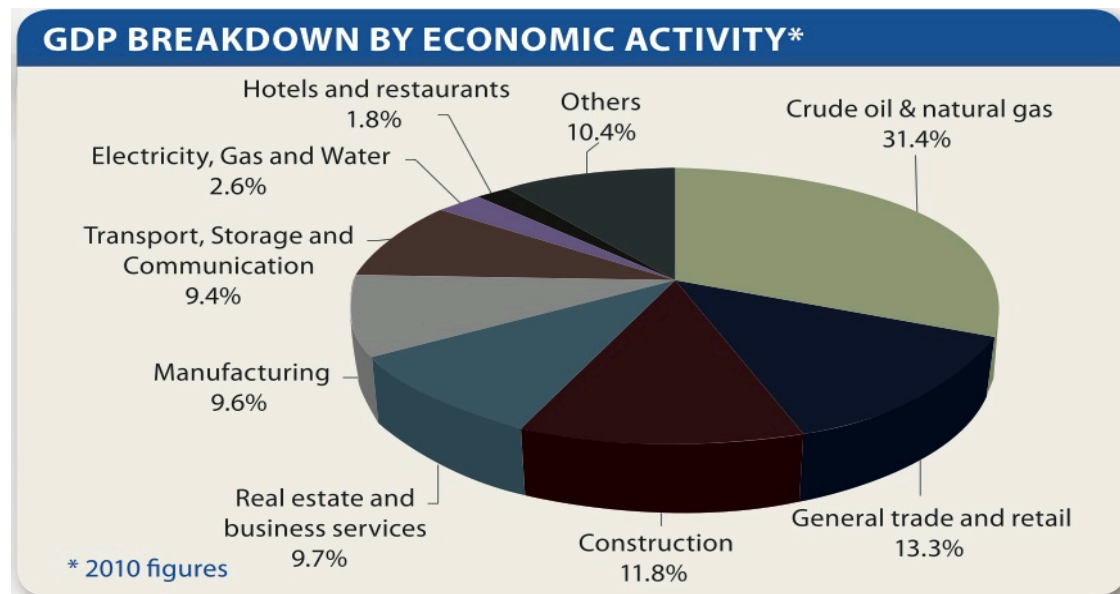
Since 2011 the State has given more attention to foreign direct investment (FDI) in view of its importance in creating job opportunities, supporting development, bringing in modern technology and providing management techniques. A law on foreign investment was drafted to provide the legal framework and required protection for foreign investments, regulating their flow, providing the required institutional support and stimulating more investment. The statistical data indicates that foreign investment flows experienced a slowdown in the past few years. They were around AED 14.7 billion in 2009, rising gradually to around AED 28.2 billion in 2011, as demonstrated by Figure 3.2, and generating a total accumulation of AED 313.4 billion approximately at the end of 2011.

*Figure 3.2: FDI Flows 2005 – 2011(in Billion AED)*

Source: Ministry of economy, Annual Economic Report 2012

With regard to sector-wide distribution of FDI, real-estate came at the top of the list for such investments, accounting for 28.7 per cent of total foreign investment, while the construction sector accounted for 19.3 per cent of t foreign investment. That is attributed to the boom in these two sectors, the enhancement of their attractiveness for investment and the increased demand on their outputs for residential and commercial purposes. The stability of the banking sector in the country has attracted nearly 20.9 per cent of the foreign investment, while the commercial sector shared about 10.1 per cent of the total foreign investment (Economy 2012). The industrial sector accounted for around 8 per cent of the total FDI, this needs to improve as it is one of the important means of attracting technology, and increasing exports , the labour force GDP (Economy 2012). Figure 3.3 summarizes the UAE's economic sectors and their contributions to GDP

*Figure 3.3: GDP Breakdown by Economic Activity*



Sources: Bank Audi, Group Research Department.

### 3.3 Development of Capital Markets in UAE

The UAE stock market is relatively new and small. The market officially started in 2000, with the establishment of two stock exchanges, Abu Dhabi Securities Market (ADSM) and Dubai Financial Market (DFM) under the supervision of the Emirates Securities and Commodities Authority (ES&CA).

Between 1975 and 1982 UAE market witnessed the creation of many corporates due to rising oil prices and the strong interest of the Federal Government in building a stable and strong economy. However, the crash of the Kuwaiti stock market in 1983 (Al-Manakh market) and falling oil prices in 1986 had a negative impact on its capital market.

During the period from 1993 to 1997, due to the establishment of many new corporates, the UAE capital market rose again. Consequently, during the summer of 1998, the UAE capital market experienced another deep decline caused by negative speculative trading, lack of regulation, manipulation of the market by block traders and professional investors, a drop in oil prices and lack of financial disclosure and transparency (Moustafa 2004).

As a result of the 1998 market crisis the UAE government officially re-organised its stock market by establishing the Emirates Securities and Commodities Authority (ESCA) on 1 February 2000 pursuant to Federal Law No 4 of 2000 under the chairmanship of the Minister of Economy and Commerce. Its function is to regulate and develop the primary and



secondary markets, monitor the market and promote a safe and favourable environment for investors. ESCA is a legal entity reporting to the Minister with financial and administrative independence and control and executive powers necessary to discharge its tasks in line with the provisions of this law and the regulations issued for its implementation. The Authority may establish subsidiary branches or offices to discharge the task of supervising and monitoring the markets but may neither practice trade activities nor seek benefit in any project or own or issue any securities (ES&CA 2000).

The Dubai Financial Market (DFM) was founded in March 2000 as the first organized stock market in UAE. Abu Dhabi Securities Market (ADSM), which is larger than the DFM started operating in November 2000. In 2001 ESCA launched an official capital-weighted average market index with 1000 points, called the Emirates Index, consisting of all listed stocks. ESCA enacted a set of statutory orders and regulations related to arbitration, listing, practice, brokers' transparency and disclosure, financial markets' operations, trading, clearance and depository (Moustafa 2004) which were the starting point for better corporate governance in the UAE capital market.

*Table 3.2: UAE Financial Markets Performance 2010 – 2011*

(In Billion AED)			
<b>Description</b>	<b>2010</b>	<b>2011</b>	<b>Growth Rate</b>
Number of Listed Companies	128.0	128.0	0.0
General Index of Stock Prices (points)	2655.3	2341.4	(11.8)%
Market Value of Shares (AED Billions)	385.4	346.1	(10.2)%

Source: Ministry of Economy, Annual Economic Report 2012

The financial markets suffered from the effects of the global financial crisis that followed the crisis in the Euro zone. Markets are mostly affected by changes in local as well as global economic conditions. With regards to the general index of the stock prices, Table 3.2 indicates that the index fell by 11.8 per cent from 2,655.3 points at the end of 2010 to 2,341.4 points at the end of 2011, and the market value of traded shares decreased by 10.2 per cent from AED 385.4 billion in December 2010 to AED 346.1 billion in December 2011. This may suggest the extent of investors' cautiousness (Economy 2012). However, there are indications that both the Abu Dhabi Securities Market and the Dubai Financial Market have performed better during 2012 when the UAE market benefited from improved investor sentiment after Dubai started to show early signs of recovery. The DFM performed 18.8 per

cent higher in 2012 than in the previous year and the ADSM 11.33 per cent higher (Audi 2013).

According to the IMF (2013), short - and medium-term growth prospects are positive for the UAE. The non-oil economy is estimated to grow by over 4 per cent per annum in the coming years on the back of Dubai's strong core services sectors and Abu Dhabi's diversification strategy. The still uncertain global economic and financial environment could affect this favourable outlook, although UAE's sizeable foreign assets and improving fiscal position provide significant buffers. Such a positive economic outlook would have a positive impact on the UAE capital market performance. However entering a renewed boom-bust cycle (IMF 2013) requires enactment of economic policies to further strengthen the economy and mitigate the risk associated with the pace of recovery in segments such as real estate and tourism, and prudent financial sector regulation (IMF 2013). Relevant regulatory authorities need to learn from the 2009 global financial crisis in developing economic and financial policies, as well as devising better corporate governance mechanisms that are compatible with current growth in the UAE corporate sector and the economy in general. Understanding micro- operational factors that influence corporate governance as well as considering international best practice is essential for a balanced corporate governance mechanism.

The rise in oil prices, increased spending on infrastructure projects for expanding airports, road, bridge, tunnel and infrastructure projects, industrial areas and other ports, and projects related to tourism activity as well as strong performance of the other economic sectors such as trade and tourism supported by the expansionary fiscal policies the UAE economy will keep it on the path to recovery. Several new laws on foreign investment, small and medium-sized enterprises, competition, industrial property and commercial fraud will promote the business environment in the State (Economy 2012).

### **3.4 Corporate Governance, Capital Markets and Firm Performance in UAE**

Growth of capital markets in the UAE resulted in the introduction of mandatory corporate governance rules for listed companies, and their impact is analysed in this research. Listed non-financial companies are to comply with rules in areas such as board structure, separation of the roles of CEO and chairperson, board composition, board committees and internal control. All companies are required to issue an annual corporate governance report.

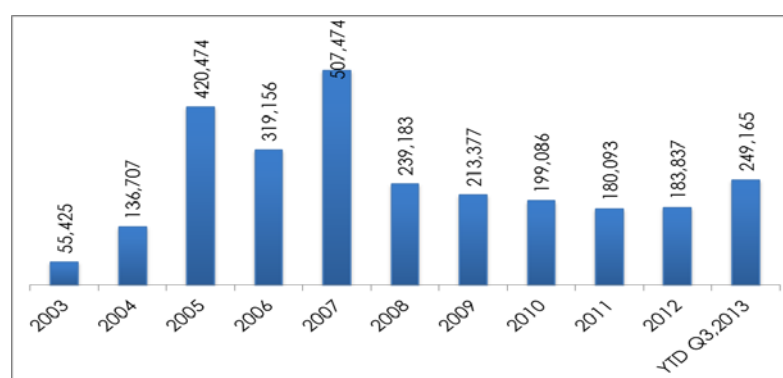
In the UAE the factors that affect firm performance and ultimately market performance are raising interest rates, inflation, oil prices, infrastructure projects and regional economic activities. On the level of actual UAE market performance, there was significant appreciation in the performance of the Emirates Securities Market (ESM) during the 2013. The ESM index posted a positive return of 9.39 per cent, while the total market value of listed companies increased by 9.5 per cent .Moreover, Net Foreign Investment value surged during the year by about AED1.230 billion, indicating restored confidence of foreign investors in the local markets as their performance continues to improve. Table 3.3 summarises the projected rate of growth of GDP of the Gulf Cooperation Council which includes Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and UAE (DFM 2013).

*Table 3.3: GCC – GDP Projections 2010 - 2013*

<b>Country</b>	<b>2010</b>	<b>2011</b>	<b>2012 e</b>	<b>2013 f</b>
Bahrain	4.1%	1.5%	3.6%	4.8%
Kuwait	3.4%	5.7%	4.5%	5.1%
Oman	4.1%	4.4%	3.6%	3.8%
Qatar	16.6%	18.7%	6.0%	4.3%
Saudi Arabia	4.1%	6.8%	3.6%	4.4%
UAE	3.2%	3.3%	3.8%	4.0%

Source: DFM.

*Figure 3.4: End of Period Market Capitalization (2003 – YTD Q3, 2013)*



Source: DFM

The growth rate of market capitalization in the first 9 months of 2013 was 36 per cent as indicated in Fig 3.4.

In his opening address at a conference on “The UAE Capital Markets – An Important Engine for Economic Growth”, H.E Mr. Abdullah Al Turifi, ESCA Chief Executive Officer,

disclosed that ESCA has so far issued 42 regulations and resolutions and is currently working on others that are expected to have a positive impact on local securities markets. These regulations include Covered Bonds, Subscription Rights, Certificate of Deposit and Rules for Listing and Trading of Stocks of Private Companies.

### **3.5 Islamic Financial Institutions in UAE**

Islamic finance is growing as a source of finance for Islamic and other investors around the world (Bley & Kuehn 2004; Rosylin Mohd & Mejda 2013). Islamic finance involves interest free financial transactions and financial instruments that fulfil the needs of Muslims. It is a growing field (Najeeb & Vejzagic 2013), especially in the Middle East and in South-East Asian countries with large Muslim populations, who maybe uncomfortable with conventional banking and financial systems which involve payment of interest.

According to Warde (2010), Islamic finance can no longer be dismissed as a passing fad or as an epiphenomenon of Islamic revivalism. Islamic financial institutions currently operate in more than 70 countries and their assets have increased more than fortyfold since 1982 to over \$200 billion. In 1996 and 1997, they grew at an annual rate of 24 and 26 per cent respectively (Warde 2010).

Islamic finance has become an integrated part of the global economy. For example, currently there is a Dow Jones Islamic Market Index, which tracks about 600 companies from within and outside the Muslim world whose services and products are based on Islamic law (Warde 2010). Multinational financial institutions such as Citibank have established their own subsidiaries of Islamic banking addition, many conventional banks in Muslim countries as well as in the United States and Europe are now offering Islamic products that may target not only Muslims but also the general community (Warde 2010). Therefore Islamic financial services and products are in many ways well-matched to the global economy (Warde 2010). According to Siddiqui, R (2008) the Dow Jones Index provided the Sharia screening guidance, through its independent Sharia Supervisory Board. Similarly, the establishment of the Dow Jones Citigroup Sukuk Index (Bonds Index) has contributed positively to the emerging Islamic financial market becoming an important part of the global economy.

In the UAE Islamic financial institutions have become an integral part of the country's economy. According to Najeeb and Vejzagic (2013), the UAE Islamic equity market comes third after Malaysia and Indonesia in Islamic equity and mutual funds, with a

total of 93 Islamic equity stocks listed and a market capitalization of USD 40.2 billion. The UAE share in the global sukuk markets (bond market) is 4.8 per cent, for the period from 2006 to 2011 (Najeeb & Vejzagic 2013). According to Magazine (2011) the UAE Islamic financial services sector represented 30 per cent of the global Islamic banking industry in 2011 due to the growing demand for Islamic financial services among different customer segments within the UAE.

The UAE has always played a significant role as a prominent hub for Sharia compliant investments. Within the GCC region, the UAE has historically been in competition with Bahrain in establishing itself as a prime location for Islamic investments. Abu Dhabi and Dubai have the most lucrative opportunities for Sharia compliant investments (Magazine 2012). The demand for Sharia compliant savings products in the UAE received a major boost especially in Dubai due to its ethical principles and prohibition of interest. The prohibition of *riba* (interest) in Islamic finance is favoured not only by UAE nationals but also by many other investors around the world, this is speculated to produce a more stable financial environment (Magazine 2012). The UAE was the fourth largest issuer of Islamic bonds in the first quarter of 2012, raising approximately \$1.9 billion (Dh7 billion) through Sukuk compared to \$6.4bn in Saudi Arabia. It is clear that the UAE Islamic finance sector plays an important role in the country's economy through public projects that are financed by Islamic Sukuk.

A new initiative to transform Dubai into a global hub for sukuks (Islamic bonds) is aimed at positioning the UAE as a top-ranked international economy. His Highness Shaikh Mohammed bin Rashid Al Maktoum, Vice-President and Prime Minister of the UAE and Ruler of Dubai, said "Transforming Dubai into a global centre for Islamic sukuk is intended to cement confidence in our economy among international financial circles" (John 2013). The plan includes Islamic finance instruments, Islamic insurance, Islamic contracts' arbitration, Islamic food industry and trade standards (Halal food), and Islamic quality management standards. Such initiatives by the country's leadership strongly indicate their commitment to support and further develop the Islamic finance sector in the UAE. In addition, the UAE has won the bid to host the 2020 World Expo which is expected to transform Dubai's economic landscape as Dubai and the UAE would benefit from an estimated \$6.9 billion budget for the infrastructure for this world event (Gulfnews.com, BDA 2013). Declaring Dubai as the capital of the Islamic economy (Gulfnews.com 2013) and the host of the World Expo 2020

reflects the vision and commitment of the UAE leadership in shaping the country's emerging economy.

## **3.6 Corporate Governance in UAE**

The regulation of UAE corporate governance is covered by: (1) the UAE Corporation Act No. 8 of 1984; (2) the Emirates Securities and Commodities Market Authority (ES&CMA) regulations and listing conditions; (3) the UAE code of governance; and (4) Dubai Financial Service Authority (DFSA). Each of these regulatory bodies provides its intended part of the corporate governance practices. Yet, these regulatory bodies cooperatively and collectively, provide a comprehensive form of UAE corporate governance practices.

### **3.6.1 Commercial Corporations Act of 1984**

The 1984 UAE Corporations Act incorporates articles that govern corporation management processes (Al Mansouri 2009). The Act contains rules related to the selection of the board of directors and its composition, duties and management processes (Articles 95-109). Article 111 stipulates a general framework of board of directors' duties. Board members will be held responsible for abuse of power, fraud, violation of law and/or the corporation bylaws and wrongful management. The Act requires that UAE corporations must be owned at least 51 per cent by UAE nationals (Adawi & Rwegasira 2011; Hassan 2011). Article 118 requires corporations to show how boards of directors' remuneration is determined while specifying that this remuneration should not exceed 10 per cent of the net income after distributing at least 5 per cent of profits as dividends.

The Act requires all corporations in the UAE to maintain proper financial records, including minimum accounting reports financial statements, statement of profit and loss and cash flow statement and notes to these accounts. These accounts, the Act states, are an integral part of the board of directors' report to shareholders at the annual general meeting (Articles 144-151). While the Act does not enforce the adoption of specific financial accounting standards, most corporate prepare their financial statements in accordance with International Financial Reporting Standards (IFRS) following the ES&CMA listing conditions (Ahmed, B & Bowden 2008; Hassan 2009). The UAE Corporation Act of 1984 requires that annual audited accounts are presented before shareholders at an annual general meeting. Chapter four sets rules that govern the selection, appointment and work of auditors,

and states that auditors must approve the financial statements and outline any irregularities to shareholders.

### **3.6.2 The Role of ES&CMA in Corporate Regulations**

The ES&CMA regulations outline rules and listing conditions of corporations and enhance corporate governance practices (ES&CMA decision No. 3 of 2000 concerning regulations on disclosure and transparency)(Hassan 2011). With respect to listing conditions (Decision No. 3 of 2000), the ES&CMA requires corporations to fully disclose with appropriate level of transparency certain corporate governance-related information. For example, decision No. 3 of 2000, Article 36 (Hassan 2011) requires listed corporations to provide information about the following:

- The names of the members of the board of directors and the executive managers, with a statement of the shares owned by each of them and their relatives to the first degree, and the membership of any of them on the boards of directors of other public joint stock companies;
- The names of those who own, or whose holdings coupled with those of their dependent children amount to 5 per cent or more of the shares of the company;
- -The percentage of the holdings of persons, who are not nationals, in the company's capital
- The amendments introduced into the company's articles of association as soon as these amendments are approved; and
- Any change relating to the company's management structure at the level of the board of directors and the executive management. The ES&CM, Article 36, explicitly requires the preparation of the UAE corporations' annual reports in accordance with the IFRS in both Arabic and English. These reports should include the board of directors report, audit report, financial statements, profit and loss statement, cash flow statement, changes in equity statement, and the notes to the financial statements.

The ES&CMA also requires the publication of these reports within 90 days from the end of the financial year. These reports should, Article 36 adds, be signed by the board of directors or the person authorized to sign on behalf the board. Both Abu Dhabi Securities Market (ADSM) and Dubai Financial Markets (DFM) are regulated by the Emirates Securities and Commodities Authority (ES&CMA).

### **3.6.3 The Code of UAE Corporate Governance**

The ES&CMA introduced in early 2007 the UAE code of corporate governance (ES&CMA decision R/32 of 2007 amended by decision 518 of 2009). This code comprehensively refines and delineates elements of corporate governance introduced by the UAE Corporation Act of 1984 and the ES&CMA decision No. 3 of 2000 concerning transparency and disclosure. The code outlines specific corporate governance requirements that corporations must comply with in order to meet what the code states are “institutional governance discipline criteria”. The code requires listed corporations to prepare, as an integral part of annual reports, a governance report.

This report should outline information about boards of directors’ duties, composition, structure, and the selection process of directors. It should also include information about board committees, internal control systems, directors’ remuneration, risk management, shareholders’ rights and rules governing the appointment and discharging of external auditors.

The ES&CMA has a timeframe to implement its code of governance across UAE listed corporations. The UAE code of governance states that UAE corporations must comply with the code requirements by May 2010 (Al Mansouri 2009).

## **3.7 Corporate Governance Reforms**

According to the IMF (2013), the UAE and in particular Dubai have put in place practical positive changes to improve corporate governance of Government Related Entities (GREs’) which contribute heavily to the UAE economy. Since the global financial crisis, Dubai government has appointed representatives to the board of directors of its GREs and introduced a requirement for approval by the Supreme Fiscal Committee of any new GRE borrowing.

Building on these improvements, key steps for further strengthening the GRE’s corporate governance include (i) delineating clearly their commercial and non-commercial operations; (ii) expanding the coverage of the 2009 corporate governance code to public companies; (iii) strengthening the role and independence of company boards to allow for more effective decision-making; and (iv) improving risk management practices. These improvements have also been recommended to mitigate GRE’s risk exposure to global financial market (Audi 2013).



## 3.8 UAE Judicial System

The legal structure is a key element of the corporate governance mechanism of a country. Transparency and accountability cannot be realized unless there are appropriate rules and regulations in place. It provides and ensures legal protection for investors and enforces their ability to exercise their rights. (Gul & Tsui 2004) reported that the operation of a country's capital markets is determined by its legal environment.

To maintain harmony between the seven Emirates, they were given the constitutional right to either join the Federal judicial system or to maintain their own independent system. Except for Dubai and Ras Al Khaima who maintain their own judicial systems, the other Emirates have joined the Federal system.

The Federal UAE courts, like courts in most countries in the area, are organised to form two main divisions, civil and criminal law, and are also generally divided into three stages of litigation namely courts of First Instance, Appeal and the Federal Supreme Court (referred to as Court of Cassation) and the Sharia court (Mahmoud 2008). The jurisdiction of the third division, namely the Sharia courts, which initially were to review matters of personal status, was expanded in certain Emirates such as Abu Dhabi to include serious criminal cases, labour and other commercial matters. Important cases with a security aspect are referred to special courts. Dubai and Ras Al Khaima initially organised their courts in two stages, which was later expanded in Dubai by the establishment of the Dubai Court of Cassation (Mahmoud 2008). The UAE legal system is based on both civil laws and Islamic legislation.

Federal Law No. 4 of 2000 concerning the ES & CMA, amended by Ministerial Resolution No. 518 of 2009 Concerning Governance Rules and Corporate Discipline Standards Article (1) Corporate Governance, states rules, standards and procedures. This amendment aims at achieving corporate discipline in the management of the company in accordance with international standards through determination of responsibilities and duties of members of boards of directors and executive management, taking into consideration protection of shareholders' and stakeholders' equity (Al Mansouri 2009). This clearly indicates the authority's commitment to ensuring not only shareholders' protection but also protection of all related stakeholders with whom corporates engage in business transactions. In addition, Resolution 518 enforces the law concerning the following areas which are the key for improving corporate governance: board of directors of the company, chairman of the

board of directors, members of the board of directors, board committees, remuneration of board members, internal control, audit committee, the external auditor, delegation of management, shareholders' rights, disclosure of the concerned parties and issuance of an annual corporate governance report. For example, Article (3) of the resolution outlines the following: : (a) method of formation of the board of directors, number of board members and term of membership; (b) the formation of the board of directors shall take into consideration an appropriate balance between executive, non-executive and independent board members, provided that at least one-third of members shall be independent members and a majority of members shall be non-executive members who shall have technical skills and experience for the good of the company. In all cases, when selecting non-executive members of the company, it shall be taken into consideration that a member shall be able to devote adequate time and effort to his/her membership and that such membership is not in conflict with his/her other interests; (c) no person may simultaneously assume the offices of the chairman of the board of directors, the company manager and/or the managing director; (d) the board of directors shall meet at least once every two months at the written notice of the chairman of the board of directors; (e) the minutes of meetings of the board of directors shall be recorded; (f) the board of directors shall develop procedural rules for corporate governance, supervise and control the application of the same consistent with the provisions of this Resolution and shall be liable for the application thereof ; (g) the board of directors shall offer suitable development programs for all members of the board of directors to improve their knowledge and skills and ensure effective participation in the board.

Article 4 of Resolution 518 focuses on the role of the chairman of the board of directors. The chairman shall: ensure that the board of directors acts efficiently, fulfils its responsibilities and discusses issues in a timely manner; develop and approve the agenda; encourage all members to efficiently participate in the board; adopt suitable procedures to secure efficient communication with shareholders and communicate their views to the board of directors; facilitate effective participation of non-executive board members; and develop constructive relations between executive and non-executive members

Article 5 of the resolution outlines the responsibilities of members of the board of directors and management duties to board members. Duties of non-executive board members shall include: participation in board meetings to provide an independent opinion in respect of strategic issues, policy, performance, accounting, resources, basic appointments and standards of operation;

Article 6 of the resolution concerns board committees. The board of directors shall form standing committees to be directly affiliated to the board as follows:

- a. The audit committee to assume the duties stipulated under Article 9;
- b. The nomination and remuneration committee to be mainly charged with verification of ongoing independence of independent board members, formulation and review of the policy on granting remuneration, benefits, incentives and salaries to board members and employees of the company and the committee shall verify that remuneration and benefits granted to the senior executive management of the company are reasonable and in line with the company's performance. Committees shall consist of at least three (3) non-executive board members, of whom at least two (2) members shall be independent members and shall be chaired by either independent member.

Article 7 of the resolution deals with the remuneration of board members, pursuant to Article 118 of the Law of Commercial Companies No (8) of 1984 which stipulates that remuneration of board members shall be a percentage of net profit. Article 7 also states that in all cases the remuneration of board members should not exceed ten per cent (10%) of net profits, having deducted depreciation, reserve and distribution of a dividend of at least five per cent (5%) of capital to shareholders.

Article 8 of the resolution focuses on internal control of companies. A company shall apply a precise internal control system that aims at developing an assessment of the company's risk management, sound application of governance rules, verification of compliance by the company and its employees with applicable laws, regulations and resolutions that govern its operations, as well as internal procedures and policies, and review of financial information that is forwarded to the Company's senior management and used for drafting financial statements. The board of directors shall issue the internal control system; determine the objectives, duties and powers of the internal control department that shall have adequate independence to perform its duties and shall directly report to the board of directors. The board of directors shall conduct an annual review to ensure efficiency of the internal control system in the company and its subsidiaries and disclose results to shareholders through the corporate governance annual report. The board of directors shall disclose in the corporate governance report the scope of the company's compliance with the internal control system for the duration of the report, and ensure that the company's disclosures provide sufficient, accurate and true information for investors and reflect complete compliance with

disclosure rules. The company shall appoint a compliance officer who shall be charged with verification of the scope of compliance by the company and its employees with issued laws, regulations and resolutions. One person may assume the positions of compliance officer and director of the internal control department at the same time.

Article 9 of the resolution covers the composition and responsibilities of the audit committee. The board of directors shall form an audit committee consisting of non-executive board members, provided that the majority of the committee's members shall be independent members. The committee shall consist of at least three (3) members, of whom one member shall be an expert in financial and accounting affairs. One or more members from outside the company may be appointed in case the number of non-executive board members is not sufficient. The committee shall meet at least once on a quarterly basis.

Article 10 of the resolution covers the appointment and responsibilities of the external auditor. The board of directors shall nominate an external auditor at the recommendation of the audit committee. Appointment shall be made and remuneration shall be fixed by a resolution of the general assembly of the company. The external auditor shall be selected on the ground of efficiency, reputation and experience, and shall be independent from the company and its board of directors and may not be a partner, agent or a relative, even of the fourth degree, of any founder or board member of the company and a company shall adopt reasonable steps to ensure independence of the external auditor and that all operations performed by the external auditor are free from any conflict of interest.

Article 11 of the resolution deals with the delegation of management. The board of directors may delegate a board member or the executive management in some administrative issues in which it has the authority to make a decision.

Article 12 of the resolution deals with shareholders' rights. Shareholders shall have all share-related rights, in particular the right to receive their share of dividends allocated for distribution and of assets on liquidation, attend general assembly meetings, take part in deliberations, vote on general assembly resolutions, dispose of shares, have access to the company's financial statements and reports and may request to peruse the company's records and documents with the permission of the board of directors or the general assembly pursuant to the company's articles of association.

Article 12 of the resolution also deals with the disclosure of the concerned parties. If one of the concerned parties has an interest or benefit, either directly or indirectly in any

transaction made or to be made with the company, the parent company or any of its subsidiaries or sister companies and such interest or benefit involves or may involve a conflict with the interests of the company, such concerned party must disclose by means of a written letter addressed to the board of directors stating the nature and extent of his interest or benefit within a period of no more than three business days commencing from the day when the concerned party becomes aware of the conflict of interest that requires disclosure.

Article 13 deals with the code of conduct. The company shall approve the code of conduct along with other internal policies and principles in conformity with the objectives and purposes of the company and it shall adhere to applicable laws and regulations. These rules shall apply to board members, directors, employees and the internal auditor in the course of fulfilment of their duties.

Article 14 of the resolution focuses on the requirements of the corporate governance report. The corporate governance report is a report signed by the chairman of the board of directors of a company and is forwarded to the authority on an annual basis or at request during the accounting period covered in the report or for a subsequent period up to the publication date of the annual report, which shall cover all information and details in the form issued by the Authority, in particular:

1. Requirements and principles of completion of corporate governance system and approach of their application;
2. Violations committed during the financial year, reflecting their causes as well as the methods of remedy and avoidance of future occurrence; and
3. Method of formation of the board of directors in terms of member classes, term of membership, means of determining remuneration as well as the remuneration of the general manager, executive director or chief executive officer of the company as appointed by the board of directors. The board of directors shall make this report available to all the shareholders of the company at a sufficient time prior to the general assembly meeting.

Article 15 of the resolution deals with the administrative penalties. Upon breach of the provisions the Authority may impose any of the following penalties: 1. addressing a warning notice to the company to remove causes of violation, 2. suspension of the company's security listing; 3. delisting; or 4. a financial penalty that may not exceed the maximum limit hereunder

The last Article of resolution (16) deals with enforcement of the resolution and states that:

1. Companies and institutions whose securities are listed on a market shall make all necessary changes to adopt the provisions of this resolution no later than 30.04.2010.

2. This resolution shall be published in the Official Gazette and shall go into effect on the next day to its date of publication. Companies and institutions whose securities are listed on the market following the effective date of this Resolution shall abide hereby (Al Mansouri 2009). This resolution applies to all companies and institutions whose securities are listed on a securities market in the country and to their board members. However, the scope of this resolution in article 2 states that:

a. The Securities and Commodities Authority shall be charged with the supervision, control and verification of compliance by companies with the rules and provisions hereunder;

b. This resolution applies to all companies and institutions whose securities are listed on a securities market in the country and to their board members;

c. This resolution does not apply to:

(1) Companies and institutions that are wholly owned by the Federal Government or a local government.

(2) Banks, finance companies, financial investment companies, money exchange companies, monetary brokerage companies that are under the supervision of the Central Bank; and

(3) The foreign companies that are listed in any of financial markets (Al Mansouri 2009).

Financial institutions in the UAE are governed and supervised by the central bank which encourages the use of the OECD's international corporate governance best practice guidelines (AlSuwaidi 2006).

This indicates that the UAE corporate governance mechanism is a mix of both rules-based approaches applicable to listed non-financial corporates and principle-based approach applicable to listed financial institutions. The US uses a rules-based approach to its corporate governance system which is mandatory and prescriptive in nature (Clarke 2007), whereas Australia, the UK and other commonwealth countries use a principles-based approach to corporate governance which is flexible and based on the notion of comply or explain (Bozec & Dia 2012).

## 3.9 Sharia Governance

The Sharia governance mechanism in the UAE is also governed by Federal Law No. 6 of 1985, Article 5 that requires the establishment of a Higher Sharia Authority under the Ministry of Justice and Islamic Affairs to supervise Islamic financial institutions and Islamic Banks. The Higher Sharia Authority is to provide Sharia opinion on issues relating to Islamic finance and Islamic banking. The position of the Higher Sharia Authority is binding.

Article 6 requires that a Sharia Supervisory Board be established in all IFIs whose articles of association should include the responsibilities, duties, appointment and functions of a SSB. SSB members are to be appointed by shareholders at the AGM or by the board of directors. Appointment of SSB members should be approved by the Higher Sharia Authority, which itself is appointed by the government (Al Nahyan 1985). This Sharia law is applicable to IFIs listed on both the DFM and ADX.

With regard to those IFIs which are listed in Nasdaq Dubai and registered under the Dubai International Financial Centre (DIFC), they have to comply with the DIFC law and regulations. Law No.13 of 2004 deals with regulating Islamic financial business and the DIFC Services Authority represented by Dubai Financial Service Authority (DFSA) Rulebook on Islamic Financial Business Module (ISF) (LLP 2009). IFIs registered under DIFC are required by DFSA to adopt and comply with the AAOIFI Governance Standards to ensure consistency and establish confidence among investors that Sharia law is complied with by all types of IFIs.

Conventional companies registered under DIFC – Nasdaq Dubai, are required by DFSA to adopt “comply or explain principles”. The DIFC is a Federal Financial Free Zone administered by the Government of Dubai, and established in accordance with United Arab Emirates Federal Law and Dubai Law. Federal Law No. 35 of 2004 was enacted, to establish the DIFC as a financial free zone in Dubai (LLP 2009).

The DIFC has been granted authority to self-legislate in civil and commercial areas. An amendment to the UAE Constitution and a resulting federal law concerning financial free zones have allowed the DIFC Authority to create a legal framework based on the best practices of leading jurisdictions in Europe, North America and the Far East (LLP 2009).

Nasdaq Dubai is an international stock exchange located in the DIFC. Its major role in the development of regional capital markets is to attract key regional companies to list their

shares and to issue securities on the exchange. Nasdaq Dubai is expected to attract international investors and encourage portfolio flows to the region, thus accelerating the process of the region's integration with world markets. The DIFC including Nasdaq Dubai are beyond the scope of this study.

### **3.10 Conclusion**

This chapter presented the overall context of the research, including the background and development of corporate governance in the UAE leading to current progress in corporate governance. The effect of the economic environment as it impacts on firm performance in the UAE was discussed. The development of capital markets has encouraged the government to introduce regulatory reforms in corporate law and to promote rules of corporate governance that aim to attract investment.

The UAE economy and growth are based not only on the price of gas and oil, but also on the new vision of knowledge-based industries and diversification of its economic strategy. As a result, the UAE and Dubai in particular have been declared the capital of Islamic economy. Moreover, the UAE has won the right to host the 2020 World Expo, which is expected to boost the economy and have an impact on firm performance. The next chapter will focus on the theoretical perspective of the research.



# **CHAPTER 4**

## **Conceptual Framework**

### **4.1 Introduction**

In the UAE the corporate governance mechanism is defined by both the ES&CMA and UAE Central Bank. (Refer to chapter 3).

A review of the limitations in previous studies suggested that the relationship between corporate governance practices such as ownership structure, leadership structure, board characteristics, board size, audit committee composition and the existence of a Sharia Supervisory Board (SSB) in Islamic financial institutions and their impact on firm performance have not been sufficiently researched in developed and emerging markets experiencing booming economies and stable political environments compared to other middle eastern politically unstable markets. The UAE is one of such emerging market. A conceptual framework is developed in this chapter to provide to understand the impact of the above-mentioned constructs on corporate performance. This will lead to identification of hypotheses regarding the relationship of corporate governance constructs to corporate performance in the UAE. Section 4.2 presents a theoretical perspective on corporate governance and corporate performance. This is followed by the development of the theoretical framework in section 4.3. Development of a conceptual framework is discussed in section 4.4. followed in section 4.5 by discussion of the corporate governance model for this study. Section 4.6 provides examines the hypotheses development for this research and section 4.7 discusses corporate performance in relation to this research. Section 4.8 concludes the chapter.

### **4.2 Theoretical Perspective on Corporate Governance and Corporate Performance**

Corporate governance structure and the impact and role of the board of directors has been investigated by several researchers who have developed a range of competing theories (Kiel & Nicholson 2003). Researchers from the disciplines of economics (Jensen & Meckling 1976) law (Richards Jr & Stearn Jr 1999) sociology (Useem 1984), finance (Fama, EF 1980), organization theory (Johnson 1997) and strategic management (Boyd 1995) have contributed

to governance research (Kiel & Nicholson 2003). Several governance theories have been developed from these disciplines, including resource dependency theory, agency theory, stewardship theory, stakeholder theory, legitimacy theory and social contract theory. The theories that this research will apply are the agency theory, stewardship theory and the Islamic perspective of corporate governance.

#### **4.2.1 Agency Theory**

Agency theory provides a sensible argument for the principles of corporate governance mechanisms and approaches in organisations. Jensen and Meckling (1976) suggested that agency problems in the organisation arise from the principal-agent conflict of interest. The managers/agents may not maximise the profits of the shareholders principals and may focus on their own interests, resulting in decisions that do not improve the value to the shareholders.

Agency theory is concerned with ensuring that managers act in the interest of the shareholders, and is based on the inherent conflict of interest between the principals/shareholders and agent/management (Fama, EFa & Jensen 1983).

Conflict of interests may arise as a result of managers' self-motivation to pursue and attain their own personal interests at the expense of shareholders (Agrawal & Knoeber 1996; Fama, EFa & Jensen 1983; Jensen & Meckling 1976). According to agency theory, monitoring and control mechanisms are essential to mitigate the agency problem (Fama, EFa & Jensen 1983). Initiatives to control management such as the appointment of non-executive directors to a board are designed to address this issue (Fama, EF 1980). Moreover, a higher proportion of non-executive directors on the board of directors may have a positive effect on firm performance (Fama, EFa & Jensen 1983; Jensen & Meckling 1976). According to (Kiel & Nicholson 2003) and (Shleifer & Vishny 1997) agency theory leads to normative recommendations that a board of directors should be comprised of a majority of outside independent directors and that the leadership positions of chairperson and CEO should be separated to improve firm performance.

#### **4.2.2 Stewardship Theory**

Contrary to agency theory which focuses on managerial opportunistic individualism and monitoring, stewardship theory suggests that executive managers are intrinsically trustworthy individuals. Stewardship theory assumes that managers are stewards and their

actions are aligned with the objectives of their organisations. The theory suggests that managers are motivated by the success of their organizations and are therefore interested in achieving high performance, and gaining recognition from peers (Donaldson, L & Davis 1991). Stewardship theory focuses on leadership and how a leader of an organisation is a trustworthy person whose behaviour is aligned with the interests of the organisation and its owners. Therefore an organisational structure needs to be formulated that allows a leader to combine the roles of Chief Executive Officer and chairperson (Davis, Schoorman & Donaldson 1997). This leadership duality benefits companies through strong control and command and high returns to shareholders (Donaldson, L & Davis 1991). The theory also argues that a steward should be given the discretion to utilise his/her authority over the organization's resources and decision-making as he/she is trusted to work in the interest of the organisation and its shareholders and thus cut the cost of monitoring, bonding and incentives (Davis, Schoorman & Donaldson 1997).

The theory also assumes that top managers and executives usually devote their entire working lives to the firm they direct and govern and are more likely to understand its operations and the businesses environment than outside directors. Managers and executives would have better knowledge and information than outside directors, which would ensure that they take the best decisions for the corporate they manage (Donaldson, L & Davis 1991). Proponents of stewardship theory argue that financial performance is likely to be enhanced if it is associated with internal mechanisms of corporate governance a by combining the roles of CEO and the chairman (Davis, Schoorman & Donaldson 1997; Donaldson, L & Davis 1991, 1994).

### **4.2.3 Islamic Perspective of Corporate Governance**

According to Choudhury and Hoque (2006) Islamic corporate governance is a faith-based theoretical framework that uses the principles of the Islamic socio-scientific epistemology of *Tawhead*, or oneness of God. The influence of the Islamic view of corporate governance is significant especially when related to minimisation of transaction costs in decision-making environments and achieving the objectives of the corporation within the framework of Sharia law and Islamic rules and principles (Choudhury & Hoque 2006).

Consistent with Sharia principles, Islamic corporate governance has obligations extending to suppliers, customers, competitors and employees, and embraces the spiritual as well as the temporal needs of the community (Lewis 2005). This clearly indicates that the

Islamic perspective of corporate governance is a responsibility and obligation not only at the corporate level but also at the individual level and extends beyond the interests of shareholder value (Abu-Tapanjeh 2009) as held in the conventional view (Lewis 2005), to encompass the community and to environment (Abu-Tapanjeh 2009). Islamic corporate governance is about fairness to all stakeholders, a view that most Western contributors would not share t as they limit the aim of governance to corporate management and control in order to obtain long-term firm value (Ghayad 2008).

Kasri (2009) states that the main difference between conventional and Islamic perspectives of corporate governance is the philosophical aspects, comprising aims and objectives of corporations, the types of contracts involved, and key players as well as the relationships between the players. The differences stem from the Islamic perspective on corporate governance practice as a Muslim's commitment, obligation, and responsibility to God and implicit contract with God and with humans. Ultimately, these place God and Islam itself as key players in corporate governance practice, whereas the conventional view focuses on the physical and material aspects only(Kasri 2009).

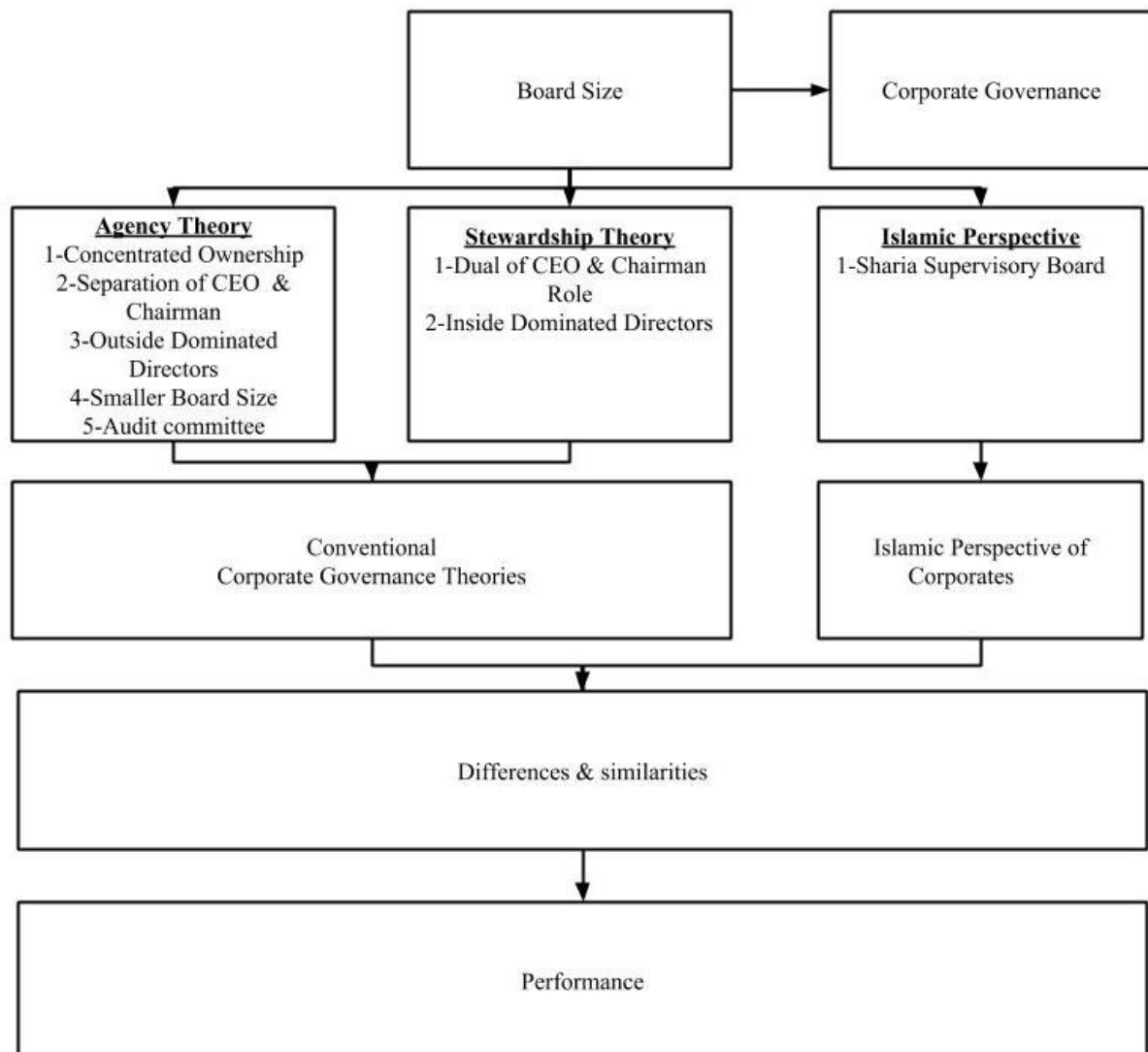
In practice most Islamic organisations use conventional corporate governance standards which may not be in accordance or consistent with Islamic values. However, in the field of governance, tools and mechanisms are relatively the same and differences are minor (Kasri 2009). The main distinguishing attribute of Islamic corporate governance is the mandatory presence of a Sharia Supervisory Board (SSB) as all business transactions have to be Sharia compliant (Alman 2012; Ghayad 2008; Kasri 2009; Safieddine 2009)

### **4.3 Theoretical Framework**

On the basis of these three theories and perspectives of corporate governance a theoretical framework was developed (Figure 4.1). The framework indicates how corporate governance affects firm performance. Agency theory is centred on the conflict of interest between principals/shareholders and agents/managers, self-interest and profit maximisation. The theory focuses on the organisation's governance structures and proposes concentrated ownership, separation of the roles of chairperson and CEO, independent boards of directors with a majority of outside directors, smaller board size and board committees. These are important for monitoring firm performance and control management behaviour. Such propositions by agency theory are assumed to result in improved performance. Stewardship theory considers managers as stewards of firms and as trustworthy agents of the principals

with inherent motivation to promote and maximise firm value, and the board members should be considered as stewards. A duality of chairperson and CEO positions and insider dominated board structure with particular skills, knowledge and experiences are assumed to maximise firm performance due to their specific interest in the and concentrated power of the leadership.

*Figure 4.1: Theoretical Framework: Corporate Governance and Corporate Performance*



The Islamic perspective of corporate governance is a faith-based theoretical framework that relates to the process of decision-making in its use of the principles of the Islamic socio-scientific epistemology of *Tawhead* or oneness of God. The influence of the Islamic view of corporate governance is significant, especially when related to minimisation of transaction costs in decision-making environments and achieving the objectives of the corporation within the framework of Sharia law, and Islamic rules and principles (Choudhury & Hoque 2006).

The Islamic perspective views corporate governance as a Muslim's commitment, obligation, and responsibility to God and consequently to all related stakeholders, and would result in fairness, honesty, credibility and integrity of reporting to the broader stakeholders groups and greater transparency to gain the confidence of not only the influenced groups but also the wider community and lead to a better performance. Any Islamic financial institution need to have a Sharia Supervisory Board (SSB) to ensure that the organisation is Sharia compliant. This study tests the impact of SSBs on performance of Islamic financial institutions.

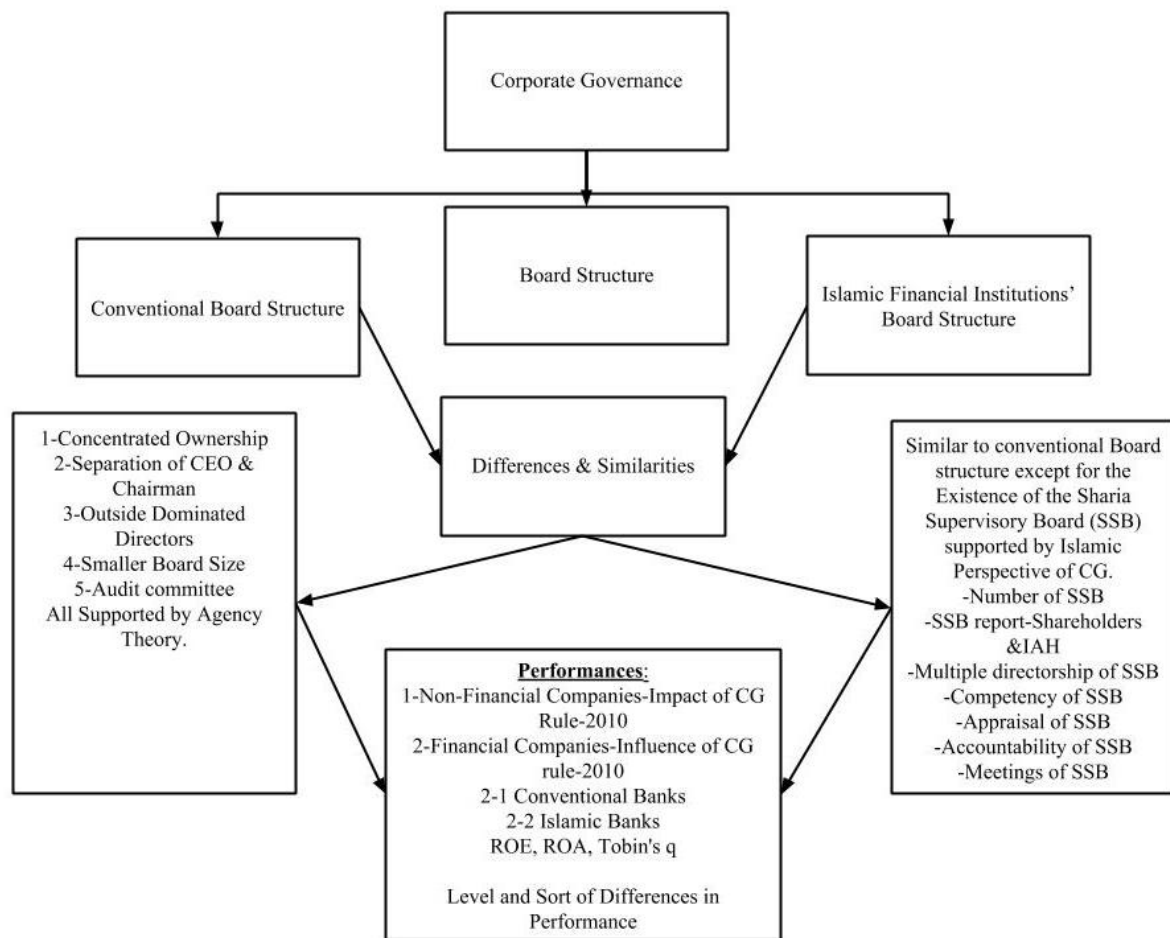
## **4.4 Development of the Conceptual Framework**

The conceptual framework for the research (Figure 4.2) explains the link between the theoretical framework (Figure 4) and operationalization of the corporate governance variables and firm. Evidence from previous studies indicates that there are several variables that influence the relationship between corporate governance and firm performance, as discussed in Chapter 2. Corporate governance instruments include ownership structure, board leadership structure, board composition, and board size, the role of the audit committee and the role of the sharia supervisory board. To measure firm performance, there are some variables (ratios) that have been identified in the corporate governance literature such as return on assets (ROA), Tobin's Q, and return on equity (ROE).

This research investigates the relationship between corporate governance and firm performance. The conceptual framework includes corporate governance variables that are considered important in affecting firm performance such as: board structure which includes ownership structure, separation of both role of chairman and CEO, duality of roles, outsider and insider dominated boards, board size, audit committee and a sharia supervisory board.

Accounting measures of ROE, ROA and market-based measure of Tobin's Q are used in the study as firm performance variables considered important in having a positive or negative impact on firm performance. The conceptual framework of the study is supported by agency theory, except the SSB variable which is supported by the Islamic perspective of corporate governance. The variables that represent firm performance are Tobin's Q, ROA and ROE. Tobin's Q measures market value of a firm and is used as a proxy for market value which measures the share price to book value. Share prices are affected by accounting information and voluntary disclosures which are reflected in the value of the shares. Accounting information contains corporate governance practices and voluntary disclosures and better governed firms are valued more by investors (Deegan & Samkin 2004).

*Figure 4.2: Conceptual Framework: Governance and Performance of UAE listed Companies*



The model represents firm performance (dependent variables), which can be affected by corporate governance instruments (independent variables), namely ownership structure, board leadership structure, board composition, board size, the role of the audit committee and the role of the sharia supervisory board. In addition, the model illustrates the similarities and differences between both conventional and Islamic corporate governance instruments in relation to board structure. The study will investigate the level and impact that such differences may have on performance. The main difference is the mandatory SSB within the board structure of the Islamic financial institutions.

## 4.5 Hypotheses Development

The hypotheses of the study were developed based on the above-mentioned theoretical and conceptual frameworks, and on the core concept of corporate governance practices that are considered important governance instruments and can impact on firm

performance. The hypotheses consisted of the following variables: ownership structure, separation of CEO & chairman, board composition, board size, audit committee and the Sharia Supervisory Board.

The UAE stock market is relatively new and performing under an emerging as well as booming economy and is therefore expected to be sensitive not only to changes in the surrounding regional but also to internal environmental and economic changes including developments in the governance mechanism requirements. Therefore, the hypotheses developed in the study were tested to investigate the impact of corporate governance practices on firm performance in an emerging market.

## **Hypotheses**

The hypotheses of the study were based on the argument that good governance practices impact on firm performance in the UAE. Good corporate governance systems play an important role in not only attracting investors, but also establishing confidence among interest groups in the capital market. One of the main variables in this study is board composition and structure. The key function of the board is to monitor the performance as well as the behaviour of the top managers for their stewardship and accountability to shareholders and other stakeholders who may be affected by the business operations of the firm. One of the corporate governance mechanisms is the ownership structure (Ha1) and the monitoring mechanism of the board is the leadership structure (H1b), board composition (H1c) audit committee (H1d) and the Sharia Supervisory Board (H1e). The board size (H1f) is another corporate governance mechanism to investigate the impact of the board size on firm performance in an emerging market.

## **Ownership Structure and Firm Performance**

As a result of separation between ownership and management, the incentives allocated to managers in the form of shares to align their interests with those of shareholders would create both agency cost and monitoring cost (Jensen & Meckling 1976).

According to Mayer (2000) there are two models of ownership structure: one is the insider system and the other is the market-based system. The insider system is used in Continental European countries such as Germany and in Japan and Asian countries, while the other model of the market-based system is used by Anglo-American corporations in the US and the UK (Bebchuk 1999; Mayer 2000).



In both models, a company would start as a private company owned, controlled and managed by its founder. It requires capital and issues shares. In the insider system it can raise that equity in the form of non-voting equity, sell shares to related firms and ensure that control remains in the hands of a small number of parties. As the company grows and expands, large new investors purchase stakes, minority stakes are sold off in companies that are purchased and the complex network and pyramid of the insider ownership structure system start to emerge (refer to Chapter 2, Figure 1)

In the Anglo-American corporations, particularly in the UK, a company sells equity on the stock market and when more than 50 per cent of the voting rights are sold, control is transferred to the market. Other companies cannot purchase stakes of more than 30 per cent in the company without making full bids. Share blocks are therefore sold off and both ownership and control become dispersed in the hands of outside individuals and financial institutions (refer to Chapter 2, Figure 2)

The insider system concentrates control in the hands of a small number of individual investors with different interests and agendas. In the Anglo-American outsider system, shareholdings are dispersed and voting is not concentrated in a few hands.

In the insider system the ownership structure demonstrates two different theoretical arguments which can have an impact on the firm. One argument, based on the agency theory, is that such organisational setups would positively impact on corporate performance through reduced agency cost.

Managers have a tendency to work towards their own best interests by allocating a firm's resources towards themselves, which may conflict with the interests of outside shareholders (Berle & Means 1932; Fama, EFi & Jensen 1983; Jensen & Meckling 1976; Shleifer & Vishny 1986). As a result of the separation of control and ownership, managers are motivated by the widely dispersed ownership structure to dispossess corporate shares in a way that negatively affects the wealth of shareholders.

Opposing agency theory indicates that the existence of large shareholders with large equity stakes or controlling shareholders can be harmful because the controlling shareholders' interests may not align with those of non-controlling shareholders (Porta, Lopez-De-Silanes & Shleifer 1999; Shleifer & Vishny 1997). But (Shleifer & Vishny 1997) found that large shareholders have a significant role which positively impacts on the share prices of firms.

Ownership structure and board structure may be related as suggested by (Munisi, Hermes & Randøy 2014) in Sub-Saharan African countries. They observed a negative relationship between ownership concentration, foreign ownership and managerial ownership and board size. Ownership concentration was also negatively correlated with the proportion of outside directors. On the other hand, government ownership was positively associated with a high proportion of outside directors.

(Demsetz, H 1983) was the first to challenge agency theory assumptions, arguing that there should be no relationship between ownership structure and company performance. He suggested that ownership structure should be considered an endogenous outcome of decisions that reflect the level of influence of shareholders. Demsetz, Harold and Lehn (1985a) also found no significant correlation between profit rates and various measures of ownership concentration. Demsetz, H (1983) argued that diffusion of ownership structure provides a better chance for corporations to survive when they are under pressure for large equity capital, but that there is no particular equity/ownership structure that is optimal if the performance of corporations is to be increased. (Demsetz, Harold & Villalonga 2001) believed that diffusion of ownership structure may induce some agency problems, but had certain compensating advantages to offset such problems. Therefore, in the case of market-mediated ownership structures, a relationship between ownership concentration and firm performance is highly unlikely.

In a study of GCC banks, (Aroui, Hossain & Badrul Muttakin 2014) observed a positive relationship for family, foreign and institutional ownership, and performance. Government ownership, CEO duality or board size failed to produce such a relationship. Unlike western countries, corporate boards are not the best governance mechanism for GCC countries.

Mehran (1995) found a positive relationship between managerial equity ownership and company performance. Zeckhauser and Pound (1990) asserted that there is a relationship between large shareholders and future performance and that a large body of shareholders can be an indicator of positive future performance. Conversely, some studies find a negative relationship between ownership concentration and firm performance. Porta, Lopez-De-Silanes and Shleifer (1999) found that when the majority of shareholders effectively control a corporation, their policy may result in expropriation of minority shareholders by not paying dividends and transferring profits to companies that they own and control. Morck, Shleifer and Vishny (1988b) examined the relationship between ownership structure and firm

performance and proposed a non-linear relationship between insider ownership and firm performance. Zeitun and Tian (2007) and Kobeissi (2004) found empirical evidence for a positive effect of ownership concentration on company performance.

Ownership structure is an important factor in corporations, as indicated by various studies in different contexts using different variables and different tools of measures. According to Tricker and Bob (1998), ownership structures of publicly-listed corporates around the globe are often complex and to understand their corporate governance, it is important to understand the ownership structure, which will show the potential to exercise power and influence. This indicates the significance of ownership structure in terms of shareholders and the role they can play in the company. Zhuang (1999) asserts that in most countries other than the US and the UK, corporate ownership is concentrated.

Taiwanese firms investing in the Greater China region prefer a shared foreign ownership structure motivated by high percentages of institutional ownership (Cho, Huang & Padmanabhan 2014). Stewardship and social capital theory were validated by these findings. According to (Faccio, M & Lang, LH 2002) ownership in financial firms may be more widely held. But (Yeh, Shu & Chiang 2014b) noted concentrated ownership in most financial institutions. This protects the private benefits of ownership control, as only affiliated members are included in their boards. Ownership rights can explain control rights, cash flow rights and their deviations. Thus, there is an incentive effect related to owners controlling the firm. But restricted ownership reduces professionalism. This adversely affected the ability of financial firms during the recent global economic crisis in Taiwan. (Lichtenberg & Pushner 1994) noted that equity ownership in financial institutions effectively substituted an external takeover market. The influence of financial institutions on globalisation remained intact during the 1980's. All these findings emphasise the importance of ownership structure on financial institutions.

Based on the above theoretical arguments and empirical evidence, the study proposes the following hypotheses in relation to the UAE context.

H0a: There is no relationship between ownership concentration and firm performance

H1a: There is a positive relationship between ownership concentration and firm performance

## Leadership Structure and Firm Performance

On the basis of the review of the literature in Chapter 2, the leadership structure of the board of directors of a firm will have an important impact on its performance. Board leadership structure is established to monitor management, including the CEO (Abdullah 2004b; Brickley, Coles & Jarrell 1997; Dalton et al. 1998; Donaldson, L & Davis 1991). Therefore the leadership structure of the board of directors in a firm can impact on firm performance. However, a weak structure or governance can be compensated by strong leadership. This can influence firm performance by increasing the scope for discretion at leadership level (Clark, Murphy & Singer 2014)

Leadership structure is an important governance mechanism identified in many internal corporate governance guidelines such as the Australian corporate governance principles guidelines (Council, ACG 2007) the US Sarbanes-Oxley Act (Valenti 2008b), the UK combined code (McKnight & Weir 2009) and the United Arab Emirates corporate governance rules (Al Mansouri 2009). All recommend an enforced separation of roles of CEO and chairperson to enhance corporate performance and reduce agency conflict and cost. The importance of firm leadership structure and separation of roles has also been considered by the Cadbury Committee (Cadbury, A (1992).

The duality of leadership structure was considered to be an inappropriate technique to articulate and design the highest and most influential relationships within a firm. For effective leadership in a firm, it is necessary to separate the positions of CEO and chairperson (Jensen 1993) as the main role of the board of directors is to monitor management including the CEO and ensure that shareholders' interests are protected (Fama, EFa & Jensen 1983). Concentrated power with one person can allow CEOs to establish their own agendas for personal benefit at the expense of the shareholders. Duality of leadership structure is linked with ineffective governance practices such as hostile takeovers (Morck, Shleifer & Vishny 1988a). Monitoring management activities is a responsibility of the board. When the CEO is also the chairman, the capability to oversee and monitor management is negatively affected and leads to conflict of interest and lack of independence (Dayton 1984; Lipton & Lorsch 1992; Lorsch & MacIver 1989; Millstein & Katsh 2003). Separating the two roles will help increase board independence providing effective checks and balances on managerial behaviour (Haniffa, RM & Cooke 2002; Lipton & Lorsch 1992). Separation of the two roles makes it easier for the board of directors to remove a non-performing CEO (Jensen 1993).

Cadbury, A (1992) suggested that if the CEO is also the chairman it is important to have an effective independent element on the board of directors.

In the UAE, Ministerial Resolution No. (518) of 2009 (effective from 30 April 2010) Concerning Governance Rules and Corporate Discipline Standards in its Article (3) Board of Directors of the Company, states that, “No person may simultaneously assume the offices of the chairman of the board of directors, the Company manager and/or the managing director. This is a mandatory requirement that the role of chairman and the CEO must be separated”. This resolution is applicable to companies whose securities are listed on the UAE stock market. This resolution indicates the need for a clear separation of duties and responsibilities for both roles to ensure a balance of power so that one person does not have unrestrained powers in decision making. When the monitoring role and the implementation role are combined, the monitoring role and the independence of the board will be impaired, affecting management’s pursuit of value maximizing activities for the firm (Abdullah 2004b).

Separation of the role of CEO and chairperson is mainly based on agency theory (Dalton et al. 1998). The main role of the board of directors is to monitor management including the CEO and make sure that shareholders’ interests are protected (Fama, EFa & Jensen 1983). Combining the two roles will result in a dominant CEO which will lead to ineffective monitoring of the management by the board (Tin Yan & Shu Kam 2008). Similarly, Jensen (1993) asserted that CEO duality increases agency problems by compromising the board’s effectiveness in monitoring the CEO performance. Agency problems and the board’s failure to properly monitor and control have been associated with negative effects, such as payment of greenmail (Kosnik 1987) and higher levels of executive compensation (Boyd 1995). Therefore, agency theory argues that the duality of the roles negatively impacts on control over the board and negatively affects board performance (Boyd 1995). Consequently, the agency model suggests that a negative relationship exists between dual leadership structure and firm performance.

But supporters of stewardship theory argue that managers are inherently trustworthy and good stewards of company resources and work to achieve a higher level of corporate profits (Donaldson, L & Davis 1991, 1994). Having the roles of chairperson and CEO combined will enable companies and organisations to diminish the costs of monitoring, bonding and incentives (Davis, Schoorman & Donaldson 1997) which will improve company performance.

A study conducted by (Donaldson, L & Davis 1991) found that 31 companies in a sample of 321 US-based companies between 1985 and 1987 relying on combined structures achieved higher shareholder returns measured by ROE, thus supporting stewardship theory. An Australian study conducted by (Kiel & Nicholson 2003) of 348 large Australian publicly-listed corporates in 1996 found that dual roles impacted positively on Tobin's q. In a sample of 192 of US-based corporates from 12 different industries between 1980 and 1984 obtained higher five-year average ROI in the case of firms with dual roles than those with an independent structure (Donaldson, L & Davis 1991). These findings support stewardship theory with respect to the concentration of corporate leadership. The theory favours the positions of CEO and Chairperson being combined in one person and assumes that CEO duality reduces the agency problem and contributes to better corporate performance.

But (Rechner & Dalton 1991) found in a sample of 141 large US-based corporations from 1978 to 1983 that corporates with the roles separated achieve better performance in terms of ROI, ROE and profit margin compared to those which had dual roles. Similarly, (Haniffa, R & Hudaib 2006) in a sample of 347 of Malaysian listed companies found that companies with separated roles performed better than those that combined the two roles. (Yermack 1996) argued that companies with separate positions of CEO and Chairperson were valued higher than companies with dual roles.

Other mixed results have also been reported. For example, (Daily, Catherine M & Dalton 1992; Vafeas & Theodorou 1998; Weir, Laing & McKnight 2002) found no relationship between CEO duality and performance. (Brickley, Coles & Jarrell 1997) found that CEO duality do not reduce performance.

(Weir & Laing 2001) did not get any clear effect for leadership duality and firm performance. Neither (Abdullah 2004b) in the case of Malaysian firms nor (Daily, Catherine M & Dalton 1992) found any relationship of leadership duality or otherwise with firm performance. (Abdullah 2004b) used data from the period before the Asian Financial Crisis of 1997/98, after which corporate governance issue became important. Generally, Malaysian firms were dominated by outside directors and most had a non-dual structure. But in a study covering the period of 1996-2000, after the crisis and when corporate governance became an important factor, (Haniffa, R & Hudaib 2006) established a relationship between role duality and accounting performance in terms of ROA. According to (Daily, Catherine M. & Dalton 1993), separation of roles is required only when there is financial stress or a weak board. In an Egyptian study, (Wahba 2014) found

the CEO duality-performance relationship moderated according to whether or not the institutional ownership is pressure-sensitive or pressure-resistant. In a Chinese context, (Firth, Wong & Yang 2014)prescribed the conditions that determine if leadership duality will be beneficial. In value-enhancing situations marginal profit-making firms would be negatively affected by CEO duality, and poor performance of the CEO will be the key factor. In non-value enhancing conditions, high profit making firms would benefit from CEO duality via reduction of non-value enhancing turnover.

(Lam & Lee 2008), in a Hong Kong study observed that CEO duality was good for non-family firms and non-duality was good for family firms. Thus ownership structure plays an important role in producing favourable effects of role duality on firm performance.

Therefore as proposed by the agency theory, the conceptual framework of this study considers the importance of separating the roles of chairman and CEO in affecting firm performance.

To test the above argument in the UAE context the following hypotheses are proposed.

H0b: There is no Relationship between the Separation of the Chairman and the CEO Positions and Firm Performance.

H1b: There is a Positive Relationship between the Separation of Chairman and CEO Positions and Firm Performance.

## **Board Composition and Firm Performance**

Board composition, in this research, refers to the proportion of outside and inside directors on the board of directors. The differentiation between the roles of outside and inside directors is important. Outside directors are critical in the internal control mechanism because they are more suitable to perform a monitoring role in an organisation (Fama, EF 1980; Fama, EFa & Jensen 1983). Inside directors have the inside detailed information and can better evaluate managers' decisions (Li 1994). Boards of directors play a crucial role in corporate governance of companies and the composition of the board is an essential part of the governance mechanism (Jensen 1993) and should be thought of as the first line of monitoring in an organisation.

The agency theory perspective suggests that outside directors act independently as monitors to protect the interests of shareholders in situations where conflicts occurs with firm

managers (Fama, EFa & Jensen 1983). Firstenberg and Malkiel (1980) advocated a majority of outside directors on corporate boards. This is consistent with a recommendation of the Australian Corporate Governance Principles that a majority of the board member should be independent non-exertive members (Council, ASXCG & Exchange 2007). Similarly, the Dubai Islamic Bank code of corporate governance indicates that the majority of the board members should be non-executive directors (Dubai Islamic Bank 2010), consistent with the directions of the UAE Ministerial Resolution No. 518 of 2009 Concerning Governance Rules and Corporate Standards (Al Mansouri 2009). The resolution states in the Article (3) that Board of Directors of a Company should have an appropriate balance between executive, non-executive and independent board members, provided that at least one-third of members shall be independent and a majority shall be non-executive members. This indicates the importance of outside directors in board composition in the UAE.

Stewardship theory argues that insider directors are better equipped than outside directors to understand and deal with the complexities of business operations (Donaldson, L & Davis 1991). This view suggests that although the outsiders, independent and nonexecutive directors, can bring objectivity and independence to the board room, they may also stifle management decisions and business opportunities through excessive monitoring and control. Stewardship theory argues that executives and managers are inherently trustworthy and not prone to misuse of corporate resources (Donaldson, L & Davis 1991). Executives and managers work to increase shareholder value. As their knowledge of the business is better than that of outside directors, this would result in better business decisions (Donaldson, L & Davis 1991). No agency costs would be incurred as top managers are naturally trustworthy (Donaldson, L & Davis 1991; Donaldson, T & Preston 1995).

Empirical evidence in support of the agency theory suggests that outside directors are valued for their ability to provide advice and to signal when the company is performing well (Mace 1971). They also play an important role in hostile takeover threats (Gibbs 1993). They can even play a political role in making things easier for the firm (Agrawal & Knoeber 2001). (Kim, Mauldin & Patro 2014) stressed the dual role of outside directors in monitoring and advising management.

The presence of outside directors is positively associated with a higher return on investment. Dehaene, De Vuyst and Ooghe (2001) found a positive relationship between outside directors and return on equity and (Jackling & Johl 2009) found that a greater proportion of outside directors is associated with improvement in firm performance, while



Baysinger and Butler (1985b) found that corporations perform better if the board includes more outsider directors.

Outside directors bring to the board expertise and reputational capital that can play an important role in guiding management in exercising firms' growth options. Good monitoring, expertise and networking within the business community by outside directors increases the prospect that the firm's growth options are exercised at an optimal time to increase the value to shareholders (Matolcsy, Stokes & Wright 2004). Having a higher proportion of independent directors enhances the company's value by providing substantial growth options (Matolcsy, Stokes & Wright 2004). In a Malaysian study of 75 firms (Abidin, Kamal & Jusoff 2009) concluded that the emphasis on outside directors by the Malaysian Code of Corporate Governance and by Bursa Malaysia is appropriate. According to a Hong Kong study (Leung, Richardson & Jaggi 2014), board independence was positively associated with performance variables only in the case of non-family firms. Based on the findings, the authors argued for a review of the requirement of independent directors in boards of family firms. Board size and composition positively influenced firm performance in terms of value added efficiency of physical and intellectual resources. Another Middle East study (Al-Najjar 2014) also obtained a positive correlation for board independence with firm performance of tourism firms. (Zattoni & Cuomo 2010) emphasised the importance of the independence, competency and incentives of independent non-executive directors for their effective functioning. (Rosenstein & Wyatt 1990) noted that although independent functioning is not considered possible for outside directors when the management selects them, in most cases they function in the interest of the shareholders. (Cannella, Jones & Withers 2014) concluded that family firms tend to appoint directors from other family firms and retain them longer. (Tran, Koufopoulos & Warner 2014) observed that non-executive directors are not always independent and they play an important role in the functioning and termination of the CEO in Vietnamese companies. (Muravyev, Talavera & Weir 2014) observed the beneficial effects of appointing executives of other firms as directors in UK firms in terms of accounting performance as they provide monitoring and advice (Peasnell, Pope & Young 2005) did not find any advantage of outside directors or audit committees in preventing financial fraud.

On the contrary, some studies indicated a positive relationship between insider's shareholding and company performance. Klein (1998) Found significant positive linkages between the percentage of inside directors and stock market performance measures. Inside

directors can provide valuable knowledge and information regarding the firms' investments decisions (Agrawal & Knoeber 1996) and (Fama, EFa & Jensen 1983).

To maintain their reputation, inside directors add value to a firm by engaging in activities that reduce the risk investors face, thereby lowering the firm's cost of capital and increasing market confidence. However, it is argued that where the board is dominated by inside directors, monitoring of the CEO by the board would be weaker as the CEO can influence the career of inside directors (Matolcsy, Stokes & Wright 2004).

The level of independent non-executive directors on a board had negative relationship on performance (Agrawal & Knoeber 1996; Bhagat, Sanjai & Black 2000; Yermack 1996). Similarly in a UK context (Laing & Weir 1999) found a negative relationship between non-executive director representation and corporate performance. Moreover, Hermalin, Benjamin E. and Weisbach (1991) reported that the presence of outside directors on a boardroom had no impact on corporate performance. Jameson, Prevost and Puthenpurackal (2014) Found that controlling shareholder board membership had negative correlation with Tobin's q, not compensated by increasing the proportion of independent directors, institutional ownership or firm size.

However, as discussed above, effective monitoring requires the presence of a high proportion of non-executive directors on the board who are independent of management. In addition, most international corporate governance codes and rules require boards of directors of publicly- listed corporations to consider the importance of the outsider directors (Al Mansouri 2009; Council, ACG 2007; McKnight & Weir 2009; Valenti 2008b). Boards dominated by non-executive directors can also influence the quality of directors in relation to decisions-making skills and the strategic direction resulting in improved corporate performance (Pearce & Zahra 1992).

(Pfeffer 1972b) suggested an equation to determine the optimum board structure. But no work on validity of this equation has been reported so far.

The relationship between board composition and firm performance has been reported in prior research, and the following hypothesis was developed based on agency theory. The conceptual framework considers the importance of non-executive directors in increasing firm performance in the context of the UAE.

H0c: A majority of non-executive directors on the board is not associated with firm performance.

H1c: A majority of non-executive directors on the board is positively associated with firm performance.

## **Board Size and Performance**

Board size is an important construct of a good corporate governance mechanism and impacts on its engagement and involvement in corporate activities and affairs. In addition, the structure of the board indicates its ability and efficiency in directing corporations.

Agency theory proposes that larger boards are ineffective, while smaller boards are effective in improving financial performance (Lipton & Lorsch 1992; Sonnenfeld 2002). According to Jensen (1993), increased board size may destroy the value of the company through reduced effectiveness with regard to communication, coordination and monitoring. This effectiveness comes from agent managers increasing board size beyond its value-maximizing level. Thus board size and performance are negatively linked. Yawson (2006) argued that larger boards experience higher agency problems and are less effective than smaller boards. Hence, limiting corporate board size may improve efficiency.

Other researchers argue that the larger the board size the better for the company as larger boards will supply resources that are valuable to the company (Hillman, Keim & Luce 2001; Pfeffer 1972a). This relationship is based on the view that board size is associated with the company's capability and ability to access significant resources and to access the external environment. Larger size increases a company's capability (Dalton et al. 1999; Hillman & Dalziel 2003). Larger boards are associated with a range of business contacts, skills and experiences that smaller boards may not possess and this offers an opportunity to secure critical resources (Haniffa, R & Hudaib 2006).

Several researchers reported that the smaller the board size the better the performance of a company (Eisenberg, Sundgren & Wells 1998; Hermalin, Benjamin E & Weisbach 2001; Jensen 1993; Singh & Davidson III 2003; Yermack 1996) and (Lipton & Lorsch 1992). These findings assert that the small size of a board increased corporate performance, which meant low agency cost (McKnight & Weir 2009), and are consistent with agency theory argument.

Kiel and Nicholson (2003) Found a significant correlation between board size and performance. Pearce and Zahra (1991) Pointed out that a larger board is more powerful and assists in building relationships and corporate identity. Connelly and Limpaphayom (2004) reported that board size does not have any relationship with company performance. Aljifri and Moustafa (2007) Noted that board size had an insignificant impact on firm performance.

Andres and Vallelado (2008) Observed that larger board size is related to higher efficiency in the directors' ability and capability to monitor and advise management and create more value for a company.

(Conger & Lawler 2009) who argued that there is no ideal size for a board, and the time it takes to form the right mix of skills, knowledge and leadership is more important for effective value adding to the company.

The hypothesis in this study was developed based on the agency theory which argues that small board size is positively associated with firm performance. The conceptual framework considers the importance of the smaller board size in increasing firm performance in the context of the UAE and proposes the following hypotheses:

H0d There is no positive relationship between board size and firm financial performance.

H1d There is a positive relationship between board size and firm financial performance.

## **Audit Committee and Performance**

Audit committees are of a particular importance to better corporate governance, more specifically in monitoring and assessing the financial reporting reliability of companies (McMullen 1996). Boards of directors and audit committees are established to monitor management's behaviour and to ensure that managers act in the best interests of the shareholders rather than their own personal interest (Fama, EFa & Jensen 1983; Jensen & Meckling 1976). This represents the agency theory perspective that an audit committee is established to reduce conflict between shareholders and managers. The significance of audit committees, their role and contribution to corporate governance structure is evident in different corporate governance mechanisms. For example, in the USA under sections 301 and 402 of the Sarbanes-Oxley Act, an audit committee is required to be established (Hoi, Robin & Tessori 2007). Australian Stock Exchange recommend the establishment of audit committees and provides guidelines about their composition, operation and responsibilities (Council, ACG 2007). In the UAE under Article 6 of the ministerial resolution, audit committee is required to be established (Al Mansouri 2009).

The primary function of the audit committee is to meet regularly with the firm's external and internal auditors to review the company's financial statements, audit processes and internal accounting controls. This helps reduce agency costs and information asymmetry by facilitating timely release of unbiased accounting information to shareholders (Klein

1998). Effective monitoring by the audit committee may also help minimise financial fraud and increase firm value.

DeFond, Hann and Hu (2005) found a significant positive relationship between the appointment of independent financial experts in the audit committee and stock return. DeZoort (1997) indicated that internal control evaluation is the most important responsibility of an audit committee. This finding drew attention to the fact that audit committee members should be carefully selected or appointed as they need to be experienced with the company's operations or have experience in accounting and finance. This will enable them to evaluate the company's internal controls. McDaniel, Martin and Maines (2002) reported a positive relationship between the presence of financial experts on audit committees and financial reporting quality. Thus, a financial expert can play an important role within an audit committee. For example, they can articulate a value-adding framework within which an audit committee would discuss, evaluate and take effective decisions with regard to the responsibility and priority of an audit committee's functions as well improving the overall effectiveness oversight (McDaniel, Martin & Maines 2002).

Qin (2007) reported a positive relationship between the presence of a financial experts in an audit committee and the quality of reported earnings while Krishnan (2005) observed that companies with financial experts and independent audit committees are less likely to have internal control problems. These results confirm the importance of audit committees and their independence within organisations. There have been many instances of incompetent audit committees members who did not understand their roles, duties and responsibilities (DeZoort 1997).

Azam, Hoque and Yeasmin (2010) found a positive relationship between the frequency of audit committee meetings and equity return (ROE). DeFond, Hann and Hu (2005) observed a positive market reaction to the appointment of financial experts in audit committees. It is imperative that audit committee members possess the appropriate financial literacy and experience as well as the relevant qualifications to improve oversight function and establishment of an effective a monitoring mechanism. Such requirements enable audit committees not only to protect shareholder interests, but also to add value through improving a company's operational and financial functions.

In the UAE, the Ministerial Resolution No 518 of 2009 Concerning Governance Rules and Corporate Discipline Standards Article (9) - the Audit Committee, states that the

board of directors shall form an audit committee consisting of non-executive board members, provided that the majority of the Committee's members shall be independent members. The Committee shall consist of at least three (3) members, of whom a member shall be an expert in financial and accounting affairs.

The relationship between the existence of a financial expert in an audit committee and firm performance has been reported in previous studies. The following hypothesis was developed on the basis of agency theory that establishment of an audit committee is positively associated with firm performance as an audit committee with competent members monitors a manager's behaviour and performance and ensures that shareholder values are maintained, protected and increase.

H0e There is no positive relationship between the existence of financial expert in an audit committee and firm financial performance.

H1e There is a positive relationship between the existence of financial expert in an audit committee and firm financial performance.

## **Sharia Supervisory Board (SSB) & Performance**

According to Choudhury and Hoque (2006) Islamic corporate governance is a faith-based and consistent with Sharia principles. Islamic corporate governance has a wide commission, with obligations covering and extending to suppliers, customers, competitors and employees, embracing the spiritual as well as temporal needs of the community (Lewis 2005). Thus the Islamic perspective of corporate governance is a responsibility and obligation not only on a corporate level but more on an individual level and extending beyond the interests of shareholders' value (Abu-Tapanjeh 2009) as held in the conventional view (Lewis 2005) to reach to the wider community and the environment (Abu-Tapanjeh 2009). Islamic corporate governance is about fairness to all stakeholders. A major philosophical difference between the conventional and Islamic perspective of corporate governance is that the objectives of companies in the conventional model is to maximise shareholders' profit or maximise the wealth of the stakeholders. Conversely, in Islamic perspective, the prime objective is clearly specified: everyone has a unity purpose in his/her life that is to serve Almighty Allah (God) SWT. This belief leads to behaviour that is honest, transparent and cooperative. Such beliefs and action will result in a society that avoids conflict of interest among its members and promotes cooperation for the benefit of all its members (Kasri 2009).

Islamic corporate governance is about fulfilling the contractual commitments and obligations towards all relevant parties, stakeholders, the environment and the general public. It is about trust and integrity and about intellectually and intentionally honest and transparent behaviour. In practice, most Islamic organisations use western corporate governance standards which may not be in accordance with Islamic values. However, in the field the governance, tools and mechanisms are relatively the same and differences are minor (Kasri 2009). This is consistent with finding by (Al-Tamimi 2012) who reported few differences between both types of banks with regard to corporate governance practices. Furthermore (Ghayad 2008) acknowledged that Islamic banks have the same purpose as conventional banks except that Islamic banks indicate that they operate according to Sharia law (Islamic rules on transactions that include not dealing or operating with interest but with profit/loss sharing principles)

Metwally (2012) reports from his study of fifteen interest-free banks (Islamic banks) and fifteen conventional banks (interest-based banks) that the two groups may be differentiated in terms of liquidity, leverage and credit risk, but not in terms of profitability and efficiency. Islamic banks are more conservative in utilizing funds for lending and are disadvantaged in their investment opportunities. However, the main distinguishing feature of Islamic corporate governance is the mandatory presence of a Sharia Supervisory Board (SSB) as all business transactions have to be Sharia compliant (Al-Tamimi, Lafi & Uddin 2009; Alman 2012; Ghayad 2008; Haron, Ahmad & Planisek 1994; Kasri 2009; Safieddine 2009) . A Sharia Supervisory Board constitutes a key organ of governance in an Islamic Bank (Ghayad 2008). The UAE issued a Federal Law No 6 of 1985 that clearly stipulates Islamic banks must comply with Islamic Sharia law (Al Nahyan 1985). The UAE Central Bank as the governance regulatory body of all Islamic and conventional financial institutions, encourages the use of the OECD's international corporate governance (AlSuwaidi 2006). This demonstrate that the main practical difference between conventional and Islamic corporate governance on the organisational level is the mandatory presence of a SSB in the Islamic institutions, in addition to other contractual arrangements on the operational level.

Bukhari, Awan and Ahmed (2013) found that the most significant dimensions which affect corporate governance in Islamic banks are the Board of Directors and Sharia Supervisory Board. Alman (2012) observed that the loan portfolio risk-taking of Islamic banks is positively influenced by increasing the size of the SSB. Al-Tamimi, Lafi and Uddin (2009) reported that the majority of UAE bank customers preferred banking with Islamic

banks, even though they were not satisfied with the types of services and products' there was a significant difference between how customers perceived UAE Islamic banks versus conventional banks. Haron, Ahmad and Planisek (1994) found 39 per cent of the Muslim respondents believed that religion was the only reason why people patronized Islamic banks. Naser, Jamal and Al-Khatib (1999) reported that 65 per cent of respondents banked with Islamic banks because the bank not only provided conventional banking but also observed Sharia rules and principles. Thus the performance of Islamic banks is largely driven by its Muslim customers-base, whose concerns are carry out their business transactions in accordance with Islamic Sharia law, particularly in Muslims countries. However Haron, Ahmad and Planisek (1994) revealed that both Muslims and non-Muslims who patronized commercial banks had a common perception in selecting their banks and therefore Islamic banks should not emphasise religion (Sharia principles) as a strategy in an effort to attract more customers.

(Bin Hasan 2011) found in a study on the perception of the roles and functions played by the Sharia Supervisory Board in Islamic financial institutions in Malaysia, the Gulf Cooperation Council GCC which includes the UAE and the UK, that the following five aspects were important: accountability, organizational communication, Sharia non-compliance risk, Islamic ethics and values, and Sharia control processes. In the Malaysian context the study revealed that IFIs were generally satisfied with the performance of the Sharia Supervisory Board, Similarly, IFIs in the UK were satisfied with the performance of their Sharia Supervisory boards. However, in the GCC, while most IFIs agreed on the positive performance of the Sharia Supervisory Board, a small percentage was dissatisfied with its. This means some IFIs in the GCC acknowledged that their Sharia Supervisory board had ignored some important aspects of Islamic Sharia governance, particularly with respect to the effectiveness of organizational communication, identifying Sharia non-compliance risk, contributing to Islamic ethics and values, and Sharia control processes (Bin Hasan 2011). It should be noted that the evaluation and assessment of the performance of the Sharia Supervisory Board is crucial not only for better governance but also for the success of IFIs as it is the most important and distinguishing character of Islamic corporate governance in Islamic financial institutions. (Rammal 2010) reported a worldwide shortage of competent Sharia advisors in the Islamic finance sector which resulted in individuals being hired to work for more than one SSB, thus raising concerns about conflict of interest. Unal (2009) survey of SSB scholars and their involvement in multiple SSB positions revealed that the top 10



scholars (holding 15 or more positions) shared 253 positions, or an average of 25.3 positions per scholar.

There may be some benefits in engaging in multiple Sharia boards; for example, a SSB member may gain experience and knowledge. However excessive Sharia board positions in Islamic financial institutions could negatively affect the efficiency of SSB scholars and consequently their performance, as well as potentially raising agency problems and conflict of interest.

With regard to specific competencies of Sharia Supervisory Boards (Bin Hasan 2011) reported that only 51.4 per cent of IFIs provided professional training, especially in the matters of finance and banking, to their Sharia Supervisory Board, and 40 per cent, , including those in Malaysia, the Gulf Cooperation Council and the UK do not assess the Sharia Supervisory Board's performance.

Ghayad (2008) asserted that Sharia members must have a qualification and professional training in finance and commerce to ensure better quality of supervision and consultation, otherwise shareholders and board of directors may possibly compromise Sharia principles for short term profit or gain (Akhtar 2006b). It is critical for Sharia Supervisory Boards to not only maintain Sharia compliance, but also use Sharia knowledge to develop new Sharia-compliant products to enable Islamic banks to generate better performance and compete with conventional.

The role of the Sharia Supervisory Board varies from one board to another and it depends upon the nature, extent and degree of Sharia compliance. Inspired by its foundational dimension and stakeholder value orientation, the Sharia board has fiduciary and obligatory duties to all stakeholders of IFIs. Moreover the integrity of IFIs is greatly dependant on the status of Sharia compliance, the impact of products, professional competence and behaviour towards observance of Sharia norms (Muhammad 2008).

The Sharia Supervisory Board is an essential part of IFIs, as they are responsible for monitoring the compliance of Sharia rules in their transactions and issuance of Sharia products. In addition, the Sharia Supervisory Board has the authority to issue Fatwas (rulings) regarding Islamic bank products and practices (Wardhany & Arshad 2012).

The Sharia Governance System demands the establishment of a Sharia Supervisory Board to ensure that Islamic banking products and operations match Sharia principles (Prudential & Compilation 2007; Wardhany & Arshad 2012). Ghayad (2008) describes the

role of the Sharia Supervisory Board as both supervisory and consultative in ensuring that Islamic banking adheres strictly to Sharia rules and principles and their banking operations.

The relationship between the SSB and firm performance has been reported in prior research. The following hypothesis was developed on the basis of Islamic perspective theory which argues that Islamic corporate governance is a faith-based and balanced approach, established on the principles of not only fair treatment of all stakeholders, but also of individual ethics and morale and of social and environmental responsibilities. SSB is the device by which IFIs can be considered Islamic-Sharia compliant and it is assumed that SSBs are associated with performance.

H0e There is no positive relationship between SSB and IFI's performance.

H1e There is a positive relationship between SSB and IFI's performance.

The above mentioned hypotheses describe the impact of corporate governance practices on firm performance. Effective corporate governance adheres to the rules established by the relevant regulatory organisations to implement best practice recommendations which suggest that boards should be comprised of a separate leadership structure, a majority of independent non-executive directors, an audit committee and a SSB in an IFI. Such corporate governance practices are considered to have an impact on firm performance through appropriate disclosures in corporate public reports. A summary of the above hypotheses is presented in Table 4.1.

*Table 4.1: Summary of Hypotheses*

<b>Constructs</b>	<b>H0</b>	<b>H1</b>
Ownership Structure	Ownership structure is not associated with firm performance.	Ownership structure is associated with firm performance.
Leadership Structure	Separate leadership structure is not associated with firm performance.	Separate leadership structure is positively associated with firm performance.
Board Composition	A majority of non-executive/ independent directors on the board is not associated with firm performance.	A majority of non-executive/ independent directors on the board is positively associated with firm performance.
Board Size	Board size is not associated with firm performance.	Board size is associated with firm performance.
Audit Committee (Financial Expert)	Financial expert within audit committee is not associated with firm performance.	Financial expert within audit committee is associated with firm performance.
Sharia Supervisory Board (SSB)	Sharia supervisory board is not associated with firm performance.	Sharia supervisory board is associated with firm performance.

## 4.6 Firm Performance

Based on the literature review in chapter 2, corporate governance is considered an important element of firm performance. This consideration is also applicable to the context of the UAE in this research.

Firm performance in this research is represented by the dependent variables of ROE, ROA and Tobin's q. ROE and ROA are used to measure the operating performance of the firm, based on shareholder equity and total assets of the company, in addition to explaining the efficiency of management. Tobin's q is used as a measure of market value of the firm and illustrates the impact of accounting information and disclosures on share prices of companies.

The conceptual framework of the research indicates that firm performance is measured by market-based and accounting-based measures and the implication of corporate governance practices on firm performance. Implementing good corporate governance

practices would result in a better monitoring of management and it ensure a transparent accountability mechanism which would result in a better allocation of resources and consequently positively impact on ROE and ROA, which in turn would result in higher share prices.

Capital market research in accounting assumes that equity markets are efficient and factor in all publicly available information, including the information available in financial statements and other financial disclosures, into share prices in an unbiased manner (Deegan & Samkin 2004).

Corporate governance is geared to the strategic-level of accountability and control. Good corporate governance is important for effective corporate performance of all organisational types. Essentially, corporate governance is a checks and balances system that ensures a focus on many perspectives and constituencies such as proper resource allocation, delegation of power and decision authority, and responsibility for making corporate changes in relation to strategic directions (Thorne, Ferrell & Ferrell 2011). Therefore good corporate governance practices are vital to firm performance, because the market value of shares is affected by the quality of disclosures and transparency in regard to corporate operational and financial affairs.

## **4.7 Conclusion**

The purpose of this chapter was to develop the conceptual framework and the hypotheses to analyse the relationship between corporate governance specific variables and firm performance for this study in the UAE context.

This chapter started with the theoretical framework which linked to the conceptual framework of the study. The conceptual framework comprised both conventional and Islamic board structure and firm performance. The hypotheses proposed were discussed within their relevant theoretical arguments. This chapter is important as it discusses the impact of corporate governance on firm performance within the UAE context. The following chapter will discuss the research methodology that will be used to examine the hypotheses developed above.

# **CHAPTER 5**

## **Research Methodology**

### **5.1 Introduction**

This chapter describes the research methodology used in this study. The models used to test the relationships between corporate governance and the performance of companies are discussed. This chapter also describes the method of data collection, the variables used to test the hypothesis, and statistical methods used to report the results.

The chapter is organized as follows: Section 5.2 discusses the different research methodologies available and justifies the research method chosen; Section 5.3 discusses the selection of sample and Section 5.4 describes the types and method of data collection; Section 5.5 deals with conceptualisation and measurement analyses of the variables; section 5.6 discusses the statistical methods used to analyse the data and finally Section 5.7 concludes the chapter.

### **5.2 Research methodologies generally used**

The two central research paradigms in social science and economic research are deductive and inductive reasoning (Veal, Anthony James 2005). The paradigm terms refers to the set of assumptions that deal with the proper techniques for any specific inquiry. This includes parts of what is to be studied, how the research is conducted, what data is collected and how it should be interpreted (Smith & Ebooks Corporation 2003). According to Veal, Anthony James (2005) if the research process starts with a theory, examining the literature and then developing the theoretical and conceptual structure which is tested by empirical observation, it is called the deductive method.

In an inductive process the theory is developed from empirical observation (Collis et al. 2003). The research method must be compatible and aligned with the theoretical paradigm. The positivist paradigm sees researchers as independent of the research they are conducting (Ticehurst & Veal 2000). This approach focuses on description, explanation and uncovering facts.

Positivists view reality as objective, measurable and therefore research emphasizes the facts and predictions to explain cause and effect. The research process of the positivist approach is to study prior literature to establish a relevant theory and develop the propositions or hypotheses, which can then be examined for association or causality by deducing logical consequences that are tested against empirical evidence (Veal, Anthony James 2005). The positivist paradigm is also referred to as scientific, experimental, empiricist, quantitative or deductive (Ticehurst & Veal 2000)

The design of research and the method used to analyse data also depends on the paradigm adopted by the researcher. Qualitative methods are mainly associated with inductive reasoning and quantitative methods are usually employed in a positivist and inductive approach. Qualitative and quantitative research methods are used by researchers in deducting reasoning depending on the research design (Veal, Anthony James 2005).

Quantitative methodology uses objective data, statistical methods of analysis and rigorous measurement. An advantage of quantitative methodology is the ability to generalize results to a large population. But this method is criticized for failing to explain 'why' the factors observed may have happened or behaved in such a way, and to provide an in-depth understanding of the phenomenon under study. Qualitative methods investigate how individuals think and react, and are directed towards deep understanding of their experience, motivation and values. However, this method is often criticized as being too subjective, biased and lacking rigor.

Two main sources of data for scientific research exist: one is the primary and the other is the secondary. The primary data is original data gathered by the researcher by using, for example, questionnaires, observations and experiments, and secondary data is data that already exist, for example, data obtained from annual reports, books, published statistics and internal records kept by companies (Veal, Anthony James 2005). Evidence required to test the hypotheses of this study is based on published statistics and annual reports. Therefore data used in this study is secondary in nature.

This study is based on a positivist paradigm employing deductive reasoning and using quantitative secondary data. It adopted a positivist approach as this approach searches for facts or causes of social phenomena. The reasoning of this study is deductive because the hypotheses were derived from existing theory and then data was collected to confirm or negate the hypotheses. The selection of the samples, the sources of data, the procedure for

collecting and coding the data, the quantification of variables and method of data analysis are described below.

## **5.3 Sample Selection**

The objective of this study was to conduct an investigation of the corporate governance practices of listed companies in the UAE, including Islamic banks, and their impact on firm performance, and in particular the impact of the SSB on the performance of Islamic banks.

The sample selection includes all listed companies (the entire population) that fall within the scope of the study from both the Abu Dhabi Securities Market and Dubai Financial Markets for the years 2008 and 2009 compared to the data for 2011 and 2012. The aim was to compare the impact of the adoption of the mandatory Ministerial Resolution No 518 of 2009 Concerning Governance Rules and Corporate Discipline Standards over the two periods. This resolution is applicable to non-financial companies. Both conventional and Islamic banks are subject to the UAE central bank governance mechanism which encourages the use of the OECD's international corporate governance standards.

The purpose of selecting the entire population of 122 listed companies in this study is to have the best possible representation of the UAE stock market and consequently produce a generalised outcome that can reflect a satisfactory and reliable picture of the UAE listed companies in relation to performance. The three types of samples of listed companies - the non-financial companies, the conventional banks and Islamic banks - present annual reports which included governance report. Corporate governance reports and other corporate governance requirements for the non-financial companies have become mandatory from May 2010. By 2012, the effect of adopting the required governance practices can be expected to produce measurable effects in performance. On the other hand, corporate governance practices of conventional and Islamic banks had remained voluntary; although they were encouraged to implement OECD corporate governance codes and standards.

## **5.4 Data Collection**

The following section discusses the types and methods of collection of data used in this study which assessed the relationship between corporate governance practices and firm performance of listed companies in the UAE. The data and information required were

collected from the Abu Dhabi Securities Market and Dubai Financial Markets websites, annual reports, and journals in as well as the ES&CA and the UAE central bank.

### **5.4.1 Data Collection Methodology**

Data on corporate governance and corporate reporting practices was collected from secondary sources. Financial data on performance was extracted from annual reports which contain data on all the financial information relevant to the performance of companies.

### **5.4.2 Types of Data collection**

Corporate governance, financial figures and relevant reporting information were collected from annual reports. The data for this study was collected for the period between 2008 and 2012. Data for 2008 and 2009 reflects the corporate governance practices of firms prior to the introduction of the mandatory Ministerial Resolution No 518 of 2009 Concerning Governance Rules and Corporate Discipline Standards which had taken effect in May 2010 and that of 2011 and 2012 reflects the corporate governance practices of firms after the introduction of the mandatory rules of 2009, implemented in May 2010. The information and the data required for the study comprised ownership structure, leadership structure, board composition, board size, inclusion of a financial expert on the audit committee and a Sharia Supervisory Board. Performance data used in the study were the return on investment (ROE), the return on assets (ROA) and Tobin's Q. The data on company size, which comprised the total assets and the market capitalization, were extracted from annual reports.

## **5.5 Conceptualisation and Measurement Analyses of the Variables**

Table 5.1 provides a list of the variables employed to operationalize the constructs and the related hypotheses developed in Chapter 4. They include the corporate governance variables of ownership structure, leadership structure, board composition, board size, composition of audit committee, the existence of a financial expert on audit committee and the Sharia Supervisory Board for company performance and the controlling variable of company size. Accounting-based measures and market-based measures are used for the corporate performance of this study and ROE and ROA are used as proxies for accounting measures. These two variables indicate the utilisation efficiencies of generating profits from shareholders' invested equity and from company assets respectively. Tobin's q is a market-



based measure used to indicate the market perception of the firm's performance (Tobin 1969; Weir, Laing & McKnight 2002)

*Table 5.1: Variables Used to Study the Corporate Governance Practices in UAE*

<b>Variables</b>	<b>Measurements tools</b>	<b>Symbol</b>
Ownership structure	Ownership concentration (OWN) is a dummy variable equal to '1' if some shareholder owns a 5% or more of shares in the firm, and '0' otherwise.	OWN
Leadership structure	Dummy variables 1 for combined roles and 2 for separate role.	Duality
Board Composition	Proportion of independent outside directors to the board size	PO
Board size	Total number of directors	BSIZE
Audit Committee Composition	Audit committee financial expertise is equal to 1 if the audit committee includes at least one financial expert and "0" if otherwise.	ACEXP
Sharia Supervisory Board (SSB)	SSB is equal to 1 if Islamic bank comply with variables of regulatory index exist and "0" if otherwise (table 6.18)	SSB
Firm performance Tobin's q	Market capitalisation + total assets - shareholders' funds / total assets	TQ
Return on total assets	Profit after tax / book value of total assets	ROA
Return on equity	Profit after tax / shareholders' funds	ROE
Control variables Company size	Price per share multiplied by total number of outstanding shares or by market capitalisation & total assets.	Firm Size

### **5.5.1 Ownership Structure**

Various researchers studying corporate governance and performance have used dummy variables to operationalize the ownership Structure. (Li, Jiatao 1994; Wiwattanakantang 2001) and Cronqvist and Nilsson (2003), stated that most studies employed ownership cut-off points at 5 per cent, 10 per cent and 20 per cent. A large shareholder holding 5 per cent of a company's total shares has been used in the US-based model (Morck, Shleifer & Vishny 1988b; Zeckhauser & Pound 1990). By law, ownership needs to be disclosed from 5 per cent and over. This study presented dummy variables for ownership structure. If the ownership was less than 5 per cent of the total shares, it was classified as dispersed and was coded '0'. If the ownership was 5 per cent and more of the total shares, it was classified as concentrated and was coded '1'. As reported in Chapter 2, research on ownership structure showed mixed results. There is evidence in support of the concentrated ownership structure positively affecting firm performance (Zeckhauser & Pound 1990; Zeitun & Tian 2007). Kobeissi (2004) also reported a positive relationship between concentrated ownership structure and firm performance. These findings indicate that concentrated ownership structure is beneficial to firm performance, supporting the agency theory.

The benefit of concentrated ownership structure has been extensively discussed (Berle & Means 1932; Fama, EFa & Jensen 1983; Jensen & Meckling 1976; Shleifer & Vishny 1986). These authors suggested that managers are motivated by the widely dispersed ownership structure to dispossess corporate shares in a way that negatively affects the wealth of shareholders. Additionally, concentrated shareholdings can make managerial monitoring easier and thus reduce agency costs (Preedanan 2005). Therefore, this study supports the concentrated ownership structure for positive firm performance.

### **5.5.2 Leadership Structure**

Dummy variables to operationalize the board leadership structure were used in the corporate governance literature (Abdullah 2004b; Kiel & Nicholson 2003; Lam & Lee 2008). This study employed dummy variables for board leadership structure. If one person occupied the dual roles of the chairperson and the CEO, it was classified as combined leadership and was coded '1'. If the roles were performed by two separate persons, it was classified as separate leadership and was coded '2'.

As discussed in Chapter 2, research on board leadership structure has shown mixed and contradictory results. However there is evidence that the separation of chairperson and CEO roles improved performance (Banks 2004; Boyd 1995; Brickley, Coles & Jarrell 1997; Rechner & Dalton 1991; Sanda, Mikailu & Garba 2005). This view supported agency theory.

The benefits of separation of the two roles were addressed by OECD principles of corporate governance Governance (2004), Cadbury, A (1992) and by the US Sarbanes-Oxley Act (Valenti 2008a), as explained in Chapter 2. The UAE, in its most recent rule regarding corporate governance practice, has mandated the separation of the two roles (Al Mansouri 2009). Hence, this study supported a separation of the two roles in the leadership structure for positive firm performance.

### **5.5.3 Board Composition**

An approach used to operationalize the board composition is the proportion of non-executive directors to total directors (Dalton et al. 1998; Kiel & Nicholson 2003; Laing & Weir 1999) In this study, board composition was defined as the number of non-executive directors divided by the total number of directors on the board.

Several studies reported a positive relationship between the proportion of outside directors and firm performance (Dehaene, De Vuyst & Ooghe 2001; Jackling & Johl 2009; Liang & Li 1999; Weir, Laing & McKnight 2002). Moreover, Baysinger and Butler (1985b) reported that a higher proportion of outside directors was positively linked to firm performance.

According to (Fama, EF 1980; Fama, EFa & Jensen 1983) outside directors are critical in monitoring the internal control mechanism because they are more willing to perform a monitoring role in an organisation. Firstenberg and Malkiel (1980) advocated that outside directors should be in the majority on corporate boards.

Non-executive directors are expected to be effective monitors of executive members. Higher proportions of non-executive directors on the board facilitate independent decision-making and will result in a better performance. This perspective is consistent with agency theory. Article (3) of the UAE resolution regarding corporate governance defines (a) the board of directors of the company, method of formation of the board of directors, number of board members and term of membership, (b) the formation of the board of directors shall take into consideration an appropriate balance between executive, non-executive and independent board members provided that at least one-third of the members shall be independent members

and a majority of members shall be non-executive members who shall have technical skills and experience for the good of the Company. To analyse compliance with the Article 3 of the UAE resolution regarding board composition a binary variable of 1 was assigned for compliance and '0' for non-compliance.

#### **5.5.4 Board Size**

Board size relates to the number of members on the board and is considered an important variable in studying the relationship between corporate governance and firm performance. Board size variable is commonly used in the corporate governance literature and is calculated by counting the number of the total board members in a company. Prior studies (Chaganti, Mahajan & Sharma 1985; Imen 2007; Kiel & Nicholson 2003) used the same methodology to construct this variable and the same method and analysis are also used in this study.

A number of researchers reported that the smaller the board size the better the performance of a company (Eisenberg, Sundgren & Wells 1998; Hermalin, Benjamin E & Weisbach 2001; Jensen 1993; Singh & Davidson III 2003; Yermack 1996) and (Lipton & Lorsch 1992), and agency cost was reduced (McKnight & Weir 2009). These findings supported agency theory.

#### **5.5.5 Audit Committee Composition**

An audit committee is of a particular importance to better corporate governance and is an important variable of corporate governance. More specifically, an audit committee plays a significant role in monitoring and assessing the financial reporting reliability of companies (McMullen 1996). Boards of directors and audit committees are established to monitor management's behaviour and to ensure that managers act in the best interests of the shareholders rather than their own personal interest (Fama, EFa & Jensen 1983; Jensen & Meckling 1976). This represents agency theory perspective of reducing the level of conflict between shareholders and managers.

Article 9 of the most recent rules regarding UAE corporate governance mandates that: the board of directors shall form an audit committee consisting of non-executive board members provided that the majority of the Committee's members shall be independent members. The Committee shall consist of at least three (3) members, of whom a member

shall be an expert in financial and accounting affairs. One or more members from outside the company may be appointed if the number of non-executive board members is not sufficient.

This variable focuses on the existence of financial expert within an audit committee and their impact on performance. Several studies found a positive relationship between the existence of a financial expert within the audit committee and performance, (DeFond, Hann & Hu 2005; Krishnan 2005; McDaniel, Martin & Maines 2002; Qin 2007). To operationalize this variable, if an audit committee included a financial expert, it was assigned a value of 1 and if not, “0” (Lin, Li & Yang 2006).

### **5.5.6 Sharia Supervisory Board**

A Sharia Supervisory Board constitutes a key organ of governance in an Islamic Bank (Ghayad 2008). The UAE issued a Federal Law No 6 of 1985 that clearly stipulates that Islamic banks must comply with Islamic Sharia law (Al Nahyan 1985).

SSB is the main distinguishing attribute of Islamic corporate governance and its presence is mandatory in Islamic financial institutions as all business transactions have to be Sharia compliant (Al-Tamimi, Lafi & Uddin 2009; Alman 2012; Ghayad 2008; Haron, Ahmad & Planisek 1994; Kasri 2009; Safieddine 2009).

Bin Hasan (2011) research on Islamic financial institutions in Malaysia, and the Gulf Cooperation Council GCC which includes UAE and the UK on the perception of the roles and functions played by the Sharia Supervisory Board in the five aspects, namely, accountability, organizational communication, Sharia non-compliance risk, Islamic ethics and values, and Sharia control processes. The results indicated that the IFIs were generally satisfied with performance of the SSB. To operationalize this variable, the two corporate governance practices (of conventional and Islamic banks) were compared in term of compliance and performance. The comparison was specific to and included only these two types of banks in the UAE context.

On the basis of the most frequent issues reported in previous literature relating to SSBs within Islamic governance practices, a table was developed to test, identify and confirm if such issues are valid in the context of the UAE market.

The following elements of the SSB and related matters were examined: Whether the total number of the members in the SSB met the recommendation of the AAOIFI regarding SSB members with relevant Sharia, finance qualifications; whether a procedure for performance

appraisal of SSB existed; whether the SSB report complied with the report format recommend by AAOIFI in relation to “appropriateness of allocation of profit & Loss between shareholders and IAHs” and the frequency of SSB meetings; and whether multiple directorship existed within the SSBs members in the UAE context. An indexing table was developed for SSB performance and descriptive statistics were used for the sub-variables in relation to SSB, in addition to a regression test.

### **5.5.7 Firm Size – (Control Variable)**

The size of a firm may be related to corporate governance characteristics and correlated with firm performance; it can be represented by market capitalization and book values of total assets of the firm.

#### **Market Capitalization**

The size of a company is measured by market capitalization which represents the total value of a firm. Market capitalization is a market estimate of the value of a company based on perceived future prospects and economic and monetary conditions. It is calculated by multiplying the current price per share by the total number of outstanding shares. Investor confidence is reflected in the market capitalization.

Companies with higher market capitalization are considered to have lower risk than companies with lower market capitalization. This may be related to the higher liquidity that the firms with higher market capitalization enjoy. On the other hand, firms with lower market capitalization may be profitable because of the higher growth potential. The shares of a company with lower market capitalisation are more risky but can have higher financial returns (Rashid 2008). Previous empirical studies found that firm performance is positively related to market capitalization (Yermack 1996).

#### **Total Assets**

Size of firm can be measured by the book value of its total assets. Prior studies have used total assets to represent firm size. Firm size can be related to other governance variables. (Pathan, Skully & Wickramanayake 2007) reported a statistically significant correlation for board size and total assets. Kiel and Nicholson (2003) reported that total assets of a company are positively correlated with board size and board composition. Hence the total assets are considered to have an impact on the variables used in this research.

### 5.5.8 Performance Measures

Research on corporate governance practices used accounting-based performance measures such as return on equity (ROE) and return on assets (ROA), and market-based measures such as Tobin's Q as proxies for firm performance (Abdullah 2004b; Bonn, Yoshikawa & Phan 2004; Daily, Catherine M. & Dalton 1993; Heenetigala & Armstrong 2011; Hermalin, Benjamin E. & Weisbach 1991; Sanjai & Bernard 2002; Yermack 1996). In this study, firm performance was measured using ROE, ROA and Tobin's Q as proxies for accounting return and market return for listed companies.

#### **Tobin's q**

Tobin q Ratio is a measurement tool for market performance. It compares the market value of a company with the value of the company's assets (Tobin 1969). It is a measure of growth prospects of assets defined by their future profitability in relation to their replacement value (Leng 2004). Kiel and Nicholson (2003) referred to Tobin q as the market value of common stock book value of preferred stock and is the book value of long term debt divided by book value of total assets. Bhagat, Sanjai and Jefferis (2002) stated that Tobin's q is the current market value of the company divided by the replacement cost of the assets, measured by the book value of the firm's assets. Adams, RB and Mehran (2005) calculated the market value of the firm as the book value of assets minus the book value of equity plus the market value of equity. Tobin's q compares the ratio of a company's market value and the value of a company's assets. If the value of the Tobin's q is equal to one, it indicates that the market value is reflected in the assets of the company. A ratio greater than one indicates that market value is higher than the book value of the company's assets. Therefore a higher Tobin's q indicates that companies can invest more capital as their value is more than the amount they paid and this creates more value for shareholders. If Tobin's q is less than one it indicates that the market value is lower than the assets of the company and thus it is undervalued. Q is a proxy for how closely shareholder and manager interests have been aligned. The higher the value of q, the more effective the governance mechanisms and the better the market's perception of the company's performance, Whereas lower values of q suggest less effective governance mechanisms and greater managerial discretion (Weir, Laing & McKnight 2002).

The following formula was used for estimating Tobin's q in this study. This ratio was used by previous authors such as (Adams, RB & Mehran 2005; Heenetigala & Armstrong 2011; Rashid 2008):

Tobin's Q = (Market capitalisation + Total assets - shareholders' funds)/Total assets



## **Return on Equity (ROE)**

Return on equity measures the rate of return on shareholders' equity. It measures a firm's efficiency in generating profits using equity funds. A higher ratio indicates a higher return and higher utilisation efficiency and a lower ratio indicates a lower return and lower efficiency (Black, Jang & Kim 2006; Claessens & Fan 2002). In this study, ROE ratio was calculated using the following formula:

$$\text{ROE} = \text{Profit after Tax} / \text{Shareholders' Funds}$$

## **Return on Assets (ROA)**

The return on assets (ROA) percentage shows how profitable a company's assets are in generating revenue. Return on assets indicates the number of dollars earned on each dollar of assets. Thus higher values of return on assets show that a business is more profitable. ROA is used in a number of studies (Abdullah 2004b; Bonn, Yoshikawa & Phan 2004; Heenetigala & Armstrong 2011). ROA ratio also indicates management's efficiency in employing company assets to generate profits. The ratio of ROA is calculated as follows:

$$\text{ROA} = \text{Profit after Tax} / \text{Total Assets}$$

# **5.6 Statistical Analysis**

The statistical analysis included descriptive statistics, t-tests, Spearman's correlation and analysis of variance (ANOVA). ANOVA and regression analysis have been used in prior studies to test the relationship between corporate governance practices and firm performance.

The aim in this context is to determine (1) whether a change in the corporate governance variables had taken place in 2010 as a result of the mandated rules introduced in 2009 by the UAE ES&CA and (2) if such mandated rules had an impact on corporate performance. In this study, the analysis used ANOVA to examine the differences between the two observed periods of the same samples. The analysis compares the differences of the variances between observations and variances in the means. This is an appropriate statistical method in the study to determine if there are statistically significant differences between the observations.

## **5.6.1 Descriptive Statistics**

Descriptive statistics measure the central tendency and dispersion and were used to analyse the basic features of the data in this study. The measures of central tendencies were: mean, mode and median with a particular focus on the mean as it is a significant measure of the central tendency. In addition, the mean was used to indicate the maximum and minimum values of the research variables to show standard deviation or the range (Veal, A.J. & Ticehurst 2005). Descriptive statistics are also useful for making general observations about the data collected. They report on trends and patterns of data and provide a basis for comparison between variables. In this study descriptive statistics provided a comparison of changes in the data between 2008-2009 and 2011-2012. They indicated the extent to which companies had complied with the corporate governance rules which were introduced by the UAE ES&CA and the trends of the firm performance variables.

### **5.6.2 T-Test**

The t-tests are used to determine if there are significant differences between two means (Veal, A.J. & Ticehurst 2005). The SPSS program was used in this study for the analysis of t-test. Two-related sample t-tests were conducted to determine if the differences in corporate governance practices in 2008-2009 and 2011-2012 were significant.

A Wilcoxon Signed Rank Test (two-related-sample tests), which is the non-parametric version of the paired sample t-test (Carver & Nash 2011), was conducted to test the significance of the means of the variables for 2008-2009 and 2011-2012; two-related-sample t-tests are used when measurements are repeated for the same sample (Carver & Nash 2011). Two-related sample t-test was conducted to identify if the differences in the characteristics of corporate governance between 2008-2009 and 2011-2012 were significant.

### **5.6.3 Spearman's Correlation**

Correlation is used to examine the relationship between two or more ordinal or ratios variables. Correlation can be measured by means of correlation coefficient. The significance of a correlation coefficient depends on its magnitude and the sample size and can be assessed by means of t-test (Veal, A.J. & Ticehurst 2005). Spearman's Rank correlation coefficient is used to identify and test the strength of a relationship between two sets of data. Furthermore, and for the purpose of this thesis it is worth noting that multicollinearity will not be an issue due to the lack of significant correlation between the independent variables.

Spearman's rank correlation is calculated as follows:

$$r = (1 - 6\sum d^2) / N(n^2 - 1)$$

Where d is the difference between the two ranked variables, n is the number of data pairs and  $\Sigma$  indicates the sum of values

### **5.6.4 Analysis of Variance**

Analysis of variance (ANOVA) is used to compare difference between more than two means at a time. Whether or not the means are from one population (with one mean) or from different sub-populations (with different means) depends not only on the differences between the means but also on how much they are spread out or dispersed (Veal, A.J. & Ticehurst 2005). ANOVA is an exploratory analysis and examines significance in the case of cross-tabulated means and determines whether the differences revealed are within the acceptable significance levels of  $<.05$ . The strong point of ANOVA is its capability to distinguish effects in response to many different sources of variations compared simultaneously or in certain cases through time. It has the ability to identify interacting factors and the capability to measure the scale of variation within a hierarchy of effects. This versatility makes it a powerful tool for answering questions about causality (Fitrijanti & Alamanda 2013).

### **5.6.5 Incremental Regression**

The incremental regression analysis was performed to determine the importance of an individual variable in affecting the performance of a firm, by removing the individual variables from the model and capturing the effect on R-squared (Field 2005). These tests highlighted the importance of individual variables in affecting the performance variable in the model.

## **5.7 Conclusion**

This chapter discussed the methodology used to test the hypotheses of the study. Sample size, data collection, the design of the variables, measurement tools and operationalization were discussed. The chapter also discussed the methodology used for data collection and the relevant statistical techniques employed to analyse and interpret the data to examine the relationship between corporate governance variables and their impact on firm performance in the UAE. Next chapter discusses the results of these statistical analyses.

# CHAPTER 6

## Statistical Results and Analysis

### 6.1 Introduction

This chapter describes the results of the research, the analyses of the data and the statistical methods used. An analysis of the relationship of corporate governance instruments and firm performance is also discussed. The descriptive statistics and analysis of means were used to compare and investigate changes between the means of the pre- (2008-2009) and post- implementation (2011-2012) periods. This enabled identification and detailed analysis of the extent to which firms have complied with new codes and how such compliance affected firm performance. T-tests were conducted to identify the significance of the changes.

The six variables described in Chapter 4 were analysed to determine the relationship between governance and firm performance. The variables described in chapter 4 were: Ownership Structure, Leadership Structure, Board Composition, Board Size, Audit Committee (Financial Expert) and the Sharia Supervisory Board (SSB).

The structure of the chapter is as follows: Section 6.2 reports on the descriptive statistics, section 6.3 reports the result of t-tests, section 6.4 outlines results of Spearman's correlation, section 6.5 gives the results of the analysis of variance, section 6.6 presents the index of the performance of Sharia Supervisory Boards, section 6.7 gives the regression analysis and section 6.8 summarises the findings of the chapter.

A regulatory and performance related index was developed to use as an indicator of the level of compliance of Islamic Banks with AAOIFI. In addition, the SSB sub-variables mentioned in table 6.1 were developed and extracted from the issues frequently mentioned in relevant literature with regard to compliance with AAOIFI and performance and conflict of interests. If the sub-variables are compliant to or considered part of the Islamic banks governance practices, then they should be clearly and transparently disclosed in the annual reports. Such practices would indicate good disclosures and transparency practices of a good corporate governance mechanism. This measure was used for evaluating compliance of Islamic banks with AAOFI codes.

## 6.2 Descriptive Statistics for CG Variables of the listed Companies of the United Arab Emirates Pre- and Post-The Ministerial Resolution No. (518) of 2009 Concerning Governance Rules and Corporate Standards

As discussed in Chapter 5, descriptive statistics for the period of pre (2008-2009) and post (2011-2012) governance were calculated separately for corporate governance and firm performance variables in the study. Descriptive statistics compared the compliance by the companies with corporate governance rules introduced in 2010. A summary of the descriptive statistics of the overall data panel are presented in the Table 6.1.

*Table 6.1: Descriptive Statistics for 2008-2009 and 2011-2012*

	Pre Governance (period 2008 &2009)					Post Governance (period 2011&2012)				
Variables	N	Min	Max	Mean	Std. Dev	N	Min	Max	Mean	Std. Dev
<b>Independent Variables</b>										
<i>Ownership Structure:</i>										
Families	165	.000	.752	.064	.154	228	.000	.741	.071	.136
Institutional	171	.0 00	1.00	.193	.269	234	.000	1.00	.340	.250
Foreign	159	.000	.840	.035	.113	218	.000	.560	.033	.103
Governments	162	.000	.800	.117	.209	224	.000	.800	.123	.200
Individuals	160	.000	.903	.092	.193	222	.000	.973	.324	.254
<i>Separate Leadership</i>	223	1.00	2.00	1.77	.423	239	1.00	2.00	1.78	.413

	Pre Governance (period 2008 &2009)					Post Governance (period 2011&2012)				
<b>Variables</b>	<b>N</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>	<b>N</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>
<i>Board composition</i>										
Executives Directors	34	.000	3.00	.882	.880	172	.000	4.00	.738	.761
Nonexecutives Dir	21	.000	9.00	5.48	2.77	151	.000	10.0	2.70	2.59
Independent Directors	23	.000	11.0	2.67	3.15	151	.000	14.0	4.21	2.93
<i>Board Size</i>	109	3.00	17.0	8.23	2.41	204	3.00	18.0	7.76	1.95
<i>Audit Committee</i>										
Financial Expert	244	.000	1	.061	.240	244	.000	1.00	.286	.453
<b>Dependant Variables</b>										
Tobin's Q	224	.033	15.0	1.16	1.80	226	-1.43	40.75	1.19	3.76
ROA	215	-44.3	29.2	3.02	8.10	227	-24.2	19.10	2.00	5.96
ROE	217	-168	57.1	6	21.80	227	-83.0	159	4.46	17.1
<i>Control Variable</i>	234	15.4	25.0	20.4	1.98	240	15.5	25.1	20.3	2.04
Assets										

Note: ROA - Return on Asset, ROE- Return on Equity

### 6.2.1 Ownership Structure

Ownership structure variable consisted of five different types of owners/shareholders: family, institutional, foreign, government and individuals. Results relating to each type are described below.

#### Family Ownership

As shown in Table 6.1, the mean frequency proportion of family ownership for the pre-governance period was 6.4 per cent ranging from a minimum value of 0 per cent to a

maximum value of 75.2 per cent. The mean value of family ownership proportion for the post-governance period was 7.1 per cent ranging from a minimum value of 0 per cent to a maximum value of 74.1 per cent. The mean and range values were almost consistent across the two periods.

### **Institutional Ownership**

The mean value of the institutional ownership for the pre-governance period was 19.3 per cent compared to the mean value of the post-governance period of 34 per cent (Table 6.1). The minimum institutional ownership proportion for both pre and post-governance periods was 0 per cent and the maximum for both pre and post-governance periods was 100 per cent. In this case, although the range was same, the mean frequency of post-governance period was much higher than the mean for the pre-governance period. This may indicate some effect of corporate governance rules.

### **Foreign Ownership**

The mean value of the foreign ownership proportion for the pre-governance period was 3.5 per cent and the mean value for the post-governance period was 3.3 percent (Table 6.1). The minimum foreign ownership proportion for pre and post-governance periods was 0 per cent and the maximum for the pre-governance period was 84 per cent and for the post-governance period was 56 per cent. The data included listed foreign companies, which had different ownership regulations. Means and minimum values were the same for both periods. However, maximum value was much lower after implementation of the new rules.

### **Government Ownership**

The mean value of the pre-governance period of government ownership was 11.7 per cent and the mean value for the post-governance period was 12.3 per cent (Table 6.1). The minimum proportion of government ownership for both pre and post-governance periods was 0 per cent and the maximum for pre and post-governance periods of government ownership was 80 per cent. In this case, all the values were similar, denoting no effect for new rules.

### **Individual Ownership**

The mean value of the pre-governance period of the proportion of individual ownership was 9.2 per cent and the mean value for the post-governance period was 32.4 per cent (Table 6.1). The minimum value of individual ownership was 0 per cent, the maximum value was 90 per cent for the pre-governance period and for the post-governance period, the

minimum value of ownership proportion was 0 per cent, and the maximum was 97.3 per cent. The mean for individual ownership increased substantially in the post-governance period. On the other hand, while the minimum was same maximum value increased slightly during post-governance period.

Overall, institutional and individual ownership increased after enforcement of the new codes. Government and foreign ownership remained static irrespective of whether or not the new corporate governance rules were implemented.

### **6.2.2 Leadership Structure**

Leadership structure relates to whether the roles of chairperson and CEO are performed by one person or by different persons. The results obtained are described below.

The mean value of the separation between chairperson and CEO role for the pre-governance period was 1.77 and the mean value for the post-governance period was 1.78. In the pre-governance period, 77 per cent of the companies had separated the roles of the chairperson and the CEO, while only 23 per cent had both roles combined. For the post-governance period, almost the same proportion (78 per cent) of the companies had separated the roles of the chairperson and the CEO while 22 per cent of companies had both positions combined (Table 6.1). The minimum value for the pre and post-governance periods was 1.00 and the maximum value for both pre and post-governance periods was 2.00, which were used as codes for dual and separated roles respectively. Thus, leadership structure remained unchanged despite the new rules.

### **6.2.3 Board Composition**

The study examined whether the board had a good balance between executive, non-executive and independent directors for effective functioning. The following are the descriptive statistics for board composition, including the proportion of executive, non-executive and independent directors.

#### **Executive Directors**

The mean value of the proportion of executive directors on boards for the pre-governance period was 88.2 per cent and the mean value of the proportion of the executive directors for the post-governance period was 73.8 per cent. This indicated that the majority of companies had executive directors on their boards. However, there were also a considerable number of companies which did not have executive directors on their board (Table 6.1). The



minimum value of both the pre and post-governance periods of the executive directors was zero. The maximum value for the pre-governance period was 3.0 while for the post-governance period it was 4.0. Number of executive directors declined when the new rules were implemented. Furthermore, the N value of board composition is quite low due to lack of disclosure.

### **Nonexecutive Directors**

The mean value of the proportion of nonexecutive directors on the board of directors for the pre-governance period is 5.48 and a mean value of 2.70 for the post-governance period as given in Table 6.1. The minimum number of nonexecutive directors in both pre and post-governance periods was 0 whereas the maximum for the pre-governance period was 9.0 and for the post-governance period was 10. Means of non-executives also decreased during the post-governance period.

### **Independent Directors**

The mean value of the independent director's proportion on board for the pre-governance period was 2.67 and the mean value of the independent director proportion for the post-governance period was 4.21. This indicated an increase in the proportion of independent directors in the post-governance period. The minimum value of the independent director's proportion for both the pre and the post-governance periods is 0.00. The maximum value for the pre-governance period is 11.0 while the maximum value of the independent directors' proportion for the post-governance period is 14.0. The substantial increase in independent directors indicates that firms tried to balance the decrease in executive directors (as required by the new rules) by increasing independent directors rather than by increasing non-executive directors.

Overall, with the introduction of the new rules there was a decrease in executive and non-executive directors, but the increase in independent directors did not adequately compensate for this decrease. This means that the board size should be reduced, as discussed below.

### **6.2.4 Board Size**

The mean value of board size for the pre-governance period was 8.23 ranging from a minimum of 3.0 to a maximum of 17.0 while the mean value of board size for the post-governance period was 7.76 ranging from a minimum board size of 3.0 to a maximum board

size of 18.0, as presented in Table 6.1. Therefore, there was a reduction in the board size reflecting decrease in both executive and non-executive directors which was not compensated by increased numbers of independent directors.

### **6.2.5 Audit Committee (Fin Expert) Variable**

The new corporate governance rules stipulated that at least one financial expert should be included in audit committees of firms. The mean value for the existence of a financial expert in audit committees for the pre- governance period was 0.061 ranging from a minimum value of 0 to a maximum value of 1.0 and the mean value for the post-governance period was 0.286 ranging from a minimum value of 0 to a maximum value of 1.0. This indicates that 6.1 per cent of companies in the pre-governance period did have a financial expert on their audit committee while 94 per cent did not. For the post-governance period, descriptive statistics indicate that 29 per cent of the listed companies had financial expert on their audit committee board while 71 per cent did not (Table 6.2). Hence the new rules had some influence but this was not significant.

### **6.2.6 Firm Performance variables**

The variables used in this study to measure firm performance were: Tobin's q, Return on Assets, Return on Equity and total assets. These are generally used as proxies of firm performance in such types of studies. Results obtained for each of these are described below.

#### **Tobin's q**

The mean value of the Tobin's q for the pre-governance period was 1.16 and the mean value for post-governance period was 1.19 (Table 6.1). The minimum value for the pre-governance period for Tobin's q was 0.033 and the minimum value for the post-governance period was -1.43. The maximum value of the pre-governance period for Tobin's q was 15.0 while the maximum value for the post-governance period is 40.75. Clearly, firm performance in terms of Tobin's q was unaffected by the new codes of corporate governance.

#### **ROA**

The mean value of the ROA for the pre-governance period was 3.02 ranging from a minimum value of -44.3 to a maximum value of 29.2 while the mean value for the post-governance period was 2.00 ranging from a minimum value of -24.2 to a maximum value of 19.10 (Table 6.1) . A positive mean value in both periods indicated that listed companies

created values for their shareholders. However, the effect of implementation of the new rules was to reduce the mean value.

## **ROE**

The mean value of the ROE for the pre-governance period was 6.0 ranging from a minimum value of -168 to a maximum value of 57.1 while the mean value for the post-governance period was 4.46 ranging from a minimum value of -83.0 to a maximum value of 159 (Table 6.1). These positive mean values indicated that UAE listed companies do create value for their shareholders. In this case, implementation of the new codes also resulted in reduction of firm value.

## **Total Assets**

The mean value of the total assets of the pre-governance period was 20.4 and the mean for the post-governance period was 20.3. The minimum asset value for the pre-governance period was 15.4 and 15.5 for the post-governance period. The maximum value of the total assets for the pre-governance period is 25 and for the post-governance period is 25.1 (Table 6.1). Thus all asset values remained constant irrespective of whether or not the new rules were implemented.

## **6.3 Two-Related-Sample T-test on corporate governance variables**

Comparison of the mean values of corporate governance characteristics and the performance of the companies for the years 2008-2009 and 2011-2012 using two related-data t-test is presented in Tables 6.2 and 6.3. The details of the t-test results are described in the following sections.

*Table 6.2: Independent Variables – Comparison of Means Values for Pre-Governance for the period of 2008 and 2009 and Post-Governance for the period of 2011 and 2012.*

<b>Variables</b>	<b>Mean of pre-governance, (period 2008 &amp; 2009)</b>	<b>Mean of post-governance (period 2011 &amp; 2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of difference in Means (%)</b>
<b>Independent Variables</b>					
<i>Ownership Structure:</i>					
Families	.064	.071	-.466	0.641	Not Significant
Institutional	.193	.340	-5.61	0.00	Significant
Foreign	.035	.033	.206	.837	Not Significant
Governments	.117	.123	-.313	.755	Not Significant
Individuals	.092	.324	-9.70	.000	Significant
<i>Leadership structure</i>					
Separate Leadership	1.77	1.78	-.401	.689	Not Significant
<i>Board composition</i>					
Executives Directors	.882	.738	.981	.328	Not Significant
Nonexecutives Directors	5.48	2.70	4.56	.000	Significant
Independent Directors	2.67	4.21	-2.28	.023	Significant
<i>Board Size</i>	8.23	7.76	1.84	.066	Not Significant a
<i>Audit Committee</i>					
Financial Expert	.061	.286	-6.86	.000	Significant

### 6.3.1 Ownership Structure

Ownership structure, an independent variable, consists of five different types of owners/shareholders: family, institutional, foreign, government and individuals. The t test results on each are given below.

### **Family Ownership**

The difference between the means of the family ownership of the pre-governance period (6.4 per cent) and post-governance period (7.1 per cent) was not significant ( $t = -0.466$ ,  $p > 0.05$ ) (see Table 6.2). Hence, the introduction of the governance rule in 2010 made no significant change to family ownership within the listed companies.

### **Institutional Ownership**

The difference between the means of the institutional ownership of the pre-governance period (19.3 per cent) and post governance period (34 per cent) was significant ( $t = -5.61$ ,  $p < 0.05$ ) (see Table 6.2). The much higher mean for the post-governance period indicated that the introduction of the governance rule in 2010 substantially increased institutional ownerships of listed companies.

### **Foreign Ownership**

The difference between means of foreign ownership of the pre-governance period (3.5 per cent) and post governance period (3.3 per cent) was not significant as shown in Table 6.2 ( $t = -0.206$ ,  $p > 0.05$ ). Thus, there is no effect for the introduction of the governance rule in 2010 on foreign ownership of listed companies.

### **Government Ownership**

Table 6.2 showed that difference between means of government ownership in the pre governance period (11.7 per cent) and post governance period (12.3 per cent) was not significant ( $t = -0.313$ ,  $p > 0.05$ ). This indicated that the introduction of the governance rule in 2010 made no significant change to government ownership of listed companies.

### **Individual Ownership**

Table 6.2 showed that the difference between means of individual ownership in the pre governance period (9.2 per cent) and post governance period (32.4per cent) was significant ( $t = -9.70$ ,  $p < 0.05$ ). The higher mean of the post-governance period indicated that introduction of the governance rule in 2010 increased individual ownership of listed companies.

### **6.3.2 Leadership Structure**

Table 6.2 showed that the difference between means of the leadership structure in the pre-governance period (1.77) and post-governance period (1.78) was not significant ( $t = -0.401$ ,  $p > 0.05$ ). This indicated that the introduction of the governance rules in 2010 made no significant change to the leadership structure within listed companies as most were already in compliance with the governance rules on separation of the roles of chairperson and CEO.

### **6.3.3 Board Composition**

Board composition comprises the proportion of executives, nonexecutives and independent directors. The following sections describe the findings obtained by t test for statistical significance of difference between means of board composition variables before and after enforcement of new codes for corporate governance.

#### **Executives Directors**

Table 6.2 showed that the difference between means of the proportion of the executive directors on the board of directors between the pre-governance period (8.82 per cent) and post-governance period (7.38 per cent) was not significant ( $t = 0.981$ ,  $p > 0.05$ ). Thus, the new codes did not affect the number of executive directors on boards.

#### **Non-Executives Directors**

Table 6.2 showed that the difference between means of proportion of non-executive directors in the pre-governance period (5.48 per cent) and post-governance period (2.7 per cent) was significant ( $t = 4.56$ ,  $p < 0.05$ ). The significant decrease of mean value in the post-governance period indicated a negative impact of the new code on this variable. The introduction of the governance rule in 2010 might have led to adjustments within board composition to ensure compliance.

#### **Independent Directors**

Table 6.2 showed that difference of means of the proportion of independent directors between the pre-governance (2.67) and post-governance period (4.21) was significant ( $t = 4.56$ ,  $p < 0.05$ ). Thus, the introduction of the governance rule in 2010 resulted in an increase of independent directors on the boards of listed companies.

### **6.3.4 Board Size**

Table 6.2 showed that the difference of means of board size between pre- governance period (8.23) and post-governance period (7.76) was not significant ( $t = 1.84$ ,  $p > 0.05$ ). This indicated no effect of the new codes on board size.

### 6.3.5 Audit Committee Composition (Fin Expert)

Inclusion of at least one financial expert on audit committees has been stipulated in the new rules. Table 6.2 showed that the differences of means of companies whose audit committees include a financial expert between the pre-governance period (6.1 per cent) and post -governance period (28.6 per cent) was highly significant ( $t = -6.86$ ,  $p < 0.05$ ). Consequently, there was a substantial increase in the number of firms having at least one financial expert on the audit committee since the introduction of the governance rule in 2010.

### 6.3.6 Firm Performance

In this study, Tobin's q, Return on Assets and Return on Equity were used as proxies for measuring firm performance and satisfying both shareholder and stakeholder interests. The results are presented below.

The differences of means values of performance indicators Tobin's q, ROA and ROE are presented in Table 6.3 below. None of the performance variables, Tobin's q ( $t=-0.105$ ,  $p > 0.05$ ), ROA ( $t=1.51$ ,  $p > 0.05$ ) and ROE ( $t=0.826$ ,  $p > 0.05$ ), produced significant difference in their means values. This indicated that the performance of listed companies remained consistent irrespective of implementation of corporate governance codes.

*Table 6.3: Firm Performance –Comparison of Means Values for Pre-Governance (period 2008 and 2009) and Post-Governance (period 2011 and 2012).*

<b>Dependent Variables</b>	<b>Mean of pre Governance (period 2008 &amp; 2009)</b>	<b>Mean of post Governance( period 2011 &amp; 2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of difference in Means (%)</b>
Tobin's Q	1.16	1.19	-.105	.917	Not Significant
ROA	3.02	2.00	1.51	.132	Not Significant
ROE	6	4.46	.826	.409	Not Significant

## 6.4 Spearman's Correlation

Spearman's correlation was used for ranked values for testing associations among pairs of variables measured in this study. The results are explained below. Table 6.4 includes the entire data for all types of listed companies.

*Table 6.4a Spearman's correlation matrix for corporate governance and performance variables Panel A: Pre-Governance (period 2008&2009)*

	FAOWN	INSTOWN	FOROWN	GOVOWN	INDIVOWN	LDS	EXDIR	NONEX	INDIR	BSIZE	AUCOMFIEX	TQ	ROA	ROE	TA
FAOWN	1.000														
INOWN	-0.035	1.000													
FOROWN	-0.043	-0.107	1.000												
GOVOWN	-0.094	-.156*	-0.064	1.000											
INDOWN	0.135	0.068	-0.103	0.125	1.000										
LDS	-0.007	0.011	0.003	-0.004	0.107	1.000									
EXDIR	0.030	-0.232	-0.341	0.214	-0.068	0.161	1.000								
NONEX	-0.311	0.177	0.172	-0.427	-0.305	0.022	-.506*	1.000							
INDIR	-0.109	-0.196	0.176	0.063	0.141	0.087	0.410	-.715**	1.000						
BSIZE	-0.195	-.283**	0.210	.266*	0.081	0.027	0.204	0.048	.538**	1.000					
AUCOMFIEX	-0.013	0.148	-0.049	0.105	.159*	0.063	0.162	-0.237	0.102	-0.060	1.000				
TQ	-0.129	0.057	-0.021	-0.147	0.079	-0.098	.619**	-.502*	0.065	-.221*	0.018	1.000			
ROA	.160*	-0.040	-0.091	0.045	-.168*	-0.120	0.102	0.038	-0.154	-0.069	0.011	-.283**	1.000		
ROE	0.150	0.021	-0.056	0.079	-.168*	-0.043	0.056	0.145	-0.293	-0.039	0.020	-.295**	.849**	1.000	
TA	-0.040	0.078	0.041	.363**	0.111	.174**	0.177	-0.399	0.147	.278**	.152*	0.079	-0.111	0.015	1.000

\*. Correlation is significant at the 0.05 level (2-tailed) \*\*. Correlation is significant at the 0.01 level (2-tailed)



*Table 6.4b Spearman's correlation matrix for corporate governance and performance variables Panel B: Post-Governance (period 2011&2012)*

	FAOWN	INOWN	FOROWN	GOVOWN	INDOWN	LDS	EXDIR	NONEX	INDIR	BSIZE	AUCOMFIEX	TQ	ROA	ROE	TA
FAOWN	1.000														
INOWN	-.187**	1.000													
FOROWN	0.061	-.263**	1.000												
GOVOWN	-0.128	-.369**	0.012	1.000											
INDOWN	-0.108	-.166*	-.274**	-.208**	1.000										
LDS	0.046	0.000	0.039	0.028	.239**	1.000									
EXDIR	.232**	-0.037	0.017	-0.049	-0.150	-.193*	1.000								
NONEX	-.168*	0.110	0.131	0.063	-0.102	0.069	-0.136	1.000							
INDIR	0.052	-0.119	-.167*	-0.003	.180*	0.001	-0.120	-.774**	1.000						
BSIZE	-0.002	-.153*	.193**	0.119	0.088	.172*	0.086	0.111	.479**	1.000					
AUCOMFIEX	-0.002	.135*	-0.131	0.004	.142*	0.117	-0.117	0.009	0.101	0.040	1.000				
TQ	-0.096	-0.091	0.036	-0.088	-0.016	-0.003	0.150	-0.027	0.022	-0.017	-0.100	1.000			
ROA	0.034	-0.105	-0.052	0.086	-0.028	-0.071	0.046	-0.039	0.051	-0.007	0.087	0.022	1.000		
ROE	0.060	-0.090	0.051	.189**	-0.106	-0.020	0.069	0.039	0.003	0.046	0.077	0.031	.786**	1.000	
TA	-.146*	-0.064	.168*	.303**	-.192**	0.106	0.134	.366**	-.196*	.283**	-0.013	-0.035	0.039	.191**	1.000

\*. Correlation is significant at the 0.05 level (2-tailed) \*\*. Correlation is significant at the 0.01 level (2-tailed)

The correlation results indicated that there were significant positive relationships between family ownership and performance variable ROA and non-significant correlations with other performance variables of Tobin's q and ROE in the pre-governance period. Correlations for the post-governance period indicated that there were significant negative relationships between family ownership and institutional ownership, nonexecutive directors and total assets, while there was a significant positive relationship with executive directors. Institutional ownership had a significant negative correlation with government ownership and board size in the pre-governance period and a significantly negative correlation with foreign ownership, government ownership, individual ownership and board size in the post-governance period, while showing a significant positive correlation with the existence of a financial expert on an audit committee.

Foreign ownership had a significant negative correlation with individual ownership and independent directors while it had a significant positive correlation with both board size and total assets in the post-governance period.

Government ownership had a significant positive correlation with board size and total assets in the pre-governance period and significant negative correlation with individual ownership in the post-governance period, while showing a significant positive correlation with both ROE and total assets. Individual ownership had a significant positive correlation with the existence of a financial expert on audit committees, and a significant negative correlation with both ROA and ROE in the pre-governance period. Individual ownership in the corresponding post-governance period showed a significant positive correlation with leadership separation, independent directors and the existence of a financial expert on audit committees, while showing a significant negative correlation with total assets in the same period.

Leadership separation had a significant positive correlation with total assets in the pre-governance period as well as with executive directors in the post-governance period, in addition to a significant positive correlation with board size.

Executive directors had a significant negative correlation with nonexecutive directors and significant positive correlation with Tobin's  $q$  in the pre-governance period. Nonexecutive directors had a significant negative correlation with both independent directors and Tobin's  $q$  in the pre-governance period as well as with independent directors in the post-governance period while it had a significant positive correlation with total assets. Independent directors have a significant positive correlation with board size the pre-governance periods, but a significant negative correlation with total assets in the post-governance period.

Board size had a significant negative correlation with Tobin's  $q$  and a positive correlation with total assets in both the pre-governance and post-governance periods. Audit committee composition with a financial expert had a significant positive correlation with total assets in the pre-governance period. Tobin's  $q$  had a significant negative correlation with both ROA and ROE in the pre-governance period. ROA had a significant positive correlation with ROE in both pre-governance and post-governance periods and ROE had a significant positive correlation with total assets in the post-governance period.

## 6.5 Descriptive Statistics for General Comparison between Financial and Non-Financial

### Listed Companies

Descriptive statistics for the pre-governance period (2008-2009), post-governance period (2011-2012), and firm performance variables are presented in Table 6.5. Descriptive statistics compared the level of similarities and differences between financial and non-financial companies in terms of the impact of the corporate governance rules introduced in 2010.

*Table 6.5: Descriptive statistics for the pre-governance period (2008-2009), post-governance period (2011-2012), and firm performance variables*

	Financial Companies					Non-Financial Companies				
Variables	N	Min	Max	Mean	Std. Dev	N	Min	Max	Mean	Std. Dev
<b>Independent V</b>										
<i>Ownership Structure:</i>										
Families	81	0.00	0.70	0.06	0.14	264	0.00	0.75	0.08	0.15
Institutional	83	0.00	1.00	0.28	0.29	274	0.00	1.00	0.29	0.26
Foreign	74	0.00	0.45	0.06	0.13	254	0.00	0.42	0.015	0.05
Governments	77	0.00	0.70	0.23	0.24	261	0.00	0.80	0.10	0.19
Individuals	77	0.00	0.62	0.14	0.19	258	0.00	0.97	0.27	0.26
<i>Leadership structure</i>										
Separate Leadership	98	1.00	2.00	1.91	0.27	314	1.00	2.00	1.78	0.41
<i>Board composition</i>										

	Financial Companies					Non-Financial Companies				
Variables	N	Min	Max	Mean	Std. Dev	N	Min	Max	Mean	Std. Dev
Executives Directors;	37	0.00	3.00	0.78	0.71	160	0.00	4.00	0.76	0.81
Nonexecutives Directors	20	0.00	8.00	6.20	2.11	146	0.00	10.0	2.59	2.52
Indep Directors	20	0.00	6.00	1.05	1.93	148	0.00	11.0	4.33	2.80
<i>Board Size</i>	68	3.00	14.0	8.30	1.97	209	3.00	18.0	7.83	1.99
<i>Audit Committee</i> Financial Expert	100	0.00	1.00	0.08	0.27	332	0.00	1.00	0.23	0.42
<b>Dependant Var</b>										
Tobin's Q	92	0.12	4.04	1.05	0.60	311	0.00	40.8	0.96	3.18
ROA	97	-29.4	10.2	0.75	4.50	302	-24.2	29.2	3.66	6.96
ROE	99	-56.7	31.3	7.63	11.4	302	-90.4	158	6.14	18.6
<b>Control Var</b> Assets	99	18.4	25.2	22.4	1.68	323	15.4	25.2	19.8	1.78

### 6.5.1 Ownership Structure

Ownership structure consisted of five different types of owners/shareholders- family, institutional, foreign, government and individuals.

#### Family Ownership

The mean value of family ownership proportion of financial companies was 6 per cent ranging from a minimum value of 0 per cent to a maximum value of 70 per cent while the mean value of family ownership proportion of non-financial companies was 7 per cent ranging from a minimum value of 0.00 per cent to a maximum value of 75 per cent. Thus, both types of firms were similar with respect to family ownership.

## **Institutional Ownership**

The mean value of institutional ownership proportion of financial companies was 28 per cent and for the non-financial companies was 29 per cent. The minimum value was 0 per cent and the maximum value was 100 per cent for the both financial and non-financial companies. Thus, there was no difference between financial and non-financial firms with respect to institutional ownership.

## **Foreign Ownership**

The mean value of foreign ownership proportion of financial companies was 6 per cent and for the non-financial companies it was 1 per cent. The minimum value for financial and non-financial companies was 0 per cent while the maximum value for the financial companies was 45 per cent and for the non-financial companies was 42 per cent. Accordingly, foreign ownership was lower for non-financial firms.

## **Government Ownership**

The mean value of government ownership proportion of financial companies was 23 per cent and for the non-financial companies was 10 per cent. The minimum value for financial and non-financial companies was 0 per cent while the maximum value for financial companies was 70 per cent and for non-financial companies was 80 per cent. Government ownership in the case of non-financial firms seemed to be lower than for financial firms.

## **Individual Ownership**

The mean value of individual ownership proportion of financial companies was 14 per cent and for the non-financial companies it was 27 per cent. The minimum value for financial and non-financial companies was 0 per cent while the maximum value for the financial companies was 62 per cent and for the non-financial companies was 97 per cent. Non-financial firms seem to have a higher proportion of individual ownership.

### **6.5.2 Leadership structure**

Leadership structure refers to the same or different person/s performing both functions of chairperson and CEO.

The mean value of leadership structure of financial companies was 1.91 and for non-financial companies it was 1.78. The minimum value was 1.0 and the maximum value was 2.0 for both financial and non-financial companies. Accordingly, about 92 per cent of

financial companies had separate persons for chairperson and CEO positions and only 8 per cent of them had both positions combined. On the other hand, only 78 per cent of non-financial companies had separate persons for chairperson and CEO positions and 22 per cent firms had the roles combined. Thus, financial firms applied the new rules better than non-financial ones.

### **6.5.3 Board Composition**

Board composition included the proportion of executives, nonexecutives and independent directors on the board of directors.

#### **Executive Directors**

The mean value of executive director's proportion on the boards of financial companies was 0.78, ranging from a minimum proportion value of 0.0 to a maximum proportion value of 3.0, while the mean value of executive directors proportion on board of non-financial companies was 0.76 ranging from a minimum proportion value of 0.0 to a maximum proportion value of 4.0. This indicated that both types of firms behaved similarly in this respect.

#### **Non-Executive Directors**

The mean value of the proportion of non-executive directors on the board of financial companies was 6.20 ranging from a minimum proportion value of 0.0 to a maximum proportion value of 8.0. In the case of non-financial companies the mean value was 2.59 ranging from a minimum proportion value of 0.0 to a maximum proportion value of 10.0. Thus, non-financial firms had a much lower proportion of non-executive directors in their boards compared to financial firms indicating a higher level of compliance with the new rules in the case of non-financial firms.

#### **Independent Directors**

The mean value of independent directors' proportion on the boards of financial companies was 1.05, ranging from a minimum proportion value of 0.00 to a maximum proportion value of 6.00. In the case of non-financial firms, the mean proportion value of independent directors on boards of non-financial companies was 4.33, ranging from a minimum proportion value of 0.00 to a maximum proportion value of 11.0. This indicated a better compliance of non-financial firms with the new codes.

#### **6.5.4 Board Size**

The mean value of board size of financial companies was 8.30 ranging from a minimum board size of 3.00 to a maximum board size of 14.0, while the mean board size of non-financial companies was 7.83 ranging from a minimum board size value of 3.00 to a maximum board size value of 18.0. Thus, both types of firms behaved similarly with respect to board size.

#### **6.5.5 Audit Committee (Financial Expert)**

The mean value of the presence of a financial expert on audit committees of financial companies was 0.08 ranging from a minimum value of 0.00 to a maximum value of 1.0 while the mean value of the presence of a financial expert on audit committees of non-financial companies was 0.23 ranging from minimum value of 0.00 to a maximum value of 1.00. Table 6.5 shows that only 8 per cent of the financial companies had a financial expert on their audit committees and 92 per cent did not have a financial expert on their audit committee. However, 23 per cent of the non-financial companies had a financial expert on their audit committee and 77 per cent did not have a financial expert on their audit committee. This clearly indicated that non-financial companies complied better with the new codes with respect to the requirement of a financial expert on their audit committees.

#### **6.5.6 Performance Variables**

Tobin's q, Return on Assets and Return on Equity were used as proxies of firm performance in this study. Performance comparison of financial and non-financial firms using these variables is described below.

##### **Tobin's q**

The mean value of the Tobin's q of financial companies was 1.05 ranging from a minimum value of 0.12 to a maximum value of 4.04, while the mean value of Tobin's q for non-financial companies was 0.96 ranging from a minimum value of 0.00 to a maximum value of 40.8. Accordingly, there was no difference between financial and non-financial firms in value creation for their shareholders.

##### **ROA**

The mean value of the ROA of financial companies was 0.75 ranging from a minimum value of -29.4 to a maximum value of 10.2, while the mean value of ROA for non-

financial companies was 3.66 ranging from a minimum value of -24.2 to a maximum value of 29.2. Thus, non-financial firms performed better than financial firms with respect to utilisation of assets to create profits.

## **ROE**

The mean value of the ROE of financial companies was 7.63 ranging from a minimum value of -56.7 to a maximum value of 31.3, while the mean value of ROE for the non-financial companies was 6.14 ranging from a minimum value of -90.4 to a maximum value of 158. Thus, the efficiency of equity utilisation for profit generation was almost equal for both types of firms.

### **6.5.7 Total Assets**

The mean value of total assets of financial companies was 22.4 ranging from a minimum value of 18.4 to a maximum value of 25.2 while the mean value of total assets for non-financial companies was 19.8 ranging from a minimum value of 15.4 to a maximum value of 25.2. Thus, higher efficiency in using equity for profit generation was observed in the case of financial rather than non-financial firms.

## **6.6 Two-Related-Sample T-test**

Comparison of the mean values of corporate governance characteristics of financial and non-financial companies and their performance for the years 2008-2009 and 2011-2012 using two related-data t-test is presented in (Tables 6.6 and 6.7). The details of the t-test results are as follows:



*Table 6.6: T-Test for General comparison between Financial & Non-financial  
Companies T-test for independents variables*

<b>Variables</b>	<b>Mean of Financial Companies</b>	<b>Mean of Non- Financial Companies</b>	<b>T</b>	<b>Sig.(2- tailed)</b>	<b>Significance Level of difference in Means (%)</b>
<b>Independent Variables</b>					
<i>Ownership Structure:</i>					
Families	0.06	0.08	0.98	0.32	Not Significant
Institutional	0.28	0.29	0.24	0.81	Not Significant
Foreign	0.06	0.01	-4.74	0.00	Significant
Governments	0.23	0.10	-4.60	0.00	Significant
Individuals	0.14	0.27	4.03	0.00	Significant
<i>Leadership structure</i>					
Separate Leadership	1.91	1.78	-3.14	0.00	Significant
<i>Board composition</i>					
Executive Directors	0.78	0.76	-0.15	0.88	Not Significant
Nonexecutive Directors	6.20	2.59	-6.11	0.00	Significant
Independent Directors	1.05	4.33	5.06	0.00	Significant
<i>Board Size</i>	8.30	7.83	-1.65	0.10	Not Significant
<i>Audit Committee</i>					
Financial Expert	0.08	0.23	3.39	0.00	Significant

### **6.6.1 Ownership Structure**

Ownership structure was an independent variable consisting of five different types of owners/shareholders -family, institutional, foreign, government and individuals.

#### **Family Ownership**

The difference between the means of the family ownership proportions of financial (6 per cent) and non-financial (8 per cent) companies was not significant ( $t = 0.98$ ,  $p > 0.05$ ) (Table 6.6). This indicated that family ownership proportion was similar for both financial and non-financial listed companies.

#### **Institutional Ownership**

Comparison of the mean difference of the institutional ownership between financial (28 per cent) and non-financial (29 per cent) companies was not significant ( $t = 0.24$ ,  $p > 0.05$ ) (see Table 6.6). Therefore, the institutional ownership proportions were similar for both financial and non-financial companies.

#### **Foreign Ownership**

The difference between the means of foreign ownership proportions between financial (6 per cent) and non-financial (1 per cent) companies was significant ( $t = -4.74$ ,  $p < 0.05$ ). (see Table 6.6). As the mean value of financial firms was higher, it meant a higher degree of foreign ownership in financial firms than in non-financial firms.

#### **Governmental Ownership**

The difference between the means of government ownership proportion in financial (23 per cent) and non-financial (10 per cent) companies was significant ( $t = -4.60$ ,  $p < 0.05$ ). (see Table 6.6). This indicated that government ownership proportion was significantly higher in financial than in non-financial companies. This might also indicate that federal and local governments in the UAE invested more in financial companies than in non-financial companies.

#### **Individuals Ownership**

The difference between the means of the individual ownership proportion of financial (14 per cent) and non-financial (27 per cent) companies was significant ( $t = 4.03$ ,  $p < 0.05$ ),

(see Table 6.6). This indicated that the individual ownership proportion was higher in non-financial than in financial firms.

### **6.6.2 Leadership Structure**

This variable compared the two types of firms with respect to whether both roles of chairperson and CEO were held by a single person or by two different persons. Results obtained are outlined below.

The difference between the means of the leadership structure of financial (1.91) and non-financial (1.78) companies was significant ( $t = -3.4$ ,  $p < 0.05$ ), (Table 6.6). Accordingly, the separation of the roles of chairperson and CEO was more dominant in financial companies than in non-financial companies.

### **6.6.3 Board Composition**

This variable compared financial and non-financial firms with respect to the board composition in terms of relative proportions of executive, non-executive and independent directors on the boards of firms. The results are explained below.

#### **Executive directors**

The difference between the means of the proportion of executive directors of financial (0.78) and non-financial (0.76) companies was not significant ( $t = -0.15$ ,  $p > 0.05$ ), (Table 6.6). Thus the two types of firms had similar proportions of executive directors on their boards.

#### **Non-Executive directors**

The difference between the means of the proportion of nonexecutive directors of financial (6.2) and non-financial (2.59) companies was significant ( $t = -6.11$ ,  $p < 0.05$ ) (see Table 6.6). Accordingly, the proportion of nonexecutive directors on the boards of financial companies was significantly higher than those of non-financial companies.

#### **Independent directors**

The difference between the means of the proportion of independent directors of financial (1.05) and non-financial (4.33) companies was significant ( $t = 5.06$ ,  $p < 0.05$ ), (Table 6.6). Thus, nonfinancial companies had a significantly higher proportion of independent directors than financial companies.

### 6.6.4 Board Size

The difference between the means of the board size of financial (8.3) and non-financial (7.83) companies was not significant ( $t = -1.65$ ,  $p > 0.05$ ), (Table 6.6). Hence, both financial and non-financial firms had similar board size.

### 6.6.5 Audit committee (Financial Expert)

The proportion of firms with at least one financial expert in their audit was compared with that of non-financial firms. The difference between the means of the inclusion of financial experts on audit committees of financial (0.08) and non-financial (0.23) companies was significant ( $t = 3.39$ ,  $p < 0.05$ ), (see Table 6.6). Therefore, a greater proportion of non-financial companies had at least one financial expert in their audit committees compared to financial companies.

## 6.7 Two-Related-Sample-t test

This test compared the means of financial and non-financial firms with respect to their financial performance as dependent variables. Tobin's q, Return on Assets and Return on Equity were tested using total assets as a control.

*Table 6.7: T-test for dependent (performance) variables*

Variables	Mean of Financial Companies	Mean of Non-Financial Companies	T	Sig.(2-tailed)	Significance Level of difference in Means (%)
Dependant Variables					
Tobin's Q	1.05	0.96	-0.28	0.78	Not Significant
ROA	0.75	3.66	3.85	0.00	Significant
ROE	7.63	6.14	-0.75	0.45	Not Significant
TA-Control	22.4	19.8	-12.8	0.00	Significant

## **Tobin's q**

The difference between the means of Tobin's q of financial (1.05) and non-financial (0.96) companies was not significant ( $t = -0.28$ ,  $p > 0.05$ ) (see Table 6.7). Hence, both types of firms behaved similarly with respect to market-based performance.

## **ROA**

The difference between the means of ROA of financial (0.75) and non-financial (3.66) companies was highly significant ( $t = 3.85$ ,  $p < 0.05$ ) (Table 6.7). Hence, non-financial companies used their assets more efficiently for profit making compared to financial companies.

## **ROE**

The difference between the means of ROE of financial (7.63) and non-financial (6.14) companies was non-significant ( $t = -0.75$ ,  $p > 0.05$ ) (see Table 6.7). Thus, both types of firms had similar efficiencies in using equity funds for profit generation.

## **Total Assets**

The difference between the means of total assets of financial (22.4) and non-financial (19.8) companies was significant ( $t = -12.8$ ,  $p < 0.05$ ), (Table 6.7). Therefore, asset generation was more efficient in the case of financial companies than non-financial companies.

## 6.8 Descriptive Statistics of Independent Variables for Pre-governance (2008-2009) and Post-governance (2011-2012) of Non-Financial Companies.

In the descriptive statistics presented in Table 6.8, changes in corporate governance variables from pre-governance to post-governance periods were compared for non-financial companies. The changes might be related to the level of compliance with the corporate governance rules introduced in 2010.

Table 6.8:

	Pre Governance (period 2008 & 2009) of Non-Financial Companies					Post Governance (period 2011 & 2012) of Non-Non-Financial Companies				
Variables	N	Min	Max	Mean	Std. Dev	N	Min	Max	Mean	Std. Dev
<b>Independent Var</b>										
<i>Ownership Structure:</i>										
Families	106	0.00	0.75	0.07	0.16	158	0.00	0.74	0.08	0.15
Institutional	112	0.00	1.00	0.18	0.27	162	0.00	0.94	0.35	0.24
Foreign	101	0.00	0.42	0.02	0.07	153	0.00	0.20	0.00	0.04
Governments	105	0.00	0.80	0.09	0.19	156	0.00	0.80	0.10	0.19
Individuals	103	0.00	0.90	0.07	0.17	155	0.00	0.97	0.40	0.24
<i>Leadership structure</i>										
Separate Leadership	152	1.00	2.00	1.74	0.44	162	1.00	2.00	1.80	0.40

	<b>Pre Governance (period 2008 &amp; 2009) of Non-Financial Companies</b>					<b>Post Governance (period 2011 &amp; 2012) of Non-Non-Financial Companies</b>				
<b>Variables</b>	<b>N</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>	<b>N</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>
<i>Board composition</i>										
Executive Directors	19	0.00	2.00	0.95	0.78	141	0.00	4.00	0.74	0.81
Nonexecutive Directors	14	0.00	9.00	4.92	3.12	132	0.00	10.0	2.34	2.3
Indep Directors	16	0.00	11.0	3.12	3.46	132	0.00	10.0	4.48	2.70
<i>Board Size</i>	61	5.00	17.0	8.18	2.32	148	3.00	18.0	7.70	1.82
<i>Audit Committee</i>										
Financial Expert	166	0.00	1.00	0.07	0.26	166	0.00	1.00	0.40	0.48

### 6.8.1 Ownership Structure

Ownership structure variable consisted of five different types of owners/shareholders - family, institutional, foreign, government and individuals.

#### Family Ownership

The mean value of family ownership proportion for the pre- governance period was 7 per cent and for the post-governance period, it was 8 per cent. The minimum value of the family ownership proportion was 0.00 for the both pre and post-governance periods. The maximum value of the family ownership proportion for the pre-governance period was 75 per cent and for the post-governance period 74 per cent. Hence, the values were similar for both periods.

#### Institutional Ownership

The mean value of institutional ownership proportion for the pre-governance period was 18 per cent (range 0.00 to 100 per cent) and the mean value for post-governance period

was 35 per cent (range 0.00 to 94 per cent.). The increase in the proportion of institutional ownership from a mean value of 18 per cent to a mean value of 35 per cent may indicate that the introduction of the governance rule might have increased the level of confidence of institutional investors and had a positive impact on the financial market.

## **Foreign Ownership**

The mean value of foreign ownership proportion for the pre-governance period was 2 per cent (range 0.00 to 42 per cent). The mean value of foreign ownership proportion for the post-governance period was 0.00 per cent (range 0.00 to 20 per cent). The reduction in the proportion of foreign ownership might have been due to the impact of the governance rule or the impact of policy changes on listed companies. The UAE commercial law limits the foreign ownership proportion to a maximum of 49 per cent and gives companies the choice of either selling the entire 49 per cent or selling nothing to foreign investors.

## **Government Ownership**

The mean value of government ownership proportion for the pre-governance period was 9 per cent (ranging from 0.00 to 80 per cent). The mean value of government ownership proportion for the post-governance period was 10 per cent (ranging from 0.00 to 80 per cent). Hence, the proportion of government ownership did not change with the introduction of new rules.

## **Individual Ownership**

The mean value of the individual ownership proportion for the pre-governance period was 7 per cent (range 0.00 to 90 per cent). The mean value of individual ownership proportion in the post-governance period was 40 per cent (range 0.00 to 97 per cent). Consequently, the new rules increased individual ownership.

## **6.8.2 Leadership Structure**

The mean value for the pre- governance period was 1.74 ranging from 1.0 to 2.0. The mean value for post-governance period was 1.80 ranging from 1.0 to 2.0. As a result, in the pre-governance period, 74 per cent of the nonfinancial companies had separate persons for chairperson and CEO positions and the remaining 26 per cent had one person performing both functions. In the post-governance period 80 per cent of the nonfinancial companies had separated the two roles and 20 per cent had the same person for both roles. As the difference



was very narrow, the level of compliance with the new rules had not changed or improved the current situation.

### **6.8.3 Board Composition**

In this part, proportions of executive, non-executive and independent directors were evaluated.

#### **Executive Directors**

The mean proportion of executive directors for the pre-governance period was 0.95 (ranging from 0.0 to 2.0). The mean value for the post-governance period was 0.74 (ranging from 0.0 to 4.0). The proportion did not change due to implementation of new codes.

#### **Nonexecutive Directors**

The mean proportion of non-executive directors for the pre-governance period was 4.92 (range 0.0 to 9.0). The mean proportion for the post-governance period was 2.34 (range 0.0 to 10.0). Thus, the new governance rules did not have any effect on the proportion of non-executive directors on boards of non-financial companies.

#### **Independent Directors**

The mean proportion of independent directors for the pre-governance period was 3.12 (range 0.0 to 11.0). The mean proportion for the post-governance period was 4.48 (range 0.0 to 10.0). This narrow difference showed that the new rules did not affect the proportion of independent directors.

### **6.8.4 Board Size**

The mean board size for the pre-governance period was 8.18 (range 5.00 to 17.0). The mean board size for the post-governance period was 7.70 (range 3.00 to 18.0). Thus, board size was not affected by the new rules enforced in 2010.

### **6.8.5 Audit Committee (Financial Expert)**

The stipulation of at least one financial expert on audit committees was enforced in 2010. Its effect is assessed below.

The mean value for the pre-governance period was 0.07 (range 0.00 to 1.0). The mean value for the post-governance period was 0.40 (range 0.00 to 1.00). Thus, only 7 per cent of the nonfinancial companies had a financial expert in their audit committees during the pre-

governance period. This increased to 40 per cent of non-financial companies having a financial expert on their audit committees during the post-governance period. Thus, there was a high level of compliance with the new rules in this respect.

## 6.9 Descriptive statistics for dependent variables

Tobin's q, Return on Assets and Return on Equity were used as proxies for performance variables. Total assets were used as the control variable. The results obtained for these variables are discussed below.

*Table 6.9: Descriptive Statistics for Dependent (Performance) Variables of Non-Financial Companies*

	<b>Pre-Governance (period 2008 &amp; 2009) of Non-Financial Companies</b>					<b>Post Governance (period 2011 &amp; 2012) of Non-Non-Financial Companies</b>				
<b>Variables</b>	<b>N</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>	<b>N</b>	<b>Min</b>	<b>Max</b>	<b>Mean</b>	<b>Std. Dev</b>
<b>Dependant Var</b>										
Tobin's Q	153	0.03	4.50	0.74	0.66	158	0.00	40.8	1.16	4.41
ROA	145	-20.6	29.1	4.88	7.10	157	-24.2	19.1	2.53	6.65
ROE	145	-90.4	57.9	8.36	17.5	157	-83.0	158	4.07	19.4
Control Var										
Total Asset	158	15.4	24.7	19.8	1.77	165	15.5	25.1	19.7	1.80

### 6.9.1 Tobin's q

The mean value of the Tobin's q for the pre-governance period was 0.74 (range 0.03 to 4.50). The mean value of Tobin's q for the post-governance period was 1.16 (range 0.00 to 40.8). The narrow difference is indicates an absence of any effect for the new codes to improve market-based performance of non-financial firms.

### 6.9.2 ROA

The mean value of ROA for the pre-governance period was 4.88 (range -20.6 to 29.1). The mean value of ROA for the post-governance period was 2.53 (range -24.2 to 19.10).

Thus, utilization of assets for profit generation was less efficient after implementation of the new codes in the case of non-financial companies.

### **6.9.3 ROE**

The mean value of ROE for the pre-governance period was 8.36 (range -90.4 to 57.9) and for the post-governance period was 4.07 (range -83.0 to 158). This indicated that the governance rule of 2010 might have had a negative impact on efficient use of equity for profit generation.

### **6.9.4 Total Assets**

The mean value of total assets for the pre-governance period was 19.8 (range 15.4 to 24.7) and for the post-governance companies was 19.7 (range 15.4 to 25.1). Total assets of Non-financial companies remained unchanged after the new codes in 2010.

## **6.10 Two-Related-Sample T-test (non-financial companies)**

Comparison of the mean values of corporate governance characteristics of non-financial companies and their performance between the pre-governance period of 2008-2009 and post-governance period of 2011-2012 using two related-data t-test is presented in Table 6.10. The details of the t-test results are as follows.

*Table 6.10: T-Test of the Non-financial Companies between pre-governance  
(period 2008- 2009) and post-governance (period 2011-2012) of independents  
variables, (Comparison of Means)*

<b>Variables</b>	<b>Mean of Non-Financial Companies Pre-Governance (period 2008 &amp; 2009)</b>	<b>Mean of Non-Financial Companies Post-Governance (period 2011 &amp; 2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of difference in Means (%)</b>
<b>Independent Variables</b>					
<i>Ownership Structure:</i>					
Families	0.07	0.08	-.38	0.70	Not Significant
Institutional	0.18	0.35	-5.43	0.00	Significant
Foreign	0.02	0.00	2.33	0.02	Significant
Governments	0.09	0.10	-.35	0.72	Not Significant
Individuals	0.07	0.40	-11.8	000	Significant
<i>Leadership structure</i>					
Separate leadership	1.74	1.80	-1.38	0.16	Not Significant
<i>Board composition</i>					
Executives Directors	0.95	0.74	1.05	0.29	Not Significant
Nonexecutives Directors	4.92	2.34	3.81	0.00	Significant
Independent Directors	3.12	4.48	-1.83	0.06	Not Significant
<i>Board Size</i>	8.18	7.70	1.60	0.11	Not Significant
<i>Audit Committee</i>					
Financial Expert	0.07	0.40	-7.42	0.00	Significant

### **6.10.1 Ownership Structure**

Ownership structure is an independent variable consisting of five different types of owners/shareholders - family, institutional, foreign, government and individuals.

#### **Family Ownership**

The difference between means of family ownership proportions of the pre – governance (7 per cent) and post-governance (8per cent) periods was not significant ( $t = -.38$ ,  $p > 0.05$ ) (see Table 6.10). Thus the proportion of family ownership companies remained the same after implementation of the new corporate governance rules.

#### **Institutional Ownership**

The difference between means of institutional ownership proportion for the pre-governance period (18 per cent) and post-governance period (35 per cent) was significant ( $t = -5.43$ ,  $p < 0.05$ ) (see table 6.10). There was a significant increase in the proportion of institutional ownership firms after the new codes were implemented. This might also indicate that the institutional investors have become more confident in the stock market since the introduction of the governance rule of 2010, which shows a positive impact of the new governance practices.

#### **Foreign Ownership**

The difference of means between foreign ownership proportions of pre (2 per cent) and post- governance (0 per cent) periods was significant ( $t = 2.33$ ,  $p < 0.05$ ) (see Table 6.10). The lower mean of the post-governance period suggests a negative effect of the new codes. The proportion of foreign ownership in the UAE market is limited to 49 per cent. Companies either choose to sell the entire 49 per cent of their shares or not to sell any of their shares to foreign investors.

#### **Governmental Ownership**

The difference of means of government ownership proportions of pre (9 per cent) and post (10 per cent) governance periods was not significant ( $t = -.35$ ,  $p > 0.05$ ). (Table 6.10). Thus the new codes had no impact on the proportion of government ownership of firms.

## **Individual Ownership**

The difference of means of individual ownership proportions between pre (7 per cent) and post-governance (40 per cent) periods was highly significant ( $t = -11.8$ ,  $p < 0.05$ ) (see Table 6.10). Therefore, the new codes increased the proportion of individual ownership of firms when they came into effect in 2010.

### **6.10.2 Leadership Structure**

The difference of means of the leadership structure between pre (1.74) and post-governance (1.80) periods was not significant ( $t = -1.38$ ,  $p > 0.05$ ), (see Table 6.10). Hence the leadership structure remained unchanged after the rules were enforced.

### **6.10.3 Board Composition**

#### **Executive directors**

The difference of means between the proportion of executive directors on boards between pre (0.95) and post-governance (0.74) periods was not significant ( $t = 1.05$ ,  $p > 0.05$ ), (see Table 6.10). Hence, there was no impact of the new codes on the proportion of executive directors on boards of non-financial companies.

#### **Non-Executive directors**

The difference of means between the proportions of nonexecutive directors for the pre-governance (4.92) and post-governance (2.34) periods was significant ( $t = 3.81$ ,  $p < 0.05$ ), (Table 6.10). Thus, the proportion of nonexecutive directors on the boards of non-financial companies decreased when the new codes were implemented.

#### **Independent directors**

The difference of means in the proportion of independent directors between pre (3.12) and post (4.48) governance periods was not significant ( $t = -1.83$ ,  $p > 0.05$ ) (see Table 6.10). Hence, the new codes had no impact on the proportion of independent directors on boards of non-financial companies.

### **6.10.4 Board Size**

The difference of means in board size between pre (8.18) and post-governance (7.70) periods was not significant ( $t = 1.60$ ,  $p > 0.05$ ), (see Table 6.10). Thus, the new codes did not affect board size of non-financial companies.

### 6.10.5 Audit committee (Financial Expert)

The difference of means for the presence of financial experts on audit committees of non-financial companies between the pre-governance period (7 per cent) and post-governance period (40 per cent) was highly significant ( $t = -7.42$ ,  $p < 0.05$ ) (see Table 6.10). Thus, there was a positive effect of the new codes in increasing compliance of firms to include at least one financial expert on audit committees.

## 6.11 The t test for dependent variables of firm performance

Tests of significance results on proxies used to measure firm performance produced the results outlined below.

*Table 6.11: T-test for Dependent Variables of Non-Financial Companies  
Between (2008-2009 pre -Governance Period) and (2011- 2012 Post-Governance  
Period), (Comparison of Means)*

<b>Variables</b>	<b>Mean of Non-Financial Companies Pre-Governance (period 2008 &amp; 2009)</b>	<b>Mean of Non-Financial Companies Post-Governance (period 2011 &amp; 2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of difference in Means (%)</b>
<b>Dependant Variables</b>					
Tobin's Q	0.74	1.16	-1.18	0.23	Not Significant
ROA	4.88	2.53	2.95	0.00	Significant
ROE	8.36	4.07	2.01	0.04	Significant
TA-Control	19.8	19.7	0.54	0.59	Not Significant

### **6.11.1 Tobin's q**

The difference of means in Tobin's q between pre (0.74) and post-governance (1.16) periods was not significant ( $t = -1.18$ ,  $p > 0.05$ ), (Table 6.11). Therefore, no impact could be attributed to implementation of new codes in increasing market-based performance of non-financial firms.

### **6.11.2 ROA**

The difference of means in ROA between pre (4.88) and post-governance (2.53) periods was significant ( $t = 2.95$ ,  $p < 0.05$ ), (Table 6.11). However, after implementation of the new codes non-financial firms had reduced efficiency in using their assets for increasing profits.

### **6.11.3 ROE**

The difference of means in ROE between pre (8.36) and post-governance (4.07) periods was significant ( $t = -0.75$ ,  $p > 0.05$ ) (see Table 6.11). Thus, efficiency of utilisation of equities decreased when the new codes were implemented.

### **6.11.4 Total Assets**

The difference of means in total assets between pre (19.8) and post-governance (19.7) periods was not significant ( $t = 0.54$ ,  $p > 0.05$ ) (see table 6.11). Thus there was no impact of the new codes on total assets of non-financial companies.

## **6.12 Descriptive statistics for financial companies of both pre-governance period (2008-2009) and post-governance period (2011-2012)**

Descriptive statistics compared the level of compliance, influence and changes resulting from the introduction of the corporate governance rules in 2010 between the pre and post-governance periods of financial companies presented in the following table.



Table 6.12:

	Financial Companies Pre-Governance (2008-2009)					Financial Companies Post-Governance (2011-2012)				
Variables	N	Min	Max	Mean	Std. Dev	N	Min	Max	Mean	Std. Dev
<b>Independent Var</b>										
<i>Ownership Structure:</i>										
Families	35	0.00	0.70	0.06	0.16	46	0.00	0.51	0.06	0.11
Institutional	35	0.00	1.00	0.21	0.30	48	0.00	1.00	0.32	0.27
Foreign	33	0.00	0.24	0.04	0.08	41	0.00	0.45	0.08	0.16
Governments	33	0.00	0.70	0.23	0.26	44	0.00	0.70	0.22	0.24
Individuals	33	0.00	0.62	0.11	0.22	44	0.00	0.56	0.15	0.18
<i>Leadership structure</i>										
Separate Leadership	49	1.00	2.00	1.91	0.27	49	1.00	2.00	1.91	0.27
<i>Board composition</i>										
Executive Directors	13	0.00	3.00	0.92	1.03	24	0.00	1.00	0.70	0.46
Nonexecutive Dir	5	5.00	8.00	7.00	1.22	15	0.00	8.00	5.93	2.31
Indep Directors	5	0.00	3.00	0.60	1.34	15	0.00	6.00	1.20	2.11
<i>Board Size</i>										
Board Size	32	3.00	14.0	8.34	2.40	36	6.00	12.0	8.25	1.52
<i>Audit Committee</i>										
Financial Expert	50	0.00	1.00	0.06	0.24	50	0.00	1.00	0.10	0.30
<b>Dependant Variables</b>										
Tobin's Q	48	0.12	4.04	1.14	0.76	44	0.62	2.30	0.95	0.34
ROA	48	-29.4	10.3	0.43	5.56	49	-18.3	5.14	1.06	3.16
ROE	50	-56.7	31.3	6.88	13.68	49	-25.1	25.6	8.40	8.63
<b>Control Variables</b>										
Asset	50	18.4	25.0	22.3	1.68	49	18.7	25.2	22.4	1.70

### **6.12.1 Ownership Structure**

Ownership structure variable consist of five different types of owners/shareholders - family, institutional, foreign, government and individuals:

#### **Family Ownership**

The mean value of the family ownership proportion for the pre- governance period was 6 per cent (range 0.00 to 70 per cent) and for the post-governance period was 6 per cent (range 0.00 to 51 per cent). Thus, the proportion of family ownership firms remained the same despite implementation of the new codes.

#### **Institutional Ownership**

The mean value of institutional ownership proportion for the pre- governance period was 21 per cent (range 0.00 to 100 per cent) while the mean value of the post-governance period was 32 per cent (range 0.00 to 100 per cent).

#### **Foreign Ownership**

The mean value of the proportion of foreign ownership for the pre- governance period was 4 per cent (range 0.00 to 24 per cent) and for the post -governance period was 8 per cent (range 0.00 to 45 per cent).

#### **Government Ownership**

The mean value of the government ownership proportion for the pre- governance period was 23 per cent (range 0.00 to 70 per cent). The mean value of the post-governance period was 22 per cent (range 0.00 to 70 per cent).

## **Individual Ownership**

The mean value of individual ownership proportion for the pre-governance period was 11 per cent (range 0.00 to 62 per cent) and for the post-governance period was 15 per cent (range 0.00 to 56 per cent).

### **6.12.2 Leadership Structure**

The mean value of the leadership structure for the pre-governance period was 1.91 (range 1.0 to 2) and for post-governance period was 1.91 (range 1.0 to 2.0). This meant that in the pre and post-governance periods 92 per cent of the financial companies had separate persons as chairperson and CEO. In only 8 per cent of the firms the same person handled the two roles.

### **6.12.3 Board Composition**

#### **Executive Directors**

The mean value for the proportion of executive directors in the boards for the pre-governance period was 0.92 (ranging from 0.0 to 3.0) and for the post-governance period was 0.70 (ranging from 0.0 to 1.0).

#### **Nonexecutive Directors**

The mean value for the proportion of non-executive directors for the pre-governance period was 7.00 (range 0.0 to 8.0) and for the post-governance period was 5.93 (ranging from 0.0 to 8.0).

#### **Independent Directors**

The mean value for the proportion of independent directors for the pre-governance period was 0.60 (range 0.0 to 3.0) and for the post-governance period was 1.20 (range 0.0 to 6.00).

### **6.12.4 Board Size**

The mean value of board size for the pre-governance period was 8.34 (range 3.00 to 14.0) and for the post-governance period was 8.25 (range 6.00 to 12.0).

### **6.12.5 Audit Committee (Financial Expert)**

The mean value for the presence of a financial expert on audit committees for the pre-governance period was 0.06 (range 0.00 to 1.0) and for the post-governance period was 0.10 (ranging from 0.00 to 1.00). Only 6 per cent of the financial companies in the pre-governance period had a financial expert on their audit committees. On the other hand, 10 per cent of financial companies had a financial expert on their audit committee during the post-governance period.

### **6.12.6 Dependent variables**

Tobin's q, Return on Assets and Return on Equity were used as proxies for firm performance and total assets were used as the control variable.

#### **Tobin's q**

The mean value of Tobin's q for the pre-governance period was 1.14 (range 0.12 to 4.04) and for the post-governance period was 0.95 (range 0.62 to 2.30).

#### **ROA**

The mean value of ROA for the pre-governance period was 0.43 (range -29.4 to 10.3). The mean value of ROA for the post-governance period was 1.06 (range -18.3 to 5.14).

#### **ROE**

The mean value of the ROE for the pre-governance period was 6.88 (range -56.7 to 31.3) and for the post-governance period was 8.40 (range -25.1 to 25.6).

#### **Total Assets**

The mean value of total assets for the pre-governance period was 22.3 (range 18.4 to 25.0). The mean value for the post-governance period was 22.4 (range 18.7 to 25.2).

## 6.13 Two-Related-Sample T-test (Financial Companies)

Comparison of the mean values of corporate governance characteristics of financial companies and their performance between the pre-governance period of 2008-2009 and post-governance period of 2011-2012 using two related-data t-test is presented in Table 6.13. The details of the t-test results are as follows.

*Table 6.13: T-Test for pre-governance (period 2008-2009) and post-governance (period 2011-2012) of listed financial companies:*

<b>Variables</b>	<b>Mean of Financial Companies Pre-Governance (period 2008-2009)</b>	<b>Mean of Financial Companies Post-Governance (period 2011-2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of difference in Means (%)</b>
<b>Independent Variables</b>					
<i>Ownership Structure:</i>					
Families	0.06	0.06	0.29	0.77	Not Significant
Institutional	0.21	0.32	1.80	0.07	Not Significant
Foreign	0.04	0.08	1.50	0.14	Not Significant
Governments	0.23	0.22	0.25	0.80	Not Significant
Individuals	0.11	0.15	0.69	0.50	Not Significant
<i>Leadership structure</i>					
Separate Leadership	1.91	1.91	0.00	1.00	Not Significant
<i>Board composition</i>					
Executive Directors	0.92	0.70	0.87	0.39	Not Significant

<b>Variables</b>	<b>Mean of Financial Companies Pre-Governance (period 2008-2009)</b>	<b>Mean of Financial Companies Post-Governance (period 2011-2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of difference in Means (%)</b>
Nonexecutive Directors	7.00	5.93	0.97	0.34	Not Significant
Independent Directors	0.60	1.20	0.59	0.56	Not Significant
<i>Board Size</i>	8.34	8.25	0.19	0.84	Not Significant
<i>Audit Committee</i>					
Financial Expert	0.06	0.10	0.73	0.47	Not Significant

### **6.13.1 Ownership Structure:**

Ownership structure is an independent variable consisting of five different types of owners/shareholders -family, institutional, foreign, government and individuals;

#### **Family Ownership**

The difference between means of the proportion of family ownership firms between the pre- governance period and post-governance period was not significant ( $t = 0.29$ ,  $p > 0.05$ ) (Table 6.13). This indicated that the new corporate governance codes did not have any impact on the proportion of family ownership of firms.

#### **Institutional Ownership**

The difference between means of the proportion of institutional ownership firms between the pre- and post-governance periods of financial companies was not significant ( $t = -1.80$ ,  $p > 0.05$ ) (see Table 6.13). Hence the new rules did not have any effect on the proportion of institutional ownership of firms.

#### **Foreign Ownership**

The difference between the means of the foreign ownership proportions between the pre and post-governance periods of financial companies was not significant ( $t = -1.50$ ,  $p > 0.05$ ) (Table 6.13). Thus the new corporate governance rules did not affect the proportion of foreign ownership of firms.

### **Government Ownership**

The difference between means of government ownership of financial companies in the pre and post-governance periods was not significant ( $t = 0.25$ ,  $p > 0.05$ ), (Table 6.13). Hence, the proportion of firms with government ownership remained the same during both periods and the new rules do not seem to have made any influence.

### **Individuals Ownership**

The difference between means of the proportion of individual ownership in the pre and post-governance periods was not significant ( $t = -0.69$ ,  $p > 0.05$ ), (Table 6.13). Therefore, there was no impact for the new corporate governance rules on this variable.

## **6.13.2 Leadership Structure**

The difference of means of the leadership structure between the pre and post-governance periods was not significant ( $t = 0.00$ ,  $p > 0.05$ ) (see Table 6.13). There are no differences between the means, as well as no difference in the number of cases between the both periods. Therefore, the  $t$  value was 0.00 and not significant.

## **6.13.3 Board Composition**

### **Executive directors**

The difference between the means of the proportion of executive directors for pre and post-governance periods of financial companies was not significant ( $t = 0.87$ ,  $p > 0.05$ ), (Table 6.13). Thus the proportion of executive directors remained the same in both periods.

### **Non-Executive directors**

The difference between the means of the proportions of nonexecutive directors for the pre and post-governance periods was not significant ( $t = 0.97$ ,  $p > 0.05$ ), (Table 6.13). This indicated an absence of any impact of the new rules on this variable.

### **Independent directors**

The difference between the means of the proportions of independent directors for their- governance period and post-governance period was not significant ( $t = -0.59$ ,  $p > 0.05$ ), (Table 6.13). Thus there was no effect of the new codes on the proportion of independent directors.

#### **6.13.4 Board Size**

The difference between the means of the board size for the pre-governance and post-governance periods was not significant ( $t = 0.19$ ,  $p > 0.05$ ) (see Table 6.13). This showed the absence of any effect of the new codes on board size.

#### **6.13.5 Audit committee (Financial Expert)**

The difference between the means of the presence of a financial experts on audit committees for the pre and post-governance periods was not significant ( $t = -0.73$ ,  $p > 0.05$ ), Table 6.13). Therefore, no impact of the new codes was observable in this respect.



## 6.14 T test of dependent variables of performance of financial firms

Tobin's q, Return on Assets and Return on Equity were used as proxies for firm performance. Total assets were used as a control variable. The results are presented in Table 6.14 below.

*Table 6.14: T-test of dependent (performance) variables for pre-governance period (2008-2009) and post- governance period (2011-2012) (Comparison of Means)*

<b>Variables</b>	<b>Mean of Financial Companies Pre-Governance (period 2008&amp;2009)</b>	<b>Mean of Financial Companies Post-Governance ( period 2011&amp;2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of difference in Means (%)</b>
<b>Dependant Variables</b>					
Tobin's Q	1.14	0.95	1.56	0.12	Not Significant
ROA	0.43	1.06	-0.68	0.50	Not Significant
ROE	6.88	8.40	-0.65	0.51	Not Significant
TA-Control	22.3	22.4	-0.48	0.63	Not Significant

None of the differences in means of performance variables and of total assets between pre and post-governance periods was statistically significant. Thus firm performance remained the same regardless of new corporate governance rules.

## **6.15 Descriptive statistics comparing Islamic Banks with Conventional Banks for Pre-governance and Post-governance periods**

Descriptive statistics compared the level of compliance, influence and changes in corporate governance variables of Islamic Banks with those of conventional banks due to the impact of the corporate governance rules introduced in 2010. The data is presented in Table 6.15. This comparison was expected to identify differences and similarities if any between the two types of banks with respect to any corporate governance variable.

Table 6.15: Descriptive statistics comparing Islamic Banks with Conventional Banks on corporate governance variables during Pre-governance and Post-governance periods

	Islamic Banks										Conventional Banks									
	Pre-Governance period (2008-2009)					Post-Governance period (2011-2012)					Pre-Governance period (2008-2009)					Post-Governance (period 2011-2012)				
Variables	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD
<b>Independent Variables</b>																				
<i>Ownership Structure:</i>																				
Families	7	0.00	0.70	0.10	0.26	8	0.00	0.30	0.04	0.10	7	0.00	0.11	0.01	0.04	8	0.00	0.06	0.01	0.03
Institutional	7	0.00	1.00	0.41	0.45	8	0.00	1.00	0.48	0.38	7	0.00	0.80	0.13	0.30	8	0.00	0.76	0.35	0.28
Foreign	7	0.00	0.20	0.05	0.09	8	0.00	0.44	0.09	0.16	7	0.00	0.00	0.00	0.00	7	0.00	0.00	0.00	0.00
Government s	7	0.00	0.64	0.27	0.22	8	0.00	0.32	0.13	0.13	7	0.00	0.64	0.19	0.22	8	0.00	0.58	0.20	0.24
Individuals	7	0.00	0.59	0.16	0.27	8	0.00	0.53	0.26	0.23	7	0.00	0.62	0.08	0.23	8	0.00	0.56	0.13	0.20
<i>Leadership structure</i>																				

	Islamic Banks										Conventional Banks									
	Pre-Governance period (2008-2009)					Post-Governance period (2011-2012)					Pre-Governance period (2008-2009)					Post-Governance (period 2011-2012)				
Variables	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD
Separate Leadership	8	2.00	2.00	2.00	0.00	8	2.00	2.00	2.00	0.00	8	2.00	2.00	2.00	0.00	8	2.00	2.00	2.00	0.00
<i>Board composition</i>																				
Executive Directors	-	0	0	0	0	1	0.00	0.00	0.00	0.00	2	1.00	1.00	1.00	0.00	4	1.00	1.00	1.00	0.00
Nonexecutive Directors	-	0	0	0	0	1	3.00	3.00	3.00	0.00	0	0.00	0.00	0.00	0.00	1	8.00	8.00	8.00	0.00
Independent Directors	-	0	0	0	0	1	6.00	6.00	6.00	0.00	0	0.00	0.00	0.00	0.00	1	0.00	0.00	0.00	0.00
<i>Board Size</i>	4	5	9	7.5	1.91	4	7.00	9.00	7.75	0.96	6	3.00	11.0	7.33	3.61	6	9.00	11.0	9.70	1.03
<i>Audit Committee</i>																				
Financial Expert	8	0.00	0.00	0.00	0.00	8	0.00	0.00	0.00	0.00	8	0.00	0.00	0.00	0.00	8	0.00	1.00	0.13	0.35

	Islamic Banks										Conventional Banks									
	Pre-Governance period (2008-2009)					Post-Governance period (2011-2012)					Pre-Governance period (2008-2009)					Post-Governance (period 2011-2012)				
Variables	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD	N	Min	Max	Mean	SD
Dependant Variables																				
Tobin's Q	6	0.73	1.00	0.87	0.11	6	0.75	0.97	0.86	0.09	8	0.76	1.87	1.08	0.39	6	0.80	0.98	0.89	0.08
ROA	8	0.12	1.80	1.28	0.61	8	-1.97	1.55	0.81	1.20	8	-0.32	2.63	1.47	1.12	8	1.21	2.19	1.62	0.37
ROE	8	1.09	24.0	11.0	7.83	8	-18.1	13.5	5.00	1.00	8	-2.68	16.40	8.50	6.62	8	6.04	13.80	10.45	3.00
Control Variables																				
Asset	8	22.1	23.86	23.0	0.70	8	22.3	24.0	23.22	0.75	8	18.4	24.50	22.11	2.26	8	19.80	24.63	22.53	1.81

### **6.15.1 Ownership Structure**

The ownership structure variable consists of five different types of owners/shareholders - family, institutional, foreign, government and individuals. The results presented in Table 6.15 are described below.

#### **Family Ownership**

In the case of Islamic Banks, the mean value of the proportion of family ownership for the pre-governance period was 10 per cent (range 0 per cent to 70 per cent) and for post-governance period was 4 per cent (range 0 per cent to 30 per cent). On the other hand, the mean values of the proportion of family ownership for the pre-governance period of conventional banks were 1 per cent (range 0 per cent 11 per cent). The mean value for the post-governance period was 1 per cent (ranging from 0 per cent to 6 per cent).

#### **Institutional Ownership**

In the case of Islamic Banks, the mean value of the proportion of institutional ownership for the pre-governance period was 41 per cent and for the post-governance period it was 48 per cent. The minimum value was 0 per cent and the maximum value was 100 per cent for both periods.

For conventional banks, the mean value of the proportion of institutional ownership for the pre- governance period was 13 per cent and 35 per cent for the post-governance period. The minimum value was 0 per cent for the both periods and the maximum value was 80 per cent for pre-governance period and 76 per cent for post-governance period.

#### **Foreign Ownership**

In the case of Islamic Banks, the mean value of the proportion of foreign ownership for the pre-governance period was 5 per cent (ranging from 0 per cent to 20 per cent). The mean value for the post-governance period was 9 per cent (range 0 per cent to 44 per cent). In contrast, the mean value of the proportion of foreign ownership for both the pre and post-governance periods for Conventional Banks was 0 per cent with the zero value as the range for both periods.

#### **Government Ownership**

In the case of Islamic Banks, the mean value of the proportion of government ownership for the pre-governance period was 27 per cent (ranging from 0 per cent to 64 per

cent). The mean value for the post-governance period was 13 per cent (ranging from 0 per cent to 32 per cent).

In comparison the mean value of the proportion of government ownership of conventional banks for the pre- governance period was 19 per cent (ranging from 0 per cent to 64 per cent).

#### Individual Ownership

In the case of Islamic Banks the mean value of the proportion of individual ownership for the pre-governance period was 16 per cent and 26 per cent for the post-governance period. The minimum value was 0 per cent for both periods. The maximum value was 59 per cent for the pre-governance period and 53 per cent for the post-governance period.

In comparison the mean value of the individual ownership for conventional banks in the pre-governance period was 8 per cent and 13 per cent in the post-governance period. The minimum value was 0 per cent for both periods. The maximum value was 62 per cent for the pre-governance period and 56 per cent for the post- governance period.

### **6.15.2 Leadership Structure**

The data on results obtained for ownership structure is given in Table 6.15, and described below.

In the case of Islamic Banks, the mean value of leadership structure for both pre and post-governance periods were 2.00. The minimum value was 2.00 and the maximum value was 2.00 for both periods. There were no differences between pre and post-governance periods in regard to leadership structure which suggest that leadership structure of Islamic banks has been consistent over the two periods. Furthermore, this indicates that 100 per cent of the Islamic banks had separated the roles of chairperson and CEO ., in conformity with the governance rule of 2010.

Similarly, in the case of Conventional Banks the mean value of leadership structure of both pre and post-governance periods was 2.00 and the minimum and the maximum values were 2.00 for both periods. Thus the leadership structure of conventional banks had also been consistent over the two periods with 100 per cent of the conventional banks separating the roles of chairperson and CEO. This also shows that conventional banks have met the requirements of the governance rule of 2010.

### **6.15.3 Board Composition**

The results on board composition are given in Table 6.15, and described below.

#### **Executive Directors**

No information on the proportion of executive directors of Islamic banks in both the pre and post-governance periods was available.

The mean value of the proportion of executive directors on boards of conventional banks was 1.00 for both pre and post-governance periods. The minimum and maximum values for both pre and post-governance periods of the proportion of executive directors on boards of conventional banks were also 1.00 with 0.00 standard deviation.

#### **Nonexecutive Directors**

No information on the proportion of nonexecutive directors on the boards of Islamic banks for pre-governance period was available. The mean, minimum and maximum values of Islamic banks for the post-governance period were 3.00.

Information on the proportion of for nonexecutive directors on the boards of conventional banks for the per-governance period was not available. The mean, minimum and maximum values on boards of conventional banks for the post-governance period were 8.00.

#### **Independents Directors**

The information on the proportion of independent directors on boards of Islamic banks for the pre-governance period was not available. The mean, minimum and maximum values of the proportion of independent directors on boards of Islamic banks were 6.00 for both pre and post-governance periods.

No information was available for the proportion of independent directors on the boards of conventional banks for both the pre and post-governance periods.

### **6.15.4 Board Size**

The mean value of board size of Islamic banks in the pre-governance period was 7.50 and 7.75 in the post-governance period. The minimum value was 0.00 for both the pre and post-governance periods and the maximum value was 9.00 for both pre and post-governance periods.



The mean value of the board size of conventional banks for the pre-governance period was 7.33 and 9.70 for the post-governance period. The minimum value was 0.00 and the maximum value was 11.00 for both the pre and post- governance periods.

#### **6.15.5 Audit Committee (Financial Expert)**

No information was available about whether or not there was a financial expert on audit committees in Islamic banks in both the pre and post-governance period, and in conventional banks in the pre-governance period. .The mean value of the existence of a financial expert on audit committees of conventional banks for the post-governance period was 0.13, ranging from a minimum value of 0.00 to a maximum value of 1.00.

#### **6.15.6 Tobin's q**

The mean value of Tobin's q for Islamic banks in the pre-governance period s was 0.87 ranging from a minimum value of 0.73 to a maximum value of 1.00. The mean value of Tobin's q for Islamic banks for the post-governance period was 0.86 ranging from a minimum value of 0.75 to a maximum value of 0.97.

The mean value of the Tobin's q of conventional banks in the pre-governance period was 1.08 ranging from a minimum value of 0.76 to a maximum value of 1.87 while the mean value for post-governance period was 0.89 ranging from a minimum value of 0.80 to a maximum value of 0.98.

#### **6.15.7 ROA**

The mean value of ROA of Islamic Banks for the pre-governance period was 1.28 (range 0.12 to 1.80), and for the post-governance period was 0.81 (range -1.97 to 1.55).

The mean value of ROA of Conventional Banks for the pre-governance period was 1.47 (ranging from -0.32 to 2.63) and for the post-governance period was 1.62 (ranging from 1.21 to 2.19).

#### **6.15.8 ROE**

The mean value of ROE of Islamic Banks for the pre-governance period was 11.0 (range 1.09 to 24.0), and for the post-governance period was 5.00 (ranging from -18.1 to 13.5).

The mean value of ROE of Conventional Banks for the pre-governance period was 8.50 (range -2.68 to 16.40) and for the post-governance period was 10.45 (range 6.04 to 13.80).

### **6.15.9 Total Assets**

The mean value of the total assets of Islamic banks for the pre-governance period was 23.00 and it was 23.22 for the post-governance period. The minimum value was 22.1 for the pre-governance and 22.3 for the post-governance period. The maximum value for the pre-governance period was 23.86 and 24.00 for the post-governance period.

The mean value of the total assets of conventional banks for the pre-governance period was 22.11 and 22.53 for the post-governance period. The minimum value was 18.4 for the pre-governance period and 19.80 for the post-governance period. The maximum value for the pre-governance period was 24.50 and 24.63 for the post-governance period.

In general, descriptive statistics for ownership structure indicated more similarities than differences between Islamic banks and conventional banks on both the level of influence of the 2010 governance rule as well as on the level of variation between both types of banks, with the exception of the proportion of foreign ownership.

Both types of banks shared the same tendencies and similarities even on the level of disclosure of information about their board composition. The corporate governance rule of 2010 seemed to have made an insignificant influence on both types of banks. In addition, descriptive statistics indicated that both types of banks had almost similar disclosure practices as only limited information was available about their board members and composition except for leadership structure. There were more similarities than differences between Islamic and conventional banks both on the level of the influence of the 2010 governance rule and the level of comparison between both types of banks.

## **6.16 Two-Related-Sample T-test (Islamic banks pre and post-governance vs. conventional banks pre and post-governance)**

Statistical significance for the difference between mean values of corporate governance characteristics of Islamic banks and conventional banks were tested using t-test on independent and dependent variables for both types of banks. The significance of differences between pre-governance and post-governance periods was also tested for both bank types using the same method, the t-test data is in Table 6.16. The results are explained below.

*Table 6.16: T-Test of Independents and Dependents Variables for Both Types Islamic and Conventional Banks for Pre-Governance period (2008-2009) and Post-Governance period (2011-2012) Comparisons of Means). This is to determine the influence of the Governance Rules of 2010 on both types of banks and to identify the extent to which the two types of banks are similar or different*

Islamic Banks						Conventional Banks				
Variables	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)
<b>Independent Variables</b>										
<i>Ownership Structure:</i>										
Families	0.10	0.04	0.17	0.55	Not Significant	0.01	0.01	0.17	0.87	Not Significant
Institutional	0.41	0.48	-0.30	0.77	Not Significant	0.13	0.35	-1.50	0.16	Not Significant
Foreign	0.05	0.09	-0.55	0.60	Not	0.00	0.00	-0.54	0.60	Not Significant

Islamic Banks							Conventional Banks			
Variables	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)
					Significant					
Governments	0.27	0.13	1.51	0.15	Not Significant	0.19	0.20	-0.13	0.90	Not Significant
Individuals	0.16	0.26	-0.77	0.45	Not Significant	0.08	0.13	-0.38	0.70	Not Significant
<i>Leadership structure</i>										
Separate Leadership	2.00	2.00	0.00	0.00		2.00	2.00	0.00	0.00	
<i>Board composition</i>										
Executive Directors	0.00	0.00	0.00	0.00		1.00	1.00	0.00	0.00	
Nonexecutive Directors	0.00	3.00	0.00	0.00		0.00	8.00	0.00	0.00	

Islamic Banks							Conventional Banks			
Variables	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)
Independent Directors	0.00	6.00	0.00	0.00		0.00	0.00	0.00	0.00	
<i>Board Size</i>	7.5	7.75	-0.23	0.82	Not Significant	7.33	9.70	-1.52	0.16	Not Significant
<i>Audit Committee</i>										
Financial Expert	0.00	0.00	0.00	0.00		0.00	0.13	-1.00	0.34	Not Significant
<b>Dependant Variables</b>										
Tobin's Q	0.87	0.86	0.07	0.94	Not Significant	1.08	0.89	1.24	0.24	Not Significant

Islamic Banks							Conventional Banks			
Variables	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)	Mean Pre-Governance (period 2008 & 2009)	Mean Post-Governance (period 2011 & 2012)	T	Sig.(2-tailed)	Significance Level of difference in Means (%)
ROA	1.28	0.81	0.97	0.35	Not Significant	1.47	1.62	-0.34	0.74	Not Significant
ROE	11.0	5.00	1.31	0.21	Not Significant	8.50	10.45	-0.76	0.46	Not Significant
<i>Control Variables</i> Assets	23.0	23.22	-0.60	0.55	Not Significant	22.11	22.53	-0.26	0.80	Not Significant

None of the independent or dependent variables showed significant difference between means of the pre and post governance periods either for Islamic or conventional banks. Therefore the introduction of new corporate governance rules in 2010 had no effect on any of the corporate governance characteristics. Both types of banks remained where they were before the new regulations.

## 6.17 Two-Related-Sample T-test (Islamic Banks vs. Conventional Banks)

The difference between Islamic banks and conventional banks with respect to differences between their means for all corporate governance variables and performance variables were evaluated using t-test. For each bank type, values of all years were combined and means estimated for each variable. The results are presented in Table 6.17 and are discussed below.

T-Test of independent and dependent variables of both Islamic and conventional banks (Comparisons of Means of both types of banks). This is to determine the similarities and differences between Islamic and conventional banks in relation to the level of significance between different variables

Table 6.17:

<b>Variables</b>	<b>Mean of Islamic Banks (period 2008, 2009, 2011 &amp; 2012)</b>	<b>Mean of Conventional Banks (period 2008, 2009, 2011 &amp; 2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of Difference in Means (%)</b>
<b>Independent Variables</b>					
<i>Ownership Structure:</i>					
Families	0.07	0.01	1.02	0.31	Not Significant
Institutional	0.44	0.25	1.50	0.14	Not Significant
Foreign	0.08	0.00	2.22	0.03	Significant



<b>Variables</b>	<b>Mean of Islamic Banks (period 2008, 2009, 2011 &amp; 2012)</b>	<b>Mean of Conventional Banks (period 2008, 2009, 2011 &amp; 2012)</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of Difference in Means (%)</b>
Governments	0.19	0.20	-0.10	0.91	Not Significant
Individuals	0.21	0.11	1.20	0.24	Not Significant
<i>Leadership structure</i>					
Separate Leadership	2.00	2.00	0.00	0.00	
<i>Board composition</i>					
Executive Directors	0.00	1.00	0.00	0.00	
Nonexecutive Directors	3.00	8.00	0.00	0.00	
Independent Directors	6.00	0.00	0.00	0.00	
<i>Board Size</i>	7.62	8.50	-0.81	0.43	Not Significant
<i>Audit Committee</i>					
Financial Expert	0.00	0.06	-1.00	0.33	Not Significant
<b>Dependant Variables</b>					
Tobin's Q	0.86	1.00	-1.48	0.15	Not Significant
ROA	1.04	1.54	-1.60	0.11	Not Significant
ROE	8.02	9.47	-.56	0.58	Not Significant
<i>Control Variable</i>					
Assets	23.13	22.32	-.30	0.76	Not Significant

Only the difference in foreign ownership was significant. The proportion of Islamic banks with foreign ownership was 8 per cent compared to zero for conventional banks. The higher foreign ownership of Islamic Banks could be due to investment from foreign Muslims or their organisations.

The results of Table 6.16 and Table 6.17 clearly indicated that irrespective of the type of bank, there is reluctance to practise corporate governance rules. This accounts for the comparison of the two periods. Both types of bank behaved similarly with respect to all corporate characteristics. Accordingly, there were general similarities between the two types of banks with respect to their corporate structures as well as implementation of new rules of corporate governance.

## 6.18. Descriptive Statistics for Sharia Supervisory Boards of the Listed Islamic Banks in the UAE Market

The degree of compliance of Islamic banks with the Islamic codes on Sharia Supervisory Boards according to the AAOIFI governance standards for Islamic financial institutions and best practice corporate governance is presented in Table 6.18.

*Table 6.18: Descriptive Statistics of the Sub-Variables for Sharia Supervisory Board of Listed Islamic Banks in the UAE Market*

	Sub-Variables	No	Min	Max	Mean	Std. Dev
1	Total number of SSB members (Min 3 by AAOIFI). (1) Is assigned for 3 members and more (compliant) and (0) for incompliant.	4	1.00	1.00	1.00	0.00
2	SSB Report includes assurance that the Financial Statement has been examined for “appropriateness of allocation of profit & Loss between shareholders and IAHs” and maintained in accordance with Shari ‘principles (recommended by AAOIFI). (1) Is assigned for (complaint) and (0) for incompliant.	4	0.00	1.00	0.25	0.50
3	If Multiple directorship of SSB Members Exist. (1) Is assigned for existence of multiple directorships) and (0) for (nonexistence of multiple directorships).	4	1.00	1.00	1.00	0.00
4	SSB Members with Shari knowledge, finance and relevant qualifications and experience. (1) Is assigned	4	1.00	1.00	1.00	0.00

	Sub-Variables	No	Min	Max	Mean	Std. Dev
	for (existence of Knowledge, finance and relevant qualifications and experience) and (0) for (nonexistence of knowledge, finance and relevant qualifications and experience).					
5	If Appraisal conducted on the performance of SSB Members. (1) Is assigned for (If Appraisal Conducted) and (0) for (If Appraisal has not been Conducted).	4	0.00	0.00	0.00	0.00
6	Accountability of SSB. (1) Is assigned for (If accountability of SSB do exist) and (0) for (If accountability do not exist).	4	0.00	1.00	0.75	0.50
7	Frequency of SSB meetings. (1) Is assigned for (If SSB meets on a regular basis) and (0) for (If SSB do not meet on a regular basis).	4	0.00	0.00	0.00	00.0

Source: Author's calculations, 2014.

### 6.18.1 Total number of SSB members

The minimum, maximum and the mean values for (sub-variable 1, Table 6.18) with regard to the total number of SSB member's compliant with the 1999 AAOIFI Governance Standard for Islamic Financial Institutions is 100% with a standard deviation of 0.

### 6.18.2 Appropriateness of allocation of profit & loss between shareholders and IAHs

The mean value for the (sub-variable 2, Table 6.18) with regards to the inclusion of the SSB report containing an assurance paragraph that the examination of the financial statement was performed and the "appropriateness of allocation of profit and loss between shareholders and IAHs" is 0.25 ranging from a minimum value of 0.00 to a maximum value of 1.00. Thus, only 25 per cent of the Islamic banks complied with this requirement of the AAOIFI and 75 per cent did not. The assumptions used in this sub-variable were: (a) the word "depositors" is different from IAHs. Therefore, those banks which used the term

“depositors” were considered non-compliant with regard to the SSB opinion paragraph within the SSB report. (b) Banks that did not issue an SSB report are considered non-compliant with AAOIFI requirements. (c) AAOIFI was used as the benchmark to measure the level of compliance though it was not mandatory for Islamic banks listed on the DFM & ADX (d) the subject matter and the context were more relevant in the report of the SSB than disclosure in a note in annual reports or financial statements. These assumptions were based on the significance of the IAHs funds invested in the Islamic banks as being more important than depositors as indicated in the relevant literature (Al-Deehani, Karim & Murinde 1999; Archer, Karim & Al-Deehani 1998; Ghayad 2008; Karim 2001)(Al-Sadah 2007). In addition, the requirement of the AAOIFI is clear when it talks about the “appropriateness of allocation of profit and loss between shareholders and IAHs” rather than depositors.

### 6.18.3 Multiple directorships of SSB members

The minimum, maximum and the mean values for multiple directorships of SSB members (sub-variable 3 tables 6.18) were 100 per cent with a standard deviation of 0 per cent. If multiple directorships of SSB members existed in Islamic banks, it was scored 1 and if not 0. The results indicated existence of multiple directorships of SSB members within the SSB of Islamic banks.

### 6.18.4 SSB member’s knowledge

The minimum, maximum and the mean values on the knowledge of SSB members about Sharia, finance and relevant qualifications and experience (sub-variable 4, Table 6.18) were 100 per cent with 0 per cent as standard deviation. This indicated that the majority of SSB members possessed the relevant Sharia and business skills and qualifications.

### 6.18.5 Appraisals of the performance of SSB Members

The minimum, maximum, mean and standard deviation values for appraisals on performance of SSB members (sub-variable 5 Table 6.18) were 0 per cent. This indicated that none of the Islamic banks had disclosed or mentioned that SSB members were subject to periodical appraisals.

### 6.18.6 Accountability of SSB

The mean value for accountability of SSB members (sub-variable 6, Table 6.18) was 75 per cent (range 0 per cent to 100 per cent) with a standard deviation of 50 per cent. This

indicated that 75 per cent of Islamic banks had reported that SSBs were accountable to shareholders while only 25 per cent had not reported that its SSB was accountable.

### 6.18.7 SSB Meetings

The minimum, maximum, mean and the standard deviation values for SSB meetings (sub-variable 7, Table 6.18) were 0 per cent. This indicated that none of the Islamic Banks had disclosed information showing the frequency or schedule of SSB meetings held during the reporting period.

## 6.19 Two-Related-Sample T-test (Abu Dhabi Stock Exchange vs. Dubai Financial Market) (Comparisons of Means)

The t-Tests for performance (dependents) variables of both the Abu Dhabi Stock Exchange and Dubai Financial Market were done to determine the similarities and differences in performance of the two stock exchanges, as the companies selected for this study belonged to these two exchanges. In addition, to identify if DFM as an international and well-known attractive regional market perform similar or different from ADX .The results are presented in Table 6.19 and are elaborated below.

*Table 6.19*

<b>Variables</b>	<b>Mean of Abu Dhabi Stock Exchange</b>	<b>Mean of Dubai Financial Market</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of Difference in Means (%)</b>
<b>Dependant Variables</b>					
Tobin's q	0.59	1.89	-4.75	0.00	Significant
ROA	3.20	1.61	2.36	0.01	Significant
ROE	7.64	2.18	2.94	0.00	Significant
<b>Control Variable</b>					

<b>Variables</b>	<b>Mean of Abu Dhabi Stock Exchange</b>	<b>Mean of Dubai Financial Market</b>	<b>T</b>	<b>Sig.(2-tailed)</b>	<b>Significance Level of Difference in Means (%)</b>
Total Assets	20.45	20.31	0.74	0.46	Not Significant

### **6.19.1 Tobin's q**

The difference between the means of Tobin's q of the companies listed on the Abu Dhabi Stock Exchange and those listed on the Dubai Financial Market for the period 2008 to 2012 was significant ( $t=-4.75$ ,  $p < 0.05$ ) (Table 6.18). The means were 0.59 for the ADX and 1.89 for the DFM. Therefore, the companies listed on the DFM were more efficient in market-based performance measures.

### **6.19.2 ROA**

The difference between the means of ROA of the companies listed on the ADX and DFM for the period 2008 to 2012 was significant ( $t=2.36$ ,  $p < 0.05$ ) (Table 6.18). The mean value of ADX (3.20) was higher than that of DFM (1.61). Hence, firms listed on the ADX used their assets more efficiently for profit generation than those listed on the DFM.

### **6.19.3 ROE**

The difference between the means of ROE of the companies listed on the Abu Dhabi Stock Exchange and those listed on the Dubai Financial Market for the period 2008 to 2012 was significant ( $t=2.94$ ,  $p < 0.05$ ) (Table 6.18). The mean value of the ADX was 7.64 and that of the DFM was 2.18. Therefore, the companies listed on the ADX utilised their equities more efficiently for profit generation than those listed on the DFM.

### **6.19.4 Total Assets**

The difference between the means of total assets of the companies listed on the Abu Dhabi Stock Exchange and the companies listed on the Dubai Financial Market for the period 2008 to 2012 was not significant ( $t=2.94$ ,  $p > 0.05$ ) (Table 6.18). Thus the assets remained more or less equal for companies listed in either stock market. Therefore, better

performance of the ADX in the case of ROA was not due to lower assets, but to its utilisation efficiency to generate more profits.

## 6.20 Regression Analysis

Regression analyses were performed to test the hypothesis of the research described in Chapter 4. Regression analysis was performed to determine the mathematical relationship between the dependent (Tobin's q, ROA, ROE) and independent variables (corporate governance variables). In addition, in the case of the Islamic banks, Sharia Supervisory Board's sub-variables were also regressed against performance.

As mentioned in the methodology (Chapter 5), treatments were given and variables were transformed to natural logarithms. The results are given in Table 6.20.

The results indicated a significant positive relationship for family ownership with ROA and ROE and a negative relationship with Tobin's q. There were positive relationships between government ownership and Tobin's q. Individual ownership was significantly associated with ROA and ROE. A negative relationship was indicated between leadership separation and ROA. Concerning the relationship of SSBs with performance, there was significant negative relationship between complying with the disclosure paragraph recommended by the AAOIFI and Tobin's q. There was a significant positive relationship between SSB accountability of SSB and Tobin's q. Furthermore, and for the purpose of this thesis it is worth noting that multicollinearity will not be an issue due to the lack of significant correlation between the independent variables (table 6.4).

Table 6.20: Regression Coefficients

Model		Unstandardized Coefficients						Standardized Coefficients			T-Value			Sig		
		B			Std. Error			Beta								
1	Dependent Variables	ROA	ROE	Tob q	ROA	ROE	Tob q	ROA	ROE	Tob q	ROA	ROE	Tob q	ROA	ROE	Tob q
	Independent Variables															
	Ownership Structure															
	(Constant)	6.869	-4.691	1.429	4.15	11.02	1.947				1.657	-0.43	0.734	0.1	0.67	0.463
	Family	5.316	17.128	-2.8	2.6	6.899	1.243	0.112	0.134	-0.12	2.049	2.483	-2.253	0.04	0.01	0.025
	Institutions	-1.6	-0.471	-1.28	1.53	4.047	0.727	-0.06	-0.01	-0.1	-1.05	-0.12	-1.761	0.3	0.91	0.079
	Foreign	-6.89	-8.506	-0.11	3.64	9.672	1.693	-0.11	-0.05	-0	-1.89	-0.88	-0.062	0.06	0.38	0.951
	Government	1.745	9.135	-2.39	2.03	5.362	0.975	0.051	0.101	-0.15	0.861	1.704	-2.449	0.39	0.09	0.015
	Individual	-3.25	-9.527	-0.14	1.48	3.939	0.688	-0.12	-0.13	-0.01	-2.19	-2.42	-0.203	0.03	0.02	0.839
	Total Asset	-0.18	0.467	0.035	0.21	0.542	0.096	-0.05	0.049	0.021	-0.87	0.861	0.369	0.39	0.39	0.712
	Leadership Structure															
	(Constant)	8.26	-11.51	1.698	3.74	10.33	1.522				2.21	-1.11	1.116	0.03	0.27	0.265
	Total Asset	-0.14	1.021	-0.01	0.18	0.49	0.072	-0.04	0.102	-0.01	-0.78	2.084	-0.152	0.44	0.04	0.879
	Duality	-1.63	-2.325	-0.19	0.85	2.354	0.349	-0.09	-0.05	-0.03	-1.92	-0.99	-0.55	0.06	0.32	0.582
	Board Composition															
	(Constant)	4.53	-3.479	1.474	6.13	13.67	2.816				0.738	-0.25	0.523	0.46	0.8	0.601
	Total Asset	-0.09	0.35	-0.02	0.31	0.697	0.143	-0.03	0.043	-0.01	-0.3	0.501	-0.145	0.77	0.62	0.885
	Non-executive Directors	-0.04	0.287	-0.04	0.19	0.433	0.089	-0.02	0.056	-0.04	-0.2	0.662	-0.453	0.84	0.51	0.651
	Board size															
	(Constant)	3.043	-27.66	1.858	4.7	13.76	1.634				0.647	-2.01	1.137	0.52	0.05	0.256
	Total Asset	0.012	1.709	-0.01	0.24	0.689	0.082	0.003	0.149	-0	0.053	2.48	-0.066	0.96	0.01	0.947
	Board Size	-0.13	-0.402	-0.08	0.21	0.6	0.073	-0.04	-0.04	-0.07	-0.64	-0.67	-1.141	0.52	0.5	0.255
	Audit Comm															
	(Constant)	5.403	-14.1	1.183	3.44	9.451	1.412				1.569	-1.49	0.838	0.12	0.14	0.402
	Total Asset	-0.15	0.927	0.004	0.17	0.459	0.069	-0.04	0.096	0.003	-0.88	2.019	0.064	0.38	0.04	0.949
	Financial Exp	0.505	1.672	-0.54	0.87	2.376	0.357	0.028	0.033	-0.07	0.584	0.704	-1.502	0.56	0.48	0.134
	Sharia Supervisory Board (SSB)															
	(Constant)	1.505	5.871	0.744	0.48	4.857	0.008				3.138	1.209	97.43	0.01	0.25	0
	SSB 2 (table 6.18)	0.436	1.577	-0.09	0.59	5.948	0.011	0.205	0.077	-0.46	0.742	0.265	-8.537	0.47	0.8	0
	SSB 6 (table 6.18)	-0.76	2.343	0.228	0.59	5.948	0.011	-0.36	0.114	1.136	-1.29	0.394	21.09	0.22	0.7	0

.Significance level is at 0.05% and 0.01%



### **6.20.1 Ownership structure**

Ownership structure consists of five types of ownerships -family, institutions, foreign, government and individuals.

#### **Family Ownership**

According to the values of regression coefficients, family ownership as an independent variable reasonably explained the variation in the dependent variables ROA, ROE and Tobin's q. Thus one unit increase in family ownership proportion would lead to an increase in ROA by a factor of 5.31, an increase in ROE by a factor of 17.12 and a decrease in Tobin's q by a factor of -2.80.

#### **Institutional Ownership**

Regression analysis for institutional ownership did not show any statistically significant relationship with any of the dependent variable. Thus the proportion of institutional ownership had no impact on performance.

#### **Foreign Ownership**

Regression analysis for foreign ownership did not show any statistically significant relationship with any of the dependents variable. Therefore, the proportion of foreign ownership did not affect performance.

#### **Government Ownership**

Government ownership had a significant negative relationship at  $P < 0.05$  with Tobin's q. Thus the proportion of government ownership as an independent variable reasonably explained the variation in market-based performance. The values show that one unit increase in the proportion of government ownership would lead to a decrease in Tobin's q by a factor of -2.38.

#### **Individual Ownership**

Individual ownership had significant a negative relationship at  $P < 0.05$  with ROA and ROE. Thus individual ownership as an independent variable reasonably explained the variation in the dependent variables of ROA and ROE. A unit of increase in the proportion of individual ownership would lead to a decrease in ROA by a factor of -3.25 and to a unit decrease in ROE by a factor of -9.52.

### **6.20.2 Leadership Structure**

Leadership separation is close to a statistically significant negative relationship at  $P > 0.055$  with ROA. Hence, leadership separation as an independent variable might have partly explained the variation in the dependent variable of ROA. A unit of increase in leadership separation would lead to a decrease in ROA by a factor of -1.63.

### **6.20.3 Non-executive Directors**

Regression analysis for the proportion of non-executive directors on boards did not show any statistically significant relationship with any of the dependents variables. Thus, the proportion of non-executive directors did not have any impact on performance.

### **6.20.4 Board Size**

Regression analysis for board size did not show any statistically significant relationship with any of the dependents variables of ROA, ROE and Tobin's q. Therefore, there was no impact of board size on performance.

### **6.20.5 Audit Committee (Financial Expert)**

Regression analysis for inclusion of a financial expert in the audit committees did not show any statistically significant relationship with any of the dependents variables. Therefore, performance did not depend on inclusion of a financial expert in the audit committees.

### **6.20.6 Sharia Supervisory Board and performance of Islamic Banks**

#### **SSB Sub-Variable 2 table 6.18**

The disclosure paragraph is an independent variable. The regression analysis did not show a statistically significant relationship between the specific disclosure paragraph in the SSB report and performance indicators of ROA and ROE. However, it showed a negatively significant relationship with Tobin's q at  $P < 0.05$ . The values indicated that a unit increase in disclosure of that specific paragraph in table 6.18 sub-variable 2 would lead to a decrease in Tobin's q by a factor of -.092. Therefore, market performance is affected by how well the Islamic firm complied with Sharia requirements.

## **SSB Sub-Variable 6 table 6.18**

Accountability of SSB as an independent variable: the regression analysis did not show a statistically significant relationship between accountability of SSB and performance indicators of ROA and ROE. However, there was a significant positive relationship with Tobin's q at  $P < 0.05$ . The values showed that a unit increase in the accountability of SSB in table 6.18 sub-variable 6 would lead to an increase in Tobin's q by a factor of .228.

## **6.21 Conclusion**

The chapter presented the results of the statistical analyses. Descriptive statistics of independent variables of governance mechanisms were presented for ownership structure, leadership structure, board composition, board size and financial experts on audit committee, and the Sharia Supervisory Board. In addition, the descriptive statistics of the dependent performance variables, ROA, ROE and Tobin's q were presented. T-test was used to identify the level of significance between means. To verify the eleven hypotheses proposed in this work, the correlation analyses were performed to analyse and identify the association among variables. Regression analyses were performed to estimate the incremental effects of statistically significant independent variables in explaining the variations in corporate performance variables.

The result of the test suggested a significant positive relationship between family ownership and ROA and ROE and a significant negative relationship with Tobin's q; a significant negative relationship between government ownership and Tobin's q; a significant negative relationship between individual ownership and ROA and ROE; a close non-significant negative relationship between leadership separation and ROA; a significant negative relationship between SSB sub-variable 2 and Tobin's q; and a positive significant relationship between SSB accountability sub-variable 6 and Tobin's q. The implications of these results are discussed in the next chapter.

# CHAPTER 7

## **Discussion and Implications of the Results: Governance and Performance of the UAE Listed Companies Including Islamic Banks**

### **7.1 Introduction**

This study was carried out to answer the following research question:

What is the impact of the new corporate governance rules introduced in 2010 on corporate governance variables and performance of non-financial and financial firms and Islamic and conventional banks listed on the DFM and the ADX?

The aim of the study was to answer to the research question. A set of nine objectives were developed to achieve this aim, and were converted into testable hypotheses. The data collected and methods of analyses used conformed to the requirements of testing such hypotheses.

The results of the descriptive analyses and the relationship between the governance and performance variables of listed companies in the UAE were presented in the previous chapter. This chapter aims to interpret these results and discuss the results of the hypotheses tested in this study and their implications. The results help us to understand which of the governance variables were statistically significant in impacting on the performance of listed companies in the UAE.

The process of operationalization of these hypotheses was as follows.

Hypothesis 1 of the research (H1) was that the ownership structure is associated with firm performance. Hypothesis 2 (H2) was that separate leadership structure is positively associated with performance. Hypothesis 3 (H3) was that a majority of non-executive directors on boards is positively associated with performance. Hypothesis 4 (H4) was that board size is associated with firm performance. Hypothesis 5 (H5) was that the presence of financial experts on audit committees is associated with firm performance. Hypothesis 6 (H6)

was that Sharia Supervisory Board parameters are associated with performance of Islamic Banks which was represented by compliance with the Regulatory index (AAOIFI). The chapter is structured as follows: Section 7.2 Summary of the Regression Results; Section 7.3 Discussion and implications;

Section 7.4 Correlation results; Section 7.5 Comparison of financial and non-financial companies; Section 7.6 Impact of the governance rule on non-financial companies, Section 7.7 Influence of the governance rule on financial companies; Section 7.8 Islamic versus conventional banks in the UAE; Section 7.9 Comparison of Abu Dhabi and Dubai Financial Markets, Section 7.10 regression result, Section 7.11 Summary of results and implications of corporate governance practices in the UAE and Section 7.12 presents the conclusion of the chapter.

## 7.2. Summary of the Regression Results

The main aim of this study is to evaluate the impact of corporate governance rules on corporate governance variables and performance of listed UAE firms. The impact can be assessed by examining the extent to which each corporate governance variable is related with performance. Regression studies were undertaken for this purpose.

Table 6.20 presented the results of the regression model describing the relationship between the independent governance variables and the dependent governance variables used in the study. The summary of the results of testing those hypotheses with regard to the relationship of governance and performance variables are given in Table 7.1.

*Table 7.1: Summary of Results of Hypotheses*

Hypotheses Number	Hypotheses and relationship with performance	Expected relationship	Actual results	Outcome	Sig. Level
H1	<b>Ownership structure and performance</b>	Positive			
H1-1	Family ownership and performance	Positive	P<0.014 (+)	Accepted	Significant
H1-2	Institutional ownership and performance	Positive	P>0.079	Rejected	Not significant

<b>Hypotheses Number</b>	<b>Hypotheses and relationship with performance</b>	<b>Expected relationship</b>	<b>Actual results</b>	<b>Outcome</b>	<b>Sig. Level</b>
H1-3	Foreign ownership and performance	Positive	P>0.060	Rejected	Not significant
H1-4	Government ownership and performance	Positive	P<0.015(-)	Rejected	Significant
H1-5	Individual ownership and performance	Positive	P<0.016(-)	Rejected	Significant
H2	Separate leadership structure and performance	Positive	P<0.055(+) /(-)	Partly Rejected	Close to Sig
H3	Board independence and performance	Positive	P>0.617	Rejected	Not significant
H4	Board size and performance	Positive	P>0.255	Rejected	Not significant
H5	Audit committee (Financial expert) and performance	Positive	P>0.584	Rejected	Not significant
H6	Sharia Supervisory (SSB) and performance	Positive			
H6-2	SSB report disclosure of “shareholders & IAH”	Positive	P<0.000(-)	Rejected	Significant
H6-6	SSB accountability	Positive	P<0.000(+)	Accepted	Significant

Corporate Governance Practices and Firm Performance of Listed Companies included Islamic Banks of the DFM & ADX of the United Arab Emirates.

## 7.3 Discussions and Implications

This research was undertaken to test and evaluate the impact of UAE corporate governance rules amended in 2009 and implemented in 2010 on listed firm performance. Market and accounting performance indicators of Tobin’s q, ROA and ROE were tested for

their correlation with various corporate governance variables. When a significant relationship was obtained, it indicated that the firm performance, with respect to the particular financial indicator, was related with the particular corporate governance variable. Absence of such a relationship was assumed to indicate that firm performance with respect to the particular indicator was not affected by the particular corporate governance variable. Absence of a relationship may not mean that there is no relationship at all. Intervening or other variables may cover the investigated relationship. The assumption is that the change between pre and post CG rules periods is caused by the implementation of 2010 corporate governance rules.

### **7.3.1 Corporate Governance Variables**

The first part of the research question is to establish whether there was any change in any corporate variable when the new rules were implemented. This was assessed by measuring the change in the values of these variables from the pre-implementation period to post-implementation period of the new governance rules. The results obtained are discussed below.

According to the data in Table 6.1 and Table 6.2, there is a clear trend of institutional and individual ownership increasing substantially during the post-governance period. Many of the codes and rules are not applicable for individual ownership. For example, the requirement for anon-executive or independent director does not apply in the case of an owner/manager. Most firms are reluctant to be bound by regulations about how to conduct their business. Therefore, it is may be that more individual ownership was observed in the data. Whether this resulted from new firms being formed with single ownership in an unregulated manner or because some firms with other ownership styles reverted to individual ownership is not clear. The UAE was severely affected by the prevailing global economic crisis in 2010. Many firms would have suspended their operations or changed structure to manage the crisis. This applies especially to the non-oil sector to which the UAE was keen to diversify, as indicated in chapter 3.

However, separation of leadership roles was the same (about 77 per cent) in pre-governance and (about 78 per cent) in the post-governance periods. An increase of institutional ownership should have increased separation of leadership roles. However, this does not seem to be the case in the UAE context where the proportion of individual ownership increased from 9.2 per cent to 32.4 per cent (an increase by about 23 points) while institutional ownership increased from 19.3 per cent to 34 per cent, an increase by only about

15 points. The greater impact of individual ownership seems to have undermined the effect on the proportion of dual leadership due to the increase in institutional ownership.

The proportions of both executive and non-executive directors on boards declined from the pre-governance to the post-governance period. There were also many firms without executive directors on their boards. This should have increased the proportion of independent directors, as was observed. But it cannot be stated that this increase compensated for the decline in executive and non-executive directors, because compared to about a 36.6 per cent increase in independent directors, the combined decline in executive and non-executive directors was about 44.8 per cent.

There was a decrease but not a significant one in board size from pre-governance to post-governance periods. When there is a decline in both executive and non-executive directors which is not fully compensated by independent directors, board size should shrink.

Significantly, more firms (29 per cent against 6 per cent) included a financial expert in their audit committees during the post-governance period. This was expected to improve performance with better financial management and prevention of fraud. Risks involved in not having adequate internal controls would have prompted more firms to comply with this regulation.

### **7.3.2 Dependent (performance) Variables**

According to the research question, there is also a need to establish whether performance variables have changed due to implementation of the new rules. This was done by measuring change due to implementation of new rules on performance variables. The results of this assessment are discussed below.

Firm performance variables, Tobin's q, ROA and ROE values did not change over the two periods. In the case of Tobin's q, the minimum value decreased from 0.33 to a negative number (-1.43) and the maximum value increased from 15 to 40.75 from the pre to the post-governance periods. Tobin's q measures market performance in terms of market value of its assets. The higher the value the better the market performance due to better governance. In this study it is assumed that the effectiveness of governance increases with increasing compliance with corporate governance rules. Although there was no overall effect, performance of the low-end firms (Tobin's q = 0.033 decreased to -1.43) did not benefit from the governance rules, possibly because they were at too low a level to obtain any significant impact. Their presence in the market would also be too low to enhance firm



market value. Firms in the top end with high pre-governance Tobin q values (15) benefitted from the rules as they were more market-efficient and thus obtained a higher Tobin q value of 40.75 in the post-governance period.

In the case of ROA, the minimum value changed from a higher negative number (-44.3) to a lower negative number of -24.2 from pre to post-governance periods. The maximum value decreased from 29.2 to 19.1 between the pre- to the post-governance periods. ROA indicates how efficiently the company assets are used for profit generation. For example, better use of process machinery (an asset) for higher production or to improve quality can increase price and/or sale volume and consequently give higher returns. It is the ratio of profit after tax to total assets. Therefore, ROA is often used to gauge the profitability of a business. Firms at the lower end of profitability (-44.3) benefitted by CG rules, as changes in their asset values are lower compared to changes in profit and are reflected in higher ratios. Firms which were at high levels of profitability (29.2) might either have increased their assets more than proportionate to profit growth or they may not have utilised their assets to the optimum level. The global economic crisis could have forced large companies not to go for aggressive profit making.

In the case of ROE, minimum negative values decreased from -168 to -83 and the maximum values increased from 57.1 to 159 from the pre to post-governance periods. Minimum values behaved in the same way as ROA with negative numbers involved. A company is more efficient when it is capable of generating high profits using shareholder equity. This can lead to high dividends to shareholders. Therefore, when compared to Tobin's q or ROA, ROE it is more relevant to changing governance mechanisms as it is directly related to shareholders' return. At the lower end of the values, although market efficiency was lower (indicated by decreasing Tobin's q), better utilization of assets (ROA) and better utilization of shareholder funds (ROE) increased profit of lower end firms. Increase in maximum values indicates the capability of high end firms in using share equities for large profit increases as their market performance (Tobin's q) is also high. Minimum values might have been from small firms and maximum values might have been from larger firms. If this is correct, corporate governance rules will benefit larger rather than smaller organisations.

The impact did not reflect on means of any of the three performance variables because both minimum and maximum were affected in a similar manner.

## 7.4 Correlation Results

The new rules are expected to impact on performance through their impact on corporate governance variables. So, if relationships can be established between corporate governance variables and performance, it can be reasonably concluded that the new rules impacted on performance through their effects on corporate governance variables. By comparing the pre-governance and post-governance periods, the relationship due to change effected by the new rules can be evaluated, as discussed below.

The effect of the new corporate governance rules on corporate governance variables of firms and the impact of this on firm performance can be evaluated by comparing correlations of corporate governance variables with performance variables during pre-governance and post-governance periods. A summarized table (Table 8.1) provides a comparison based on Table 6.4 in the results section.

*Table 8.1: Comparing the significant correlations of CG variables with firm performance variables during pre-governance and post-governance periods*

<b>Pre-governance</b>	<b>Post-governance</b>
<b>Family ownership vs ROA*</b>	Family ownership vs TA* Negative
<b>Government ownership vs TA**</b>	Foreign ownership vs TA*
<b>Individual ownership vs ROA, ROE-Negative*</b>	Government ownership vs ROE** and TA**
<b>Leadership structure vs TA**</b>	Individual ownership vs TA** Negative
<b>Executives vs Tobin Q**</b>	Non-executive director vs TA**
<b>Non-executives on board vs Tobin Q* Negative</b>	Independent director vs TA* Negative
<b>Board size vs Tobin Q* Negative, TA**</b>	Board size vs TA**
<b>Audit committee expert vs TA*</b>	

Note: ROA- Return on Assets; ROE-Return on Equity; TA-Total Assets

There were variations in the relationship of corporate governance variables with performance variables when comparing the pre-governance and post-governance periods. Only two relationships of government ownership with TA and of board size with TA during the pre-governance period were maintained during post-governance period.

### **Family ownership**

Family ownership was significantly and positively correlated with ROA in the pre-governance period. This means that during the pre-governance period increasing the proportion of family ownership increased ROA. ROA is the ratio of net profit after tax to total assets. It indicates the utilisation efficiency of assets to generate profits. Family owned firms invest their funds very carefully by selecting the best profit options. With good management structure involving mostly family numbers, such efficiency can be more likely achieved. When the proportion of such ownership increases, more profits are generated with the available assets. This could be the reason for the observed relationship.

In the post-governance period, increasing proportion of family ownership had a negative relationship with TA. The relationship with ROA no longer exists. TA is the denominator of ROA. If ROA did not increase when TA decreased, it means that profit also decreased. This means that corporate governance rules negatively affected profitability of firms with a higher proportion of family ownership.

### **Government Ownership**

The correlation coefficient of government ownership with TA was significant and positive for both the pre- and the post-governance periods. In the pre-governance period, increasing proportions of government ownership increased total assets as the government invests highly to fund its projects. Also, many investors may consider government-owned firms safer for investment even if the returns are lower. Thus total assets increased with increasing proportions of government ownership which also continued during the post-governance period. In the post-governance period implementation of corporate governance rules increased the efficiency of government owned firms and thus profits were obtained from equity investments. This increased ROE.

### **Individual Ownership**

A negative relationship of individual ownership with ROA and ROE during the pre-governance period changed to a negative relationship with TA during the post-governance

period. TA is the denominator of ROA, but not of ROE. In the pre-governance period, increasing proportions of individual ownership decreased ROA and ROE. Both can decrease when total assets increase. Increase of individual ownership means an increase in the number of single ownership firms. When profitability declines single owners may try to save the situation by selling off some of their assets. This will reduce total assets. Total assets declined although the proportion of individual ownership continued to increase during the post-governance period, possibly to escape the strict requirements of the new corporate governance rules. This means that the observed relationships are free of any effect of corporate governance rules. It must be remembered that the proportion of individual ownership proportion significantly from the pre- to post-governance period.

In the post-governance period, when TA decreased with the increasing proportion of individual ownership, ROA or ROE did not increase, as expected if only TA decreased. This can happen only if profit also decreases proportionately to the decline in assets. Therefore, new corporate government rules adversely affected the profitability of individual ownership.

### **Foreign ownership**

Foreign ownership was affected only in the post-governance period. It was positively correlated with TA after corporate governance rules were implemented. Hence, increasing the proportion of foreign ownership increased total assets. Improved compliance with the new corporate governance rules, attracted foreign investments to increase equity assets in the post-governance period.

### **Leadership structure**

Leadership structure was positively correlated with TA only in the pre-governance period. When more firms adopt the structure of having a separate chairman and CEO, there is greater compliance with corporate governance rules. The separation of roles would have helped to improve the efficiency of firms to acquire assets and more equities, and resulted in higher TA. This had already occurred in the pre-governance period, and no effect was observed in the post-governance period. Separation of the roles of chairperson and CEO was shown to result in better performance (Haniffa, R & Hudaib 2006), increased ROE and ROI (Rechner & Dalton 1991), and increased firm value (Yermack 1996). Other studies also show negative or neutral results. However, this study supports the positive effects of role separation. Leadership separation levels remained unchanged in the post-governance period.

The relationship effect is due to leadership separation, rather than compliance with the new rules, already being practised in many listed firms.

### Board Size

The significant relationship between board size and total assets both in the pre- and the post-governance periods is not surprising. As stated above, total assets represent firm size. Generally, the board size increases with the firm size, although it may not be proportional. There are numerous studies on the effect of board size on performance. A positive relationship was reported by Hillman, Keim and Luce (2001); Pfeffer (1972b); Dalton et al. 1999; Hillman and Dalziel (2003); Kiel and Nicholson (2003) and Pearce and Zahra (1991). The last two authors also reported a positive relationship with Tobin's  $q$ . A negative relationship was observed by Eisenberg, Sundgren and Wells (1998); Hermalin, Benjamin and Weisbach (2001); Jensen (1993); Singh and Davidson (2003); Yermack (1996); Lipton and Lorsch (1992); McKnight and Weir (2009); and Conger and Lawler (2009) all of whom asserted that the small size was better for corporate performance due to low agency costs. Some authors who reported no effect are Connelly and Limpaphayom (2004) and Andres and Vallelado (2008). One finding on the UAE by Aljifri and Moustafa (2007) also found a non-significant relationship.

A study by (Eisenberg, Sundgren & Wells 1998) found that the relationship between assets and board size was highly significant with an  $r$  value of 0.287. In the UK board size had a negative impact on Tobin's  $q$  and ROE. A negative relationship was observed for large firms having large boards (Guest 2009). Thus total assets can be indicative of board size and in turn firm size. Performance may be affected by board size.

Board size was negatively related with Tobin  $q$  in the pre-governance period. This effect disappeared during the post-governance period. As both board size and Tobin's  $q$  remained constant between the pre- and the post-governance periods (Tables 6.1 and 6.2), no relationship existed.

### Executives on the board

A higher proportion of executives on the board increased Tobin's  $q$  only in the pre-governance period. Tobin's  $q$  reflects efficiency of market capitalisation. While agency theory supports more outside directors, stewardship theory supports more inside directors. Donaldson and Davis 1991) observed that inside directors are more capable of dealing with business complexities of the firm, as they have inside information, while Klein (1998) noted

that the more the inside directors the better the performance, and that this reduced investment risks due to their better knowledge of firm operating conditions. The effect disappeared and no other effect was observed in the post-governance period.

### **Non-executive directors on the board**

While the relationship of executive directors with Tobin's  $q$  was positive in the pre-governance period, it was negative in the case of non-executive directors. One may be the reason for the other. Although firm value increases with a higher proportion of non-executive director (Matolcsy, Stokes & Wright 2004), it did not reflect in Tobin's  $q$  in this study. On the other hand, the negative effects of non-executive directors on firm performance has been reported by Agrawal and Knoeber (1996), Bhagat, Sanjai and Black (2000), Yermack (1996), Laing and Weir (1999) and Hermalin and Weisbach (1991).

The negative relationship of non-executive directors with Tobin's  $q$  during the pre-governance period changed to a negative relationship with TA during post-governance period.

Total assets are the denominator of Tobin's  $q$ . In the pre-governance period, either total assets increased or firm market value decreased or both occurred in such a way that the net effect was decreasing Tobin's  $q$ . In the post-governance period, the proportion of non-executive directors significantly decreased from 5.48 to 2.7. Therefore, there was a general decline in the proportion of non-executive directors. This could also have been due to conversion of firms to individual ownership. With the decreased level of non-executive directors, efficiency due to lack of monitoring would have been reduced, affecting TA.

### **Independent directors**

TA was negatively related with an increased proportion of independent directors on the board during the post-governance period. More independent directors led to less total assets after corporate governance rules were implemented.

In the literature, both the terms "non-executive" and "independent" are used synonymously. The presence of a higher proportion of non-executive or independent directors should suggest higher equity investment due to enhanced reputation and this should reflect in TA, but this did not happen in the present study.

## **Financial expert on audit committee**

There was a positive correlation of having a financial expert on the audit committee with TA during the pre-governance period. An audit committee prevents financial irregularities in the firm. The presence of an effective audit committee enhances the trust of investors and consequently increases investments. Thus TA will increase. Here, only 6 per cent of the firms had a financial expert in the audit committee in the pre-governance period. Yet this effect was observed only in the pre-governance period although compliance with this provision of corporate governance rules increased significantly in the post-governance period. The existence of an audit committee with or without a financial expert increases investor confidence. Therefore, if the listed firms already had audit committees due to the earlier regulation or adoption of international standards, then an increase of TA is expected during the pre-governance period. Improved performance as a result of the existence of a financial expert is not quite clear in this specific context.

## **General discussion on correlation results**

This research was undertaken to answer the question: What is the impact of the new corporate governance rules introduced in 2010 on corporate governance variables and performance of non-financial and financial firms and Islamic and conventional banks listed on the DFM and ADX?

Based on the correlation results during both periods, variables related to ownership concentration and board structure had the greatest impact. Among the performance variables, ROA was positively correlated only with family ownership in the pre-governance period. ROA and ROE was negatively associated with individual ownership in the pre-governance period and ROE positively associated with government ownership in the post-governance period. Tobin q and TA were the most frequently affected performance variables during the pre-governance period. TA was the only performance variable affected during the post-governance period. Based on these results, as TA is not a performance measure, it is difficult to conclude that the performance of firms which have ownership concentration or board structure in compliance with corporate governance rules were impacted positively.

Other studies obtained varied results. In the following two sections these are briefly reviewed in relation to the effect of ownership concentration and board structure on firm performance. The review may help to explain the results obtained in this study.

## Ownership concentration

(Demsetz, Harold & Lehn 1985b) and (Demsetz, Harold & Villalonga 2001) did not obtain any significant relationship between ownership structure and firm performance. They concluded that although diffused ownership might increase agency problems, it had features that compensated for such problems. Market-mediated ownership structures do not have any impact on firm performance. The authors used percentage shares owned by management and owned by largest 5 per cent of shareholders as the dependent variables. Ownership structure significantly varied with firm size, profitability, instability rate, and whether a regulated utility or financial institution or mass media or sports industry. If diffuse ownership can compensate for negative factors and thus enhance performance, it should positively correlate with firm performance. This present study showed that individual ownership affected ROA and ROE negatively, only family ownership affected ROA positively, and government ownership affected TA. Total assets were used as a control variable reflecting firm size. There is also an effect of diffusion of ownership in this study. Ownership diffuses when the firm grows larger (Demsetz, Harold & Lehn 1985a). The impact of TA could be non-significant until ownership diffusion reaches a higher level and then shows significance. When ownership is with individuals, there is no diffusion. The absence of control mechanisms increases risks leading to negative effects on performance measures of ROA and ROE which was found in this study. The relationship with ROA became positive when there was a slight diffusion of ownership into a family. During the post-governance period rules of corporate governance are assumed to have been implemented by all or most organisations. After implementing of the rules, individual ownership was negatively correlated with the control variable, total assets. Individual ownership affected TA negatively to a significance level of 0.01, family ownership affected TA negatively to a significance level of only 0.05, foreign ownership affected TA positively to a significance level of 0.05 and government ownership affected TA positively to a significance level of 0.01. Accordingly, as the ownership diffusion increased, direction and extent of the relationship became more favourable for an increase of total assets.

In this study only government ownership was related with ROE. Government ownership is highly diffused because it is public money. Therefore, implementation of corporate governance rules did not affect performance variables except in a very limited way. (Aljifri & Moustafa 2007) noted a positive relationship between government ownership and firm performance in the UAE in terms of Tobin's q, but ROE was not measured. For



institutional investors, the board size, the firm size and the audit type had a non-significant relationship with firm performance. Institutional ownership is more restricted than government ownership. Therefore, the findings of Aljiri and Moustafa (2007) demonstrated that more corporate variables are affected when ownership diffusion is less. New evidence from GCC countries (Aroui, Hossain & Muttakin 2014) suggests a significant positive association of family, foreign and institutional ownership on performance of GCC banks. Government ownership was not related with the performance of GCC banks. The two findings are contrary to those obtained in this study.

## **Board Structure**

In a study on 1796 Indian firms, (Jameson, Prevost & Puthenpurackal 2014) obtained a negative correlation of controlling shareholder board membership with Tobin's q. About 63 per cent of Indian firms have founder families on their boards and these families own more than 50 per cent of outstanding shares. Control of the firms remains with the families irrespective of board characteristics. Therefore, the observed relationship was not diminished by a higher proportion of independent directors, higher institutional ownership or large firm size. Also in this study a , negative correlation of Tobin's q for non-executives on the board and board size was observed, but this was before the rules were implemented. Often board members are given equity participation as a part of the compensation package. Then non-executives become shareholder members. Thus, the findings of this study are consistent with the Indian research.

In a Hong Kong study (Leung, Richardson & Jaggi 2014) observed that board independence, board size and composition positively influenced firm performance in terms of value-added efficiency of physical and intellectual resources. As these resources are assets, total assets increased. Since value-adding has occurred, it should have also reflected on Tobin's q. But this effect was not measured by the authors. In this present study, increasing the proportion of independent directors in the post-governance period was negatively related with total assets. This effect could be assumed to be due to implementation of corporate rules. If this is true, increasing independent directors to comply with the new corporate governance rules adversely impacted on performance.

According to Abidin, Kamal and Jusoff (2009) the stress on outside directors on boards by the Malaysian Code of Corporate Governance and by Bursa Malaysia are appropriate. To some extent this conclusion is different from that of Leung, Richardson and

Jaggi (2014). In the case of individual ownership, the question of the board and membership does not arise. In the case of family firms, rules may be amended to accommodate relatives on the board which then would not be independent. Therefore, the argument for a review of the rules is valid, particularly when it comes to independent board members on a board controlled by a family. But the effect of this on performance is not clear. Contrary to the positive association between board independence and performance reported by (Leung, Richardson & Jaggi 2014) and Al-Najjar (2014), no relationship was obtained by (Hermalin, Benjamin E. & Weisbach 1991) or by (Haniffa, R & Hudaib 2006). Hence, it is not certain that more independent members means greater effectiveness or better control leading to performance enhancement.

According to Clark, Murphy and Singer (2014), in a weak and ambiguous structure leadership influences firm performance. This means strong leadership can compensate for weak structure and influence firm performance. However, it is equally possible that weak structure does not allow the leadership to exercise its discretion effectively to influence firm performance. The findings of this present study indicated that this conclusion could be true. Almost all ownership types have shown a relationship with total assets before and/or after implementing the rules. Thus there is no evidence of a strong leadership affecting performance.

The results of Arouri, Hossain and Muttakin (2014) suggest that CEO duality and board size failed to give such a relationship. However, the findings were specifically related to the banking sector.

Most of the corporate governance studies have been conducted in western countries where corporate governance theories originated (Zeitun & Gang Tian 2007). The applicability of corporate governance theories to emerging market needs to be verified in specific contexts such as emerging markets which have their own unique cultural characteristics, and financial and tax systems as well as their unique political and geographical position which could have an impact on firm performance (Pedersen & Thomsen 1997).

Overall, it is difficult to support either agency theory or stewardship theory to explain the diverse findings on the relationship of board structure and composition with performance, which may be a reality in still emerging markets. The results of this study are also inconclusive.

## 7.5 Comparison of Financial and Non-Financial Companies

The research question included a comparison of financial and non-financial companies. Usually, corporate governance norms are more strictly enforced on financial firms. Comparative studies on financial versus non-financial firms might lead to assessing this element and subsequently link this with the differences in performance between the two types of firms. The results obtained are given in Table 6.6 and are discussed below.

### 7.5.1 Ownership Structure

The difference between mean values of family (0.06 for financial and 0.08 for non-financial) and institutional ownership (0.28 for financial and 0.29 for non-financial) were not significant. For the other three types, the differences were significant. Thus foreign (0.06 for financial vs 0.01 for non-financial), government (0.23 for financial vs 0.10 for non-financial) and individual (0.14 for financial and 0.27 for non-financial) ownership structures recorded significantly different values between financial companies and non-financial ones.

Generally, the compliance and the rule requirements are more stringent in the case of financial firms. This may discourage individuals from operating in the financial sector and may explain the lower mean value of individual ownership in the financial sector. Foreign companies may wish to influence foreign trade and financial policies in their favor. They enter in a way that allows them to finance large government development projects and other big ventures. Therefore, their presence in the financial sector is higher than that in the non-financial sector. If institutional types of financial and non-financial firms remain the same, the only other type of ownership which can enter the financial sector is the government. Governments may enter into the financial sector not only to own more shares and have investment returns but also to help the financial sector in case of crises and promote trust and stability to not only to the financial sector as the main development driver, but also the general economy.

Faccio, M and Lang, LHP (2002) observed that ownership in financial firms is more likely to be widely held. But Yeh, Shu and Chiang (2014a) argued that most financial institutions have concentrated ownership to protect private benefits of ownership control. Only affiliated members are included in their boards. Ownership rights can explain control rights, cash flow rights and their deviations. There is an incentive effect related to controlling

owners. However, restricted ownership reduces professionalism. This adversely affected the ability of financial firms to handle the recent global economic crisis in Taiwan, as shown by the same authors. However, these theories are not supported by this present study as financial firms are widely held in the UAE.

In Japan equity ownership of financial firms can be an effective substitute for external takeover (Lichtenberg & Pushner 1994). The influence of financial firms on globalisation did not diminish during the 1980's. This factor drives entry of foreign firms into developing countries, and could be one factor for the significant increase of foreign ownership in financial firms in the UAE.

The preference of Taiwanese firms for shared ownership with firms in the Greater China region is due to the high percentages of institutional ownership (Cho, Huang & Padmanabhan 2014). Such sharing systems do not seem to have occurred in the UAE. The data available from the UAE is inadequate to verify this.

In a study on Sub-Saharan African countries, (Munisi, Hermes & Randøy 2014) noted that ownership concentration, foreign ownership and managerial ownership were negatively related to board size. The ownership concentration was also negatively associated with outside directors. Government ownership was positively correlated with the proportion of outside directors. These results demonstrate the impact of several factors in determining the ownership structure of organisations: protection of ownership rights and control; the extent of professionalism required; external takeover threats; globalisation factors, the impact of the recent global economic crisis, the need to comply with country regulations on collaborations; and competitive edge of foreign partnership in determining the ownership structure of firms.

### **7.5.2 Leadership Separation**

According to Table 6.6, separation of the roles of chairperson and CEO is more frequent in financial (1.91) than in non-financial (1.78) firms, though the 2010 governance rule is mandatory for non-financial companies. No effect was noticed in the firm performance (ROA, ROE Earnings per share-EPS and profit margin) of Malaysian firms which had single or dual leadership during the 1994 to 1996 financial years (Abdullah 2004a). However, this study does not measure any effect of corporate governance rules, as the issue of corporate governance became dominant only after the Asian financial crisis of 1997/98. Outside directors and non-dual leadership structure generally dominated Malaysian boards. In effect, the study has measured the relationship of single leadership structure on firm performance.

On the other hand, results obtained by Haniffa, and Hudaib (2006) showed duality to be related to accounting performance for the period 1996-2000, when corporate governance became a dominant issue.

Daily and Dalton (1997), Lam and Lee (2008a), Weir and Laing (2001) and Abidin, Kamal and Jusoff (2009b) did not find any difference in firm performance whether or not the roles were separated. Wahba and Elsayed (2014) observed separation of roles to be beneficial while Brickley, Coles and Jarrell (1997) obtained better results with non-separation of the roles. The varied results prompted Firth, Wong and Yang (2014) to prescribe conditions for deciding on separation of the two roles.

In this study leadership separation was significantly and positively correlated with total assets in the pre-governance period, and was correlated with executive directors, board size and individual ownership in the post-governance period. Therefore, although performance is not directly impacted, total assets increased with increasing duality in the pre-governance period. But this effect was not sustained in the post-governance period. Increasing leadership separation occurred as a necessity when board size was increasing. When executive directors increased, there was a need to separate the roles for increased effectiveness. In addition, when the proportion of individual ownership increased, there was a need for separate roles to manage the firm effectively. Accordingly, separation of leadership roles was the result of other corporate governance variables. As such, these changes need not necessarily contribute to firm performance.

### **7.5.3 Board Composition**

According to Table 6.6 the proportion of executive directors on the board was the same both in financial and in non-financial firms. However, significantly higher numbers of non-executive directors and lower numbers of independent directors were observed in the case of financial firms compared to non-financial ones. The board size was similar in both cases.

Thus with the same board size and the same proportion of executive directors, a higher proportion of non-executive and a lower proportion of independent directors were present in financial firms compared to non-financial firms. Some extent of mutual exclusivity between non-executive and independent directors was noticeable, although it may not be accurately balanced. According to (Zattoni & Cuomo 2010) the proportion of the two categories of directors may be inter-related.

Several studies have investigated both favourable and unfavourable factors which determine the effectiveness of outside directors for monitoring and advising the company. These factors include: bias due to management selecting directors (Rosenstein & Wyatt 1990); advantage of political power (Agrawal & Knoeber 2001); effective advisory role (Kim, Mauldin & Patro 2014); and better monitoring (Cannella ; Jones and Withers (2015), role in functioning and removal of a CEO (Tran, Koufopoulos & Warner 2014), the favourable effect of having executives of other organisations as directors (Muravyev, Talavera & Weir 2014); and no advantage in preventing financial frauds (Peasnell, Pope & Young 2005). (Pfeffer 1972b) suggested an empirically determined optimal board structure equation. Any deviation from this equation can result in poor performance.

The above theories indicate that there is no specific advantage of having more outsiders as directors. Therefore, a higher number of non-executive directors or a lower number of independent directors need not have any special advantage in terms of performance.

Conflicting findings have been reported on the effect of outside directors on performance. A positive effect of outside directors on performance was reported by several studies (Baysinger & Butler 1985b), (Dehaene, De Vuyst & Ooghe 2001), (Jackling & Johl 2009), (Weir, Laing & McKnight 2002), (Krivogorsky 2006), (Musa & Eddie 2008). (Firstenberg & Malkiel 1980) even suggest that the majority should be outsiders. Australia and the UAE have rules favouring this approach. However, (Agrawal & Knoeber 1996), (Yermack 1996), (Sanjai & Bernard 2002) and (Liang & Li 1999) reported a negative relationship between presence of non-executive directors and performance. (Hermalin, Benjamin E. & Weisbach 1991) and (Haniffa, R & Hudaib 2006) suggest no relationship between the two.

There are both advantages and disadvantages of having outside or non-executive directors on the board depending on ownership, board structure and business contexts. Government, institutional and foreign firms have a better chance of having independent or outside directors. Financial institutions are more likely to experience misconduct or misuse of resources in addition to financial scandals, as the recent global economic crisis has shown. Therefore, the need for more independent and non-executive directors is higher in financial firms than in non-financial firms.

#### **7.5.4 Financial Expert on Audit Committee**

Audit committees monitor the reliability of financial reporting to enable timely identification of potential risk as well as detection of fraud. The benefits of having a financial expert on the audit committee have been endorsed by several authors (DeFond, Hann & Hu 2005; DeZoort 1997; Krishnan 2005; McDaniel, Martin & Maines 2002) and (Qin 2007). (Azam, Hoque & Yeasmin 2010) reported increased ROE in Australian firms.

In this present study more non-financial firms have a financial expert on their audit committees compared to financial firms (Table 6.6). Most persons in financial firms already possess good knowledge of finance, but non-financial firms do not enjoy this benefit. Non-financial firms require special financial expertise. This could be the reason for the observed trend.

### **7.5.5 Dependents (Performance) Variables**

Results given in Table 6.7 are discussed here. One aspect of the research question was comparison of the performance of financial and non-financial firms. Subsequently, the effect on performance before and after the introduction of the rules will be examined.

Tobin's q, ROA and ROE are performance variables. Only ROA and TA were significant. ROA of non-financial firms was higher than that of financial firms. Total assets (TA) is a control variable related to firm size. This was higher for financial firms. As the difference in board size of the two was not significant, the performance difference could only be attributed to ownership structure or board composition or both. Both Tobin's q and ROA have total company assets as the denominator. In the case of non-financial firms, ROA increased without increasing TA. This is possible only when higher profits are earned. Non-financial firms earned higher profits than financial firms. In the case of financial firms, only total assets increased and there was no profit increase; otherwise ROA would have increased. In the case of Tobin's q and ROE, the non-significant difference indicated equal efficiencies of both types of firms with respect to market valuation and utilisation of equity funds for profit generation.

## **7.6 Effect of Implementing the Rules on Non-Financial Companies**

Evaluation of financial and non-financial firms is done for joining the findings. The results are presented in Table 6.10 and discussed below.

### 7.6.1 Ownership Structure

Treating non-financial companies separately, Table 6.10 gives the results of the significance tests on corporate governance variables, comparing pre-governance and post-governance periods. The proportion of firms with family and government ownership structures remained constant between the two periods. The proportion of institutional and individual ownership firms increased significantly following the introduction of the rules. The increase was highest in the case of the proportion of individual ownership. On the other hand, the proportion of foreign ownership firms decreased significantly when the rules were introduced. Why should firms with different ownership structures behave differently when rules were introduced?

It can be concluded that the rules affect different ownership structures differently. The rules did not impact on corporate governance aspects of family and government ownerships. Therefore, they remained constant.

Institutional firms become more formalised when the rules are implemented. Many rules may not be applicable to individual investors. However, there is a tendency within ownership structure towards increased individual investors, which may suggest that the introduction of the governance rule increased the level of confidence within the individual investor's community as well as with institutional investors.

Rules were compassionate towards foreign firms and the UAE had a policy of promoting foreign investment. However, the proportion of foreign ownership decreased. Reluctance to operate in the turbulent Middle East environment and the after-effects of the global crisis could have forced the foreign owners to withdraw from the UAE and possibly from other countries as well.

Compare these results with what was observed as the overall effect in Table 6.2. In the overall effect, the changes in family, foreign and government ownership proportions were not significant. Institutional and individual ownerships increased significantly. However, in the case of non-financial firms, foreign firms decreased in the post-governance period.

It can be concluded that the introduction of the governance rule had a positive impact on the proportion of institutional and individual ownership while it negatively impacted on the proportion of foreign ownership of the non-financial companies for which the governance rule is mandatory.



## **7.6.2 Leadership Structure**

Table 6.10 indicates that leadership structure remained constant in both the pre- and post-governance period of non-financial companies. This suggests that there have been no significant impact on leadership structure of the introduction of the governance rule. However, the majority of non-financial companies do separate the roles of chairperson and CEO and do comply with the governance rule requirement to separate between these roles.

## **7.6.3 Board Composition**

Non-executive directors decreased significantly after the introduction of the rules. Executive and independent directors remained unchanged. The rules prescribe a specific proportion or minimum number of non-executive and independent directors. If this is already satisfied, their number will not change. Unchanged numbers of independent directors can be explained. However, in spite of the rules, non-executive directors decreased. If the companies are still within the prescribed numbers and proportions, then it should be acceptable. But with unchanged numbers of executive and independent directors, the decrease in non-executive directors alone would have reduced the board size. However, board size remained the same after the rules. This could mean that the decrease in non-executive directors was balanced by no decrease in executive directors.

In most rules, the combined number of independent and non-executive directors should be higher than the number of executive directors. The total of all directors is lower after the introduction of the rules (mean 7.70 compared to mean 8.18 before rules) and executive directors did decrease but not significantly. The overall conclusion may be that before the introduction of the rule, most firms had a higher than required number of executive and non-executive directors at the expense of independent directors. This was corrected after the rules, which required a more balanced and a properly sized board with the stipulated proportions. Before the rule, the proportion of non-executive directors was the highest, followed by lower and suitable numbers of independent directors and then executive directors in that order. After the rule, the order of directors became independent, non-executive and executive. This seems to be the impact of the rules. The trend was the same in Table 6.2.

Overall, the introduction of the governance rule had an impact on the board composition of the non-financial companies. However such an impact seems to have occurred to establish the right balance of board composition in order to reflect or to show that non-financial companies have complied with the governance rules requirements.

#### **7.6.4 Board Size**

Table 6.10 indicated that board size has remained constant in both pre- and post-governance periods of non-financial companies. This suggests that there have been no significant impact on board size by the introduction of the governance rule. However, board size has slightly decreased from a mean of 8.18 in the pre-governance period to a mean of 7.70, in the post-governance period. This may have occurred to adjust for the right board size as discussed. Furthermore, these mean values of the board size for both the pre- and post-governance rule periods are within the optimal board size range of 7.76-8.23 suggested by (Yermack 1996) who proposed that an optimal board size should be ten or lesser, whereas (Lipton & Lorsch 1992) argued that when board size exceeds seven or eight, it is less likely to function effectively. They also recommended that board size should not exceed ten members.

#### **7.6.5 Financial Expert on Audit Committee**

It seems compliance by a higher number of firms in the post-governance period, resulted in a significantly higher number of firms with a financial expert in the audit committee. Therefore, table 6.10 shows a significant change from a mean value of 0.07 in the pre-governance period to a mean of 0.40 in the post-governance period. The advantages of such an expert in audit committee have been discussed above, reflecting the general trend of Table 6.2. The governance rule of 2010 does require non-financial companies to have at least one financial expert on the audit committee.

#### **7.6.6 Dependent (Performance) Variables**

As indicated in Table 6.11, only ROA and ROE significantly decreased after the introduction of the rule. Tobin's q or total assets remained constant. Compared with the general trend, none of these was significant in Table 6.3.

Has compliance with the rules adversely affected performance? Although market performance did not differ due to the new rule, the two accounting-based performance indicators decreased after its introduction. As ROA decreased without increasing total assets, which means profits decreased. Low profits would have also decreased ROE; but this can happen if equity investment increases. If the new corporate governance rules increased the confidence of investors, irrespective of profits, equity investment can increase. This is a positive indication, which could have resulted from the introduction of the new rules.

Chhaochharia and Grinstein (2007) noted variations in compliance levels of small and large firms and concluded that compliance with corporate governance rules does not necessarily lead to improved financial returns. On the other hand, improved compliance and its effect on performance or other beneficial results due to better compliance with corporate governance rules were reported from studies in several (Goncharov, Werner & Zimmermann 2006) in Germany,; Wahab, How & Verhoeven 2007 and Saad 2010 in Malaysia, Black & Khanna 2007 and Balasubramanian, Black & Khanna 2010 in India; Alves & Mendes 2004 in Portugal; Dedman(2002 in the UK; Reddy, Locke & Scrimgeour 2010 and Chapple & Truong 2014 in New Zealand; Henry 2008 in Australia; Aggarwal & Williamson 2006 and Aggarwal, Schloetzer & Williamson 2014 in the US; and Reddy & Sharma 2014 in Fiji).

No effect on performance was noticed due to a low level of compliance in New Zealand (Hossain, Prevost & Rao 2001). A negative effect of low compliance level was noted by Shrives & Brennan (2014) in the UK, while Osemeke and Adegbite (2014) found conflicting multiple codes in Nigeria and the need for harmonisation of different codes was proposed by Ogbechie Koufopoulos (2014).

Based on a corporate governance index, Al-Malkawi, H-AN, Pillai, R &Bhatti, MI (2014) observed that 69 per cent of attributes were addressed by GCC firms. The UAE recorded best adherence to the index. In addition, the study indicated that all six GCC countries need to improve their quality of board effectiveness. They also suggested that the UAE can further improve its position on disclosure and board effectiveness content to be at the same high level of adherence observed for shareholders rights. In this present study, general lack of significance of many governance variables and lack of significance of the relationships of governance variables with performance variables suggest insufficient board effectiveness. These factors support the validity of the recommendations discussed later.

Sometimes, effectiveness of boards can compensate for low levels of compliance and the firm can perform well according to a Canadian study (Conheady et al. 2014).

The likelihood of false or mock compliance was indicated by (Joseph, Ocasio & McDonnell 2014). (Siddiqui, J & Ferdous 2014) note that this can impair the quality of the findings regarding compliance. This is consistent with the observations of (Enrione, Mazza & Zerboni 2006) who argued that late adopters of corporate governance rules/codes are likely to mimic established governance practices for the purpose of gaining legitimacy within the environment in which they operate.

The majority of the above-cited findings suggest that a higher level of compliance with corporate governance codes enhances performance measured by various instruments. It is also notable that effective boards can compensate for shortfalls in compliance at least to some extent. In spite of instances of possible mock compliance, most firms may be sincere in complying with the codes in order to improve performance and gain stockholder acceptance.

Although some research suggests unchanged performance after the introduction of codes, a few reported a decline in performance. Such a decline in performance was also observed in this study. ROE and ROA decreased after the new rules were implemented. Compared to their Western counterparts, the UAE management professionals may have lower expertise and experience. This leads to a steeper learning curve in translating corporate governance rules into business advantage. During the learning period, alignment of various policies and strategies of the firm with compliance on corporate governance rules may be inadequate. This study evaluated the effects of only the first two years of implementation of the rules. In the longer term, UAE firms may show better performance. This conclusion is supported by the findings of Al-Malkawi, H-AN, Pillai, R &Bhatti, MI (2014) that all GCC countries including UAE need to improve board effectiveness.

## **7.7 Influence of the Governance Rules on Financial Companies:**

To answer the research question on comparison of financial and non-financial firms, it is important to evaluate financial firms as has been done for non-financial firms in the above section.

### **7.7.1 Independent Variables**

The data given in Table 6.13 is discussed below.

None of the corporate governance variables (ownership structure, leadership separation, board structure, board size and independence of the board and having a financial expert on the audit committee) changed due to implementation of the rules. Thus, there is no influence of the rules on corporate governance variables of financial companies. This could be due either to these companies already meeting the rule requirements even before their introduction or to the changes made after the rules being small and having no impact. Comparing the two values of each variable, the differences between the values before and after the period were reasonably wide for institutional ownership, foreign ownership, executive, non-executive and independent directors on boards and a financial expert on the audit committee. The differences between both periods are insufficient to produce significant impact. If the financial firms had already complied with the rule requirements before their introduction, it is unlikely that any increase in these variables would take place to comply with the rules, as companies are already compliant.

In the overall result given in Table 6.2, both institutional and individual ownerships increased significantly after the rules. There was a similar result in the case of non-financial firms. It seems non-financial firms have accounted for the entire variation of ownership structure in the overall effect. Ownership structure of financial firms did not change after the rules.

The same conclusion can also be applied to the results obtained on board structure. It may be concluded that the entire variation in this case was also accounted for by non-financial firms for which the new governance rules is mandatory. Therefore, the board structure of financial firms did not change after enforcement of the new rules.

In the case of other corporate governance variables, firms in the non-financial sector but not in financial sector have changed their status at different levels of significance. Overall, the impact of the new rules on financial firms was less obvious maybe because they were already compliant with most of the requirements or because the required changes were too small to cause any significant differences.

### **7.7.2 Dependent (Performance) Variables**

The data given in Table 6.14 is discussed below.

As with the corporate governance variables, none of the performance variables or the control variables changed due to introduction of the rules. According to the literature discussed above, firm performance should improve when one or more corporate governance variable improves.

In the overall picture, none of the performance variables was significant. In the case of non-financial firms, Tobin's q increased but not significantly after the introduction of the rules and both ROA and ROE declined significantly. In the case of financial companies, none of the performance variables was significant. However, the market-based performance measure of Tobin q showed a declining trend, whereas both of the accounting-based performance measures of ROA and ROE showed increasing trends. Hence, similar results were obtained in the case of both non-financial and financial firms, although there were variations in the levels of significance.

Both in the application of corporate government rules and their effect on performance, non-financial and financial firms behaved more or less similarly. Thus, implementation of corporate rules failed to impact on either type of firms with respect to change in governance variables or performance.

## **7.8. Islamic Versus Conventional Banking (Table 6.16)**

One of the purposes of this study was to compare Islamic banks with conventional banks for any improvement in corporate governance resulting in improved performance as a consequence of the introduction of the governance rules. The research question relating to this aspect is answered in the following discussion.

Neither corporate governance variables nor performance variables were significant between the two periods for both Islamic banks and conventional banks. There was no effect of the rules on any parameter. Here too, it can be argued that both types of firms had already fulfilled the requirements of the rules regarding corporate governance structure. Hence there was no change. Consequently, no change in performance attributable to rules occurred. Moreover, this suggests that both types of banks were similar in their reaction to or the influence of the rules.

Varied results have been reported in the literature when the two types of banks are compared. In many studies, there are no clear and significant differences in performance variables. Better economic stability due to better asset quality, credit an assets growth and capitalisation, but with weak risk management and lower profitability, have been reported (Hasan & Dridi 2010; and Beck Demirgüç-Kunt & Merrouche 2013). No significant difference between the two types of banks was reported by Bourkhis and Nabi (2013) in withstanding crises (see also Ariss 2010). Islam, Alam and Hossain (2014) reported that conventional banks were more profitable in Bangladesh with higher ROA and ROE.

Generally the two types of banks are compared for various operational efficiencies and quality of operative variables. Difference exists in credit performance, but not in profitability or liquidity in Bahrain (Samad 2004). Islamic banks were better with respect to total equity, total deposits, total investments and total assets (Iqbal 2001),,in capital adequacy, better liquidity, and fewer loan losses, whereas conventional banks were better for managerial efficiency and earning ability (Jaffar & Manarvi 2011).

Results of multiple studies in the same countries- Malaysia and in GCC countries for example – for different periods show highly context-specific and period-specific effects on these differences. In the case GCC countries, Olson and Zoubi (2008) observed the same financial ratios for both and lower efficiency for Islamic banks. Zeitun (2012) observed for

the 2002-2009 period differing characteristics for the two types of banks. (Johnes, Izzeldin & Pappas 2009) for the period of 2004-2007 and Johnes, Izzeldin and Pappas (2014) found Islamic banks less cost efficient but more revenue and profit efficient with higher net efficiency reflecting in higher ROA and ROE for Islamic banks. Ho et al. (2014) studied the differences during the period 2003-2011 and found Islamic banks better in crises; ROA was lower and ROE higher than conventional banks during the early part of year. In the UAE Hassan Al-Tamimi (2010) obtained higher liquidity and concentration for conventional banks and dependence of these on cost and number of branches for Islamic banks. In Malaysia-Samad (1999a, 1999b) obtained increased managerial efficiency in conventional banks. Al-Mamon et al. (2014) noted higher ROA for conventional banks. Thim et al. (2014) noted better quality assets, more liquidity and higher profitability in conventional banks. Hence, in Malaysia, conventional banks seem to have clear superiority.

There were large differences across countries and size of Islamic banks, which is a factor in comparing studies across countries. This is possibly the reason for many researchers not finding significant differences. The size of Islamic and conventional banks could be different within the UAE itself, which could also have affected the results of this study.

There is a perception that Islamic banks are drifting away from their theoretical business model. Sticking to their theoretical model would have enabled them to withstand the crisis better than the conventional banks, as was pointed out by Bourkhis and Nabi (2013) and (Hasan and Dridi (2010)). The rules have SSB as a compulsory requirement for Islamic banks. This should ensure that Islamic banks adhere to their theoretical model. Excepting this special requirement, all the corporate governance rules and variables are the same for both types of banks. It is not easy to avoid the profit concept, even for an Islamic bank as its long-term business sustainability depends on profits.

Comparisons for different periods in the same country demonstrate how well context-specificity influences the results. Thus, the difference between the two types of banks may be due to different causes in different contexts.

In theory, Islamic banks are not as vulnerable to instability as conventional banks due to their risk sharing nature. However, they end up paying investors competitive market returns regardless of performance. Therefore, the advantage is not realised. Very often Islamic banks drift from risk sharing activities towards asset-based short-term and low-profit trade contracts. Risks due to inadequate compliance with Sharia laws, and misinterpretations



of Sharia rules, equity investment risk, and rate of return risk increases the pressure on Islamic banks to pay a competitive rate of return to their IAH to encourage them not to withdrew their funds to invest them somewhere else.

Various studies have compared Islamic and conventional banks on various aspects including performance variables like ROE and ROA. Limitations of sampling, overlap of other effects like the global economic crisis, different socio-political environments, different cultural backgrounds, different legal and regulatory requirements and not including well-known banks even in multinational studies are some of the limitations of these comparisons which affect the validity of their conclusions.

In this study there is a general absence of significance for any variable when comparing financial with non-financial institutions or when comparing Islamic banks with conventional banks between the pre- and the post-governance periods. This result strengthens the argument that UAE management professionals are on a steep learning curve and they need to increase the effectiveness of boards in aligning firm policies and strategies with corporate governance mechanisms for their best business advantage.

### **7.8.1 Sharia Supervisory Board -General Discussion**

The research question includes evaluation of Islamic banks as they are also listed on UAE stock exchanges. Compliance with Sharia laws is essential for Islamic banks. Corporate governance rules insist on such compliance specifically for Islamic banks. They need to establish a Sharia Supervisory Board to oversee this compliance and report on its status each year. Various elements of AAOFI standards are adopted by the UAE and the results obtained in this respect are discussed below.

In Table 6.18 statistics regarding Sharia supervisory boards in Islamic banks are given. Variables of compliance with AAOIFI governance standard for Islamic financial institutions were used as evaluation parameters. Full compliance was detected only with respect to details of SSB members. The compliance was partial or absent regarding their activities, accountability or appraisal. It is not clear whether there is any confusion regarding the terms “depositors” or “IAH” although in this study confusion is assumed.

(Haniffa, R & Hudaib 2007) reported a high degree of disparity between what was ideal and what was practised with respect to disclosures in annual reports by Islamic banks. This applied to SSB and its reports as well. The findings on SSB are similar to those of the present study.

(Rammal 2006) pointed out some limitations with regard to SSB functioning. In many cases SSB review becomes a mere routine, endorsing management decisions. Since the SSB members receive remuneration from the bank they serve, there is a conflict of interest with regard to their independence. They may endorse dubious transactions to ensure their continuation in the board. The relationship of external auditors with SSB is ill-defined. These problems can provide some reasons for partial or nil compliance with respect to SSB activities noticed in this study.

The survey of 29 Islamic banks by (Safieddine 2009) revealed that most of the banks complied with all aspects related to SSB with respect to their independence, composition, qualifications and enforcement of decisions. (Garas & Pierce 2010) pointed out that SSB control over Islamic financial institutions was greater than for other types of Sharia compliance. The position of an SSB in the corporate hierarchy is also not clear among different IFI. In a Pakistan report (Akhtar 2006a) attempted to apply global guidelines on corporate governance to Sharia-based corporate governance. The need to define the roles of SSB, its position in relation to the management and its board, and its role in protecting investor rights were recognised. These needs are also highlighted by the findings of this study.

(Vinnicombe 2010) used a benchmark index to measure compliance of Islamic banks with AAOIFI standards. Compliance levels were different for different governance standards like supervisory boards, reporting Murabaha contracts (high level) and zakat (tax) and Mudaraba contracts (low level). According to (Garas 2012), significant conflict of interest was noticed with respect to SSB of GCC Islamic financial institutions. The variables affected were: executive position, relation between SSB members and board of directors and membership in Islamic funding and membership in trading companies of capital markets; but their remuneration was not. Conflict of interest can affect effective functioning of SSB members. This will affect compliance with Sharia rules by Islamic financial institutions. (Rammal & Parker 2010) noted that there was only a limited number of Shari'ah advisors in Pakistan serving multiple organisations contrary to the rules and creating situations of conflict of interest. The dual internal and external role of Shari'ah advisors increases this conflict of interest. Certainly, such problems affect effective functioning of SSB and hence compliance. The level of disclosure in annual reports of Indonesian Islamic banks was tested by (Darmadi 2011) using an index. Disclosure was good with respect to board members and risk management, but it was poor in the case of internal control and board committees. (Mejía

et al. 2014) also identified these problems of SSBs in their IMF report. Some of these above reasons may explain the low compliance level with respect to some variables of SSBs observed in this study.

In Bangladesh (Belal, Abdelsalam & Nizamee 2014) found that over a period of 28 years from 1983-2010 the Islamic Bank Bangladesh Limited had been shifting focus in response to changing needs. Although disclosure through annual reports have improved over time, disclosure on sources and uses of disposable income are yet to improve. There is increasing dependence on debt-based financial instruments, which is closer to conventional banking and perhaps reflects both global and local influences. According to (Ashraf, Hassan & Basher 2014), SSBs act as an additional tier of governance rather than as an independent monitoring and control agency. This leads to lower earnings management. They studied 291 banks from 35 OIC (Organization of Islamic Cooperation) countries. They argued the additional tier of governance by SSBs was justified based on the differences in corporate governance requirements of Islamic and conventional banks and their bases of activities. SSB can mitigate lower earnings management. However, the same study indicated that the SSB characteristics like size and competence and objectivity of members are not related with earnings management. On the other hand did not obtain any relationship of SSB characteristics on financial performance of Islamic banks in the GCC and South East Asian countries. Disparity between ideal and disclosed (through annual reports) ethical identities are possible and disclosures of SSBs were negatively correlated with performance. The explanation for this result is that only disclosure of products and services and commitments towards employees were related with performance (Zaki, Sholihin & Barokah 2014). Mediating effects of ROE and ROA on the relationship between SSB effectiveness, intellectual capital and capital employee and structure and capital efficiencies were reported by (Musibah, Salem & Alfattani 2014). In Tanzanian Islamic banks SSB members appeared to be lacking competence in Islamic jurisprudence, although most of them did possess adequate knowledge of Islamic finance (Chalu 2014). There are indications of SSB characteristics affecting performance in these reports.

The findings of (Ahmed, M 2015) show that it is possible to finance a project meeting both US laws on investor protection and Sharia laws by suitably combining them. In an East Cameron Sukuk (Islamic Bonds) issuance (Islamic Bond) project in the US, protection of investor rights was achieved through ownership of assets and Sharia compliance was achieved by share of returns and risks of the project.

The above discussions clearly show that compliance with governance standards of the AAOIFI has many dimensions. The structure, knowledge and competence of SSB members, their relationship with board and top management, independence, confidentiality, conflict of interest arising out of memberships in multiple SSBs and need to match with global economic factors can determine the extent of compliance leading to variations in quantity and quality of disclosures in annual reports. The ability of SSBs to monitor financial institutions to prevent financial irregularities is also determined by these factors. Findings vary regarding the effect of SSB on performance. As was seen in Tables 6.16 and 6.17, Islamic banks did not differ significantly from conventional banks in performance either fully or as affected by the introduction of the rules.

## **7.9 SSB Discussion and Implications Specific to Sub-Variables of Table 6.18**

### **7.9.1 Sub-Variable (1) Total Number of SSB Members (Min 3 by AAOIFI)**

The descriptive analysis in Table 6.18 (sub-variable 1) in relation to the minimum number of SSB members recommended by the AAOIFI show the mean value is 100 per cent. The AAOIFI recommended that a SSB should consist of at least three members as a minimum number. The mean value of 100 per cent indicates that all the four Islamic banks in the UAE comply with the recommended number of Sharia board members and thus the SSB board size as well. However, one of the banks showed that it has outsourced the function of SSB to an external consultancy firm that provides Sharia services. Outsourcing the SSB function to a third party by an Islamic bank may indicate that the bank is not willing to keep SSB on its payroll, and aiming to cut costs. It could also indicate that outsourcing SSB is due to certain disagreements that could have occurred earlier between SSB and management or the board of directors over certain Sharia related matters. It may also indicate a shortage of qualified Shari' a scholars. The consultancy firm that offers Sharia services will not be in a position to closely monitor banking transactions and financial contracts which may result in Shari 'a compliance being overridden or compromised (Arshad & Wardhany 2012).But it is equally possible that outsourcing this function will ensure its independence, especially if there was an earlier dispute between the SSB and the firm.

Outsourcing the non-core business functions within firms is a common practice used to reduce or cut costs. Nevertheless outsourcing Shari' a function byan Islamic bank is not particularly common, as Shari's function is the core element on which IFIs are founded. Outsourcing Shari' a compliance function seems to be a growing practice within the Islamic institutions operating in Malaysia (Arshad & Wardhany 2012). AAOIFI in its Governance Standard for Islamic Financial Institutions No. 1, Para 3 states that:

Every Islamic financial institution shall have a Shari' a supervisory board to be appointed by the shareholders in their annual general meeting upon the recommendation of the board of directors taking into consideration the local legislation and regulations. Shareholders may authorise the board of directors to fix the remuneration of the Sharia supervisory board.

The standard clearly states that a SSB is to be established in every IFI and to be appointed by the shareholders in the annual general meeting. Therefore, outsourcing Shari' a compliance services contradict the fundamental principles of the AAOIFI Governance Standard requirement. On the other hand, if the local legislation and regulations allow outsourcing as an exemption to AAOIFI standards, it may be valid. Perhaps, this is what is happening in Malaysia. In this present study one bank out of four outsourced the Sharia functions to a third party. If the UAE legislation and regulations do not permit this, there is clear violation of the codes.

### **7.9.2 The SSB Report includes an assurance that the Financial Statement has been examined for “appropriateness of allocation of profit & loss between shareholders and IAHs” exist and are maintained in accordance with Sharia principles (recommended by the AAOIFI).**

The descriptive analysis in Table 6.18 (sub-variable 2) in relation to the SSB report if it includes assurance that the Financial Statement have been examined by SSB for “appropriateness of allocation of profit & Loss between shareholders and IAHs” exist and are maintained in accordance with Shari ‘principles (recommended by AAOIFI). The mean value of compliance among the four Islamic banks was 25 per cent and a standard variation of 50 per cent. It shows that only 25 per cent of the banks complied with this requirement and the remaining 75 per cent were non-compliant. Moreover, the standard deviation of 50 per cent indicates the extent of variation between the UAE Islamic banks in this respect.

The low level of compliance on assurance of financial transactions could be attributed to the principal-agency problem. According to (Ghayad 2008; Karim 2001) there is a principle-agent problem within Islamic banks which represents a conflict of interest between shareholders and IAHs and consequently may impact on performance. Islamic banks offer investment accounts and such accounts raise contractual relations between the bank’s shareholders and the holders of these investment accounts given the fact that Islamic banks are generally incorporated as a limited liability company and the contractual relations of human-made law are entered into between the IAH and the bank as a legal person and not between the IAH and the shareholders (Archer, Karim & Al-Deehani 1998). The issue lies in the imbalance between management and attributed control rights. Though the aggregate investment portfolio or asset pool of an Islamic bank is usually financed by IAHs funds, IAHs do not have the right to interfere in the management of their funds which is the responsibility of the Islamic bank. Thus, the governance practices of Islamic banks do not grant IAH any authority to interfere in the appointment of the management team, the external auditor or the SSB (Archer, Karim & Al-Deehani 1998). The management of the Islamic banks have the discretion to invest and mobilise IAH funds based on the type of contracts entered into between the two parties. But the level of commitment is limited to the details and conditions of such contracts regardless of whether it is restricted or unrestricted IAHs. Its fulfilments and satisfactions by the bank’s management remains more a matter of trust

(Archer, Karim & Al-Deehani 1998; Karim 2001). Furthermore Ghayad (2008) argues that the IAHs' capital is at risk as they do not have the authority to exercise control over management practices and are not in a position to impose monitoring measures on management. Such structural problems increase the chances of potential conflict of interest between IAH and the shareholders, an issue that is also present in the principal-agent relationship of typical conventional companies (Archer, Karim & Al-Deehani 1998). Such conflict of interest between the shareholders and IAHs is consistent with the findings of (Al-Deehani, Karim & Murinde 1999) in which an increase in investment account financing yielded positive shareholder income and this increased the Islamic bank's rate of return on equity at no extra financial risk. Thus the cost of capital remained constant and its market capitalisation value increased for the benefit of its shareholders. The non-compliance with specific requirements of the AAOIFI may indicate that no proper controls are being maintained by the SSB over the appropriateness of allocation of profit and loss between shareholders and IAHs. This may also indicate that, at least to some extent, operations of Islamic banks may not be fully in compliance with principles of Sharia law which is the core on which the Islamic banking system should operate. The inconsistency among reporting style of Islamic banks is quite evident from the use of the different terms by different banks in the same context. For example, some banks use the term "investment accounts" which is similar to the relevant literature and in agreement with the AAOIFI's and some others' use the term "depositors". The term IAH should be given particular emphasis within Islamic governance mechanisms and should be differentiated from the general term of depositors customers (Majid, Sulaiman & Ariffin 2011). These authors conducted a study to establish a "best practice" model of CG disclosure for IFI, clearly developed and suggested that a governance committee (GC) may be established specifically to ensure that conflict of interest does not exist between shareholders and IAHs, in addition to ensuring that the interest of IAHs are protected (Majid, Sulaiman & Ariffin 2011). The inconsistency in the reporting style of Islamic banks could create confusion and may raise some level of caution and concern among the users of the annual reports, some of whom would be analysts, credit rating agencies, customers and most importantly the potential investors who may be interested in investing in Islamic banks. It can be argued that inconsistencies as well as the usage of loose, unspecific and vague terms particularly in SSB reports may divert investors and consequently negatively affect the growth and performance of Islamic banks. Moreover, the continued lack of governance right of IAHs may indicate a lack or a weakness in the investors' protection, leading to a reduction in potential investors or may result in the

withdrawal of current IAHs funds to other safer environments (Olson & Zoubi 2008) remind us that one of the duties of SSB is to advise on the distribution of income or expenses among shareholders and investment account holders. It can be observed from Table 6.20 for the regression that compliance of Islamic banks on this requirement in their SSB report affects Tobin's  $q$  negatively by a factor of  $-.092$ . This may indicate that investors of Islamic banks are more conscious about ensuring a high return on their investments rather than whether their investments are Sharia compliant

### **7.9.3 If Multiple Directorship of SSB Members Exist**

According to descriptive statistics for sub-variable 3 regarding the question- If multiple directorship of SSB members exist within the four Islamic Banks, the mean value obtained in this study (Table 6.18) is 100 per cent with a standard deviation of 0 per cent. Thus all the banks reported multiple directorship practices among their SSB members. This result confirms the findings of previous studies (Bin Hasan 2011; Rammal 2010; Unal 2009). Some of these studies attributed this problem to the shortage of qualified individuals who can perform the duties of a Sharia board member. It is recognised that such practices raise conflicts of interest which may also affect accountability, as indicated in a study by (Lai 2014). There may be some benefits in engaging in multiple Sharia boards: for example, an SSB member may gain experience and knowledge and develop skills as a result of different environmental settings and exposure to different business strategies (Li, Joanne & Ang 2000). However excessive Sharia board positions in many Islamic Financial institutions at the same time could negatively affect the efficiency of SSB scholars/members and consequently their performance, in addition to potentially raising issues of agency problems and conflict of interest.

Multiple directorship practices and their relationship to corporate governance have been discussed by many authors (Alexander, Murray & Houghton 1994; Ferris, Jagannathan & Pritchard 2003; Kiel & Nicholson 2006; Li, Joanne & Ang 2000). A director's main duty is to provide continuing monitoring of management. Therefore, the amount of diligence of each director can be measured by the quantity of time spent. In this study, the number of meetings attended is considered a relevant measure to assess their performance. Furthermore, for a director to understand the details of his/her role, he/she needs to spend quality time in the company in order also to keep themselves informed about latest developments that is taking place within and outside the environment of the company. A board member has also his/her



private and professional considerations and commitments. All of this suggests that there are physical and mental limitations on how many boards a person can serve as director and can actively be involved and be efficiently participative. Li, Joanne and Ang (2000) argued that the quantity of time a director can dedicate to a board on average declines with the number of board appointments and the director is assumed to be less efficient and less effective with an increasing number of board positions. A director could not invest the required quality of time to acquire information about the firm as a precondition for efficient and effective monitoring. (Sorour & Ken 2014) observed poor SSB-related disclosures in annual reports. A large number of members sit on multiple SSBs. This affects independence, confidentiality and objectivity of these SSBs.

Value can either be increased or created by a director who dedicates his/her full time to perform his/her duties of monitoring and ensuring, compliance, regularity and smooth running of the businesses and by an expert who performs his/her job in a routine way even with limited time.

It is worth noting that a SSB member's position, duties, responsibilities and scope are extremely significant to the bank. SSB represent the whole idea of Islamic banking and for an SSB member to ensure success they therefore need to possess not only a wide knowledge of Sharia and Islamic principles, but also a full conceptualisation of the banking business model and be free of any conflict of interest. An SSB member, to be able to face future changes and complexities that are evolving within the banking industry, needs to develop and possess the qualities which will enable them to strategize Islamic banking. The debate over the impact of the multiple directorships on Islamic bank performance needs to be addressed and investigated with regard to whether it is acceptable by Sharia law and Sharia principles. About the independence of the SSB, the AAOIFI states that "The principle of objectivity imposes obligations on SSB members to be fair, intellectually honest and free of conflict of interests (neutral). (para 2)."

#### **7.9.4 SSB Members with Sharia knowledge, finance and relevant qualifications and experience**

According to the descriptive statistics, the mean values for sub-variable 4 regarding the question: Do SSB members possess the Sharia's knowledge, finance and relevant qualifications and experience exist within the four Islamic banks (Table 6.18) is 100 per cent with a standard deviation of 0 per cent. These values indicate that SSB members of Islamic

banks in the UAE are well equipped with proper educational background and expertise for a right balance of scholarship in Islamic knowledge and Sharia principles with Islamic banking experience on one hand and finance, economics and law on the other hand. Most if not all of the SSB members are doctorate degrees holders in the relevant educational disciplines. This is a positive indication, in that an SSB with the right balance of qualifications, skills and expertise would be able to deal not only with Sharia related matters, but also be capable of dealing with matters related to finance, economics and law within Islamic principles and concepts. The findings of this study are consistent with those by (Ghayad 2008) in which it was argued that in addition to knowledge of Sharia, the SSB must have the qualifications in finance and economics to deliver better quality services to Islamic banks. It is assumed that if the level of services delivered to the Islamic banks by the SSB is improved, the performance of the bank is also enhanced though an effective and constructive dialogue between SSB, management and the board of directors as all would speak a similar language. In the initial phase of Islamic banking, one of the issues faced on the managerial level was that the SSB and management had difficulties in understanding each other, because SSB members had the right knowledge of Sharia, but not the experience and knowledge of other disciplines such as law, economics and commerce. The AAOIF 7 states that “The Shari ‘a supervisory board may seek the service of consultants who have expertise in business, economics, law, accounting and/or others. The Sharia supervisory board should not include directors or significant shareholders of the Islamic financial institution”. Apparently, there was no need for the services of consultants when the SSB members were fully equipped with the required expertise.

### **7.9.5 Is Appraisal conducted on the performance of SSB Members?**

According to the descriptive statistics, the minimum, maximum, mean and the standard deviation values is 0 per cent for sub-variable 5 regarding If appraisals are conducted on the performance of SSB members, within the four Islamic bank (Table 6.18). None of the four Islamic banks has disclosed or mentioned that SSB are subject to periodical appraisals. Bin Hasan (2011) reported that 43 per cent of Islamic financial institutions in Malaysia, the Gulf Cooperation Council (GCC) and the UK do not assess or evaluate their Sharia Supervisory Board’s performance. The UAE is the context of this study and it is a member of the GCC. The trend that the SSB are beyond any evaluation and assessment within Islamic banks may raise questions regarding the effectiveness and efficiency of the SSB members. This will have an impact on the performance of the board itself and on the

overall performance of the bank. SSB is a core governance device in Islamic financial institutions and therefore it needs to be a lead example for best corporate governance practices, especially on matters such as reporting, disclosure and transparency.

### **7.9.6 Accountability of Sharia Supervisory Board**

According to the descriptive statistics regarding sub-variable 6 of Accountability of SSB within the four Islamic bank (Table 6.18) the mean value is 75 per cent with a standard deviation of 50 per cent. Thus most of the Islamic banks have their SSBs accountable to the shareholders. This also means, 75 per cent of the four Islamic banks do issue a Sharia report addressed to the bank's shareholders with the exception of one Islamic bank (bank D), where no information or data was found to suggest it issues a Sharia report or an annual report. It is assumed that issuing the SSB report to shareholders indicates that the mechanism of accountability does exist within the governance structure of the Islamic banks. It is interesting that although three out of four Islamic banks issue Sharia reports, only one of them had an assurance that financial transactions were examined and found to be in order (Results of sub-variable 2 discussed above). However, no further information regarding the functionality, processes and the implementation of accountability have been disclosed in the annual reports of the banks. It is imperative to re-emphasize that Islamic corporate governance treats accountability, disclosure and transparency as core elements of its principles (Darmadi 2013; Fitrijanti & Alamanda 2013). Lack of proper disclosure may negatively impact on public perception regarding accountability within Islamic banks. The AAOIFI in its rationale for the establishment of the IFI's governance framework in this regards states that "The governance principles are founded on the need for structures leading to enhance compliance, transparency, accountability, fairness and equitable treatment of stakeholders. (para 9)". Addressing and disclosing accountability within Islamic banks and in particular the accountability of those who are responsible to and are trusted by shareholders would strengthen the position of banks within the environment in which they operate and would help them gain legitimacy and public credibility. Furthermore, a proper disclosure in Islamic banks could enhance their reputation (Darmadi 2013). In Table 6.20 regression tests clearly indicated that there is a positive significant relationship between accountability of SSB and Tobin's q, suggesting that accountability of SSB is appreciated by the markets in the UAE. According to the regression test, a unit increase in accountability of SSB would lead to an increase in Tobin's q by a factor of .228. This is in agreement with the above mentioned standard put forward by the AAOIFI.

### **7.9.7 Frequency of SSB Meetings**

According to the descriptive statistics regarding sub-variable 7 (the frequency of SSB meetings, within the four Islamic banks, Table 6. 18) the mean value was 0 per cent. None of the four Islamic banks disclosed information regarding the frequency of SSB meetings. In fact, only one bank indicated in its annual report that its SSB has held many meetings during the financial year, but there was no information regarding the frequency of these meetings. Thus, there is no proper disclosure with regard to the SSB meetings. In other Islamic jurisdictions, for example in Indonesia, the Central Bank of Indonesia as a regulator of Islamic and non-Islamic banks, requires the SSB of Islamic banks to have board meetings at least once a month and to submit periodic supervisory reports to Bank Indonesia (Darmadi 2013). The frequency of SSB meetings during the year, the attendance of every member of the SSB, directors or significant shareholders of the banks not on the SSB, the policies and procedures relating to the appointment of the SSB, the policies and procedures relating to the dismissal of the SSB, the remuneration paid to SSB directors, the practice of SSB rotation every five years and the remuneration structure and policies of the SSB should be disclosed in the annual report of IFIs to reflect best corporate practice (Majid, Sulaiman & Ariffin 2011). Lack of disclosure about the frequency of SSB meetings, may indicate that an SSB is not performing its monitoring function properly. In such cases, Sharia principles are overridden and result in serious concern among customers and the investor community, especially among those customers and investors for whom the sharia-compliance principles are fundamental.

## **7.10 Comparison of Abu Dhabi and Dubai Financial Markets**

Since the firms selected for this study are listed either in the Abu Dhabi or Dubai financial markets, relative performance of these two markets may offer specific contexts for firm performance with respect to implementation of the new rules. Therefore these two financial markets are compared below as part of the research question addressed in this study.

From Table 6.19, higher market performance of the Dubai market was indicated by higher Tobin's q value. However, ROA and ROE were significantly higher in the case of the Abu Dhabi market. As the control variable, total assets were similar for both markets. The difference in ROA and ROE can be explained by higher profit. This means Tobin's q was

higher for DFM because of higher market capitalisation since DFM is well-known internationally and it attracts new regional and international investors to the market. Thus, only market capitalisation has contributed to the higher Tobin's  $q$  of the DFM. ROE was higher for the Abu Dhabi market. Since shareholder funds were not the reason for higher ROE (if it was, Tobin's  $q$  would have increased), profit after tax is the only variable which would have increased ROE, which also increased ROA for the Abu Dhabi markets. Furthermore, a higher ROA and ROE of the Abu Dhabi market and similar size of assets in both markets may indicate that firms operating in the Abu Dhabi market may have more effective and efficient managers who were able to utilise and manage firms' resources to realise higher returns. On the other hand, the low level of ROA and ROE observed in the case of the DFM could be due to more investments without increasing returns, as discussed above.

## 7.11 Regression Tests

Regression coefficients for all the firms together are presented in Table 6.20. Among the ownership structures, significant regressions were obtained only for family and government ownerships. For both ownerships, regression coefficient values with ROA and ROE were positive while it was negative with Tobin's  $q$  (negative). The coefficient values represent the quantity of increase or decrease in the dependent (performance) variable (depending on whether negative or positive value) per unit increase of the independent variable, the type of ownership in this study.

Translated into physical meanings, for each unit increase in the proportion of family ownership, ROA will increase by a factor of 5.316 and ROE will increase by a factor of 17.12 and Tobin's  $q$  will decrease by a factor of -2.80. Similarly, for each unit increase in the proportion of government ownership, Tobin's  $q$  will decrease by a factor of -2.38. For each unit of increase in government ownership ROA will increase by a factor of 1.745 and ROE will increase by a factor of 9.135. Effects of other ownership were not significant. Comparatively, ownership effects are higher for ROE than ROA and it is negative for Tobin's  $q$ . Family ownership values are higher than government ownership values. The tight control on finance and business operations in family ownership firms ensures better performance compared to highly formalised bureaucratic governance in government-owned firms.

Increasing the proportion of family or government ownership increases ROE and to a lesser extent ROA and decreases Tobin's  $q$ . All these can occur together only if net profit

increases more than the increase of equity assets. Therefore, the effect of the two ownership structures is to increase profitability at the cost of market valuation

Of the SSB variables, only compliance with Sharia rules regarding disclosures on profit/loss allocation between shareholders and IAHs (sub-variable 2) and accountability of SSB members (sub-variable 6) showed significance. For each unit increase in firms providing SSB assurance report disclosures as per Sharia rules, the ROA increased by 0.436 units, ROE increased by 1.577 units and Tobin's q decreased by a value of -0.092 units. These relationships are similar to the ones obtained for ownership structures above. When more firms come to the market with disclosures, investor confidence in Islamic banks as a viable alternative to conventional banks will increase. Thus, a greater proportion of equity investment will flow towards Islamic banks. When the utilisation efficiencies of these assets increase, ROA and ROE will increase. With more compliant firms in the market, increase in equity investment need not increase firm market value due to competition. Tobin's q may decrease.

However, for each unit increase in the number of firms showing accountability of SSB members, the ROA decreased by a value of -0.758 units, ROE increased by 2.343 units and Tobin's q increased by a value of 0.228 units. Decrease of ROA and increase of Tobin's q can occur if assets increase. However, the assets should be non-equity assets; otherwise ROE will also decrease. But ROE increased. This means only non-equity assets increased when more firms reported SSB accountability. This could be because increasing instances of accountability attracted more IAHs (which are not equity assets) due to greater investor confidence.

Disclosure of certain facts needs not enhance performance unless it can be shown that it enhances firm reputation leading to increased profit and accordingly ROA and ROE. Tobin's q is a market performance variable. Disclosures on profit sharing can be a double-edged sword. These can be always viewed with scepticism, as the scope for misappropriation is high. Many reports on quality of disclosures were discussed above (SSB Discussion and Implications Specific Sub-Variables Section). If the disclosure quality is poor, it can negatively affect market performance or Tobin's q. This may also be the reason for the result obtained in this study.

Accountability of SSB had significant positive regression with Tobin's q. As indicated above, while poor reporting quality could lead to loss of market performance,

responsible behaviour by an SSB can elevate a firm's reputation. This could be the reason for a positive relationship between accountability of SSBs and market performance indicator of Tobin's q. Many reports on the impact of accountability and disclosures were discussed above (see SSB Discussion and Implications Specific Sub-Variables Section)

## **7.12 Summary of Results and Implications of Corporate Governance Practices in UAE**

The summary of the results about the relationship between corporate governance and firm performance can be shown as follows.

1. Hypothesis 1- In this study, the hypothesis on the positive relationship of ownership structure with the firm performance was partly accepted. The empirical results indicated that there is a positive relationship between family ownership type and firm performance represented by ROA and ROE. However, a negative relationship between family ownership type and Tobin's q was observed. Government ownership type indicated negative relationship with Tobin's q and individual ownership type indicated negative relationship with ROA and ROE. This finding is partly support agency theory, which argues that concentrated ownership structure would positively influence corporate performance through a reduction in the agency cost.
2. Hypothesis 2 was that there is positive relationship between leadership separation and firm performance as it results in better monitoring and control. This hypothesis was rejected. The empirical results indicated that there is negative relationship between separation of leadership and firm performance represented by ROA. This finding is in support of stewardship theory, which argues that combining the chairperson and CEO roles would positively influence corporate performance by diminishing the cost of monitoring, bonding, control and incentives.
3. Hypothesis 3 was that firm performance is positively related with the majority of non-executive directors on the board of directors due better monitoring, control and protection of shareholders' interests. This hypothesis was rejected. The empirical results indicated that there is no relationship between a majority of non-executive directors on a board of directors and firm performance. This finding does not support agency theory, which argues that a majority of non-executive directors on a board

would positively influence corporate performance thorough better monitoring, control and protection of shareholders' interests.

4. Hypothesis 4 was that board size is positively related with firm performance as it results in effective and efficient dealings with a firm's affairs and in better monitoring, control and protection of shareholders' interests. This hypothesis was rejected. The empirical results indicated that there is no relationship between board size and firm performance. This finding does not support agency theory which argues that board size would positively influence corporate performance through better communication and coordination and through better involvement and engagement in a firm's affairs.
5. Hypothesis 5 was that the presence of a financial expert on audit committees is positively related with firm performance as it results in quality assessment and evaluation of control processes as well as in the production of quality financial reports. This hypothesis was rejected. The empirical results indicated that there is no relationship between the presence of a financial expert and firm performance. This finding does not support agency theory, which argues that the presence of a financial expert on an audit committee would positively influence corporate performance thorough better understanding of financial related matters and reduction in the level of agent/principle conflict of interest.
6. Hypothesis 6 was that the role and impact of SSB is positively related with the performance of IFI. Existence of SSB in the governance mechanism of IFI's operating in the UAE is mandatory to ensure that all transactions are conducted in accordance with Islamic principles and all products are Sharia complaint. This hypothesis was partly accepted. Empirical results showed a relationship of SSB report on disclosures and SSB accountability related to firm performance variables, but not any other governance variable.

This finding supports the Islamic perspective of corporate governance, which argues that corporate governance is about justice and fair treatment to all related stakeholders, with objective of everyone having a unity purpose in his/her life that is to serve Almighty Allah (God) SWT. Such belief will result in avoiding conflicting interests, true cooperation among stockholders, and better production and performance.

7. Impact of governance rule on performance of all types of companies as shown in table 6.3.



Statistical tests shown in Table 6.3 suggested no statistical significance between the pre- and post-governance period in relation to ROA, ROE and Tobin's q. This means there is no impact of the corporate governance rules of 2010 on the performance of any type of firm.

8. Impact of governance rule on performance of non-financial companies

Statistical tests shown in Table 6.11 suggest that there is a statistical significance difference between the pre- and post-governance period in relation to ROA and ROE but it was not significant for Tobin's q., such significance difference resulted from the low mean value of observed in the post-governance period as compared to the pre-governance period. This means that a non-financial company seems to have been negatively affected by the implementation of the 2010 governance rule. The governance rule is a mandatory requirement for non-financial companies.

9. Influence of the governance rule on performance of financial companies

Statistical tests shown in Table 6.14 suggest that there is no statistical significance between the pre- and post-governance period on the performance of financial firms with respect to ROA, ROE and Tobin's q. Therefore, the corporate governance rule of 2010 had no influence on performance of financial companies.

10. Influence of governance rule on performance of Islamic banks

Statistical tests shown in Table 6.16 suggest that there is no statistical significance between the pre- and post-governance period on the performance of Islamic banks with respect to ROA, ROE and Tobin's q. Hence, the new corporate governance rule of 2010 had no influence on performance of Islamic banks.

11. Influence of governance rule on performance of conventional banks

Statistical tests shown in Table 6.16 suggest that there is no statistical significance between the pre- and post-governance period on the performance of conventional banks with respect to ROA, ROE and Tobin's q. Accordingly, the new corporate governance rule of 2010 had no influence on the performance of the conventional banks.

12. Similarities and differences between Islamic and Conventional banks in terms of significance and in relation to both corporate governance variables and firm performance.

Statistical tests shown in table 6.17 suggest that there is no statistically significant difference between Islamic and conventional banks with respect to corporate governance variables except that the proportion of foreign ownership is significantly higher in Islamic banks. The same statistical table indicates that there are no statistically significant differences between the performance of Islamic and conventional banks. This suggests that there is no significant difference between Islamic and conventional banks in the scope and context of this study.

## **7.13 Conclusion- Summary of Chapter 7**

The implications of the results of the relationship between corporate governance practices and firm performance of listed companies in the United Arab Emirates were discussed in this chapter. The relationships, tested for statistical significance as per the hypotheses, were discussed in relation to the relevant theories applicable to corporate governance as obtained from the literature and the context of this study. Overall, the results revealed that the implementation of the 2010 governance rule made no significant impact on corporate performance. However, the results for the non-financial companies showed a negative impact on the performance of non-financial companies in terms of ROA and ROE. The results for financial companies revealed that the introduction of the governance rule has had no influence on the performance of financial companies. The results of the comparative tests between conventional and Islamic banks revealed no significant difference between both types of banks in term of performance and no significance influence was observed on both Islamic and conventional banks because of the introduction of the governance rule. Correlation result revealed that family ownership in the pre-governance period had a correlation relationship with ROA and government ownership had a correlation relationship with ROE in the post-governance period.

The regression model revealed that there is a positive relationship between family ownership and performance, a negative relationship between government ownership and performance, a negative relationship between SSB disclosure on appropriateness of allocation of profit and loss between shareholders and IAH and performance, and a positive relationship between SSB accountability and performance of Islamic banks in the UAE.

A summary of the findings and the conclusions are presented and discussed in chapter 8.

# **CHAPTER 8**

## **Summary, Findings and Conclusions**

### **8.1 Introduction**

This chapter begins with a discussion of the economic and political environment in which firms operate in the UAE. A brief discussion on the UAE economy as well as on the corporate governance reforms is also summarised in this chapter. The study is based on several theoretical perspectives and empirical results relevant to corporate governance practices from both developed and developing countries. This chapter is structured as follows: Section 8.2 provides an overview of the research question and Section 8.3 provides a summary of the objectives of the study. Section 8.4 presents the conclusions of the determinants of firm performance and Section 8.5 presents the findings of the study. Section 8.6 provides a discussion on the implications of the study. Section 8.7 discusses the summary of the methodology and conceptual framework. Section 8.8 discusses the limitations of the study and Section 8.9 presents contributions of the study. Section 8.10 provides recommendations for regulatory organisations and Section 8.11 discusses future research and Section 8.12 presents the conclusion of the study.

### **8.2 Overview of the Research Questions**

The purpose of this study is to explore the efficacy of corporate governance practices on performances and market values of listed companies in the UAE due to implementation of the new corporate government rules from 2010. These improvements occur by way of proper and structured corporate reporting practices in a period affected by global financial crises. These practices are expected to enhance protection of interests of shareholders and other stakeholders and improve investor confidence to attract more investment for the development of the UAE economy.

The UAE relies on local and foreign investment and regional and international trade to enhance as well as strengthen its economy. Good corporate governance practices are crucial to establish and build investor confidence in the markets to encourage inflow of capital and expand economic activities. Successfully attracting both local and foreign

investment provides stimulus to the economy leading to increased productivity and growth. For this reason, the UAE introduced regulatory reforms in corporate governance through the introduction of ministerial Resolution No, 518 of 2009 (concerning governance rules and corporate discipline standards).

This study employed comparative analyses to investigate the extent to which corporate governance practices were adhered to by firms listed in its financial markets and reflected in the UAE's market between the period of 2008-2009 and 2011-2012. The overall results of comparative analysis between the two periods indicated that the implementation of the governance rules of 2010 made no significant impact on corporate performance. However, the regression model revealed that there are positive relationships between family ownership and performance, negative relationships between government ownership and performance and a negative relationship between SSB disclosure on appropriateness of allocation of profit and loss between shareholders and IAH and performance, and a positive relationship between SSB accountability and performance.

Despite the adverse global and regional economic conditions, the growth and stability achieved by the UAE economy is partly due to good governance practices introduced by the Emirates Securities and Commodities Authority and implemented by the listed companies, as pointed out in Chapter 2.

The UAE GDP accelerated to 4.4 per cent in 2012 indicating a recovery and further improvement from the global financial crisis that hit mainly the real estate sector of the UAE. One of the most important factors for the GDP acceleration was the role played by stable oil prices in 2010 and 2011.

The UAE's Ministry of economy announced in its 2014 – 2016 strategy that it is committed to a strategic plan that aims to institute policies and economic legislation in line with best international standards for the creation of a competitive and knowledge-based economy. The plan aims to achieve the development and diversification of national industries, the growth of the small and medium enterprise (SME) sector and national entrepreneurship. Diversification of national industries is a key to a sustainable and resilient economy and continued sustainable growth.

The UAE government has always been the leader in economic initiatives and therefore firms operating in the UAE market are directly influenced by the government strategic plan and use it to guide their own sustainable strategic plans.

This study did not show any significance difference between Islamic and conventional banks in terms of corporate governance variables and performance due to the impact of the introduction of the 2009 corporate governance rules. More similarities than differences were noticed from the analyses of statistical differences between means.

## **8.3 Summary of the Objectives of this Study**

The following were the objectives of the study:

1. To examine to what extent the corporate governance rules of United Arabs Emirates have an impact on overall corporate performance
2. To identify the differences and similarities between Islamic and conventional corporate governance perspectives within the scope and framework of this study
3. To examine the impact of Islamic corporate governance practices on Islamic firm performance and if such impact differs from the impact of conventional corporate governance practices on firm performance within the scope and framework of this study
4. To examine the degree of influence of the corporate governance rule on Islamic and conventional banks in term of performance, ownership structure, board composition and audit committee composition, within the scope and framework of this study
5. To determine the relationship between corporate governance practices such as board leadership structure, board composition, ownership structure, board size, and existence of a financial expert on audit committees on firm performance
6. To examine the impact of SSB of Islamic firms on performance through the following variables; board size of SSB, SSB annual report, experience, knowledge and qualifications of SSB members, appraisal of SSB, accountability of SSB and frequencies of SSB meetings, within the scope and framework of this study
7. To investigate the extent to which the companies have adopted corporate governance practices
8. To determine through a comparative analysis the changes, impact and influence of corporate governance practices on performance within the scope and framework of this study in the period before and after the introduction of the governance rules of the following sectors:
  - Non-financial companies pre and post
  - Financial companies pre and post

- Financial companies compared to non-financial companies
  - Islamic banks pre and post
  - Conventional banks pre and post
  - Dubai FM Compared to Abu Dhabi DX, and
9. To propose corporate governance recommendations for regulatory agencies;

## **Discussion on how the above-mentioned objectives of the study were operationalized and achieved**

The development of corporate governance practices in the context of the UAE was presented in Chapter 3. UAE market performance showed significant appreciation in the performance of the Emirates Securities Market (ESM) during 2013. The ESM index posted a positive return of 9.39 per cent, while the total market value of listed companies increased by 9.5 per cent. In addition, the UAE's Net Foreign Investment value surged during the year by about AED 1.23 billion to prove restoration of confidence of foreign investors in the local markets, as the latter's performance continues to improve after the negative impact of the global financial crisis.

Growth of the capital markets of UAE resulted in the introduction of mandatory corporate governance rules for listed companies. The impact of such rules is covered in this thesis. Listed non-financial companies are required to comply with rules in areas such as board structure, separation of CEO and chairman positions, board composition, board committees and internal control. The rule requires that all such companies are to issue a corporate governance report in which compliance is to be reported. In the UAE the factors that affect firm performance and ultimately market performance are raising interest rates, inflation, oil prices, infrastructure projects and the regional economic activities.

Investigation of the extent to which the listed companies have adopted or adhered to corporate governance practices and mandatory requirements indicates how these were established in the UAE. Corporate governance mechanisms in the UAE were described in chapter 3 of the study.

An overall comparative analysis of corporate governance practices showed the extent to which the firms have adhered to or were influenced by the corporate governance rules by comparing the pre-governance period of 2008-2009 with the post-governance period of 2011-2012. Descriptive statistics in Table 6.1 showed the extent to which companies adhered to or were influenced by corporate governance practices in UAE.

In period 2008 - 2009, 77 per cent of the firms in the sample had adopted separation of the position of CEO and chairperson, whereas in the period 2011-2012 this was 78 per cent. The proportion of firms that had complied with non-executive director representation on the board during the period of 2008-2009 was 90 per cent. This decreased to 87 per cent during the period 2011-2012. The proportion of firms that had complied with independent director representation on the boards in 2008-2009 was 80 per cent which increased to 95 per cent in 2011-2012. In 2008-2009 only 6 per cent of firms had financial experts on their audit committees and this increased to 29 per cent in 2011-2012. The general comparison of data from annual reports for the pre-governance period of 2008-2009 and the post-governance period of 2011-2012 showed that the level of governance practices increased from the pre-governance to the post-governance period.

This study also examined the similarities and differences between conventional and Islamic corporate governance structures and practices and the extent of the impact such differences might have on firm performance in the UAE context. As stated in chapter 4, the theoretical frameworks given in Fig 4.1 and the conceptual framework in Fig 4.2 suggest that the main structural difference is the mandatory presence of SSB in Islamic financial institutions. Differences and similarities between Islamic and conventional banks were tested through the analyses of mean differences between means which are presented in Tables 6.15 and 6.16. The overall results of this analysis indicated that there is a very high level of similarity between both types of banks in terms of ownership structure, board composition, presence of financial experts in audit committees and performance due to the influence of the introduction of the 2010 corporate governance rule.

Table 6.10 indicates the level of impact of the governance rule on ownership structure, leadership structure, board composition, board size and financial expert in audit committee of the non-financial companies. Table 6.11 indicates that rules of governance had a negative impact on firm performance of non-financial companies. ROA of non-financial companies decreased from a pre-governance mean value of 4.88 to a post-governance mean value of 2.52. Similarly the mean value of ROE decreased from a pre-governance mean value of 8.36 to a post-governance mean value of 4.07. The analysis reported in Table 6.13 and in Table 6.14 indicated that no difference has occurred between pre- and post-governance rule periods in the case of financial companies.

Table 6.6 indicates the level of differences and similarities through analysis of differences between means of financial and non-financial companies in relation to

ownership structure, leadership structure, board composition, board size and presence of a financial expert on audit committees. Data given in Table 6.7 indicates that non-financial companies performed better than financial companies with respect to ROA. The mean value of ROA of the financial companies was 0.75 while for the non-financial companies it was 3.66.

To determine the relationship between corporate governance practices such as ownership structure, leadership structure, board composition, board size, presence of financial experts on audit committees and firm performance in the UAE, the study used Spearman's correlation. In Table 6.4, Panel A shows the correlation between corporate governance practices and firm performance for the pre-governance period and table 6.4 Panel B shows the correlation between corporate governance practices and firm performance for the post-governance period.

Table 6.4 Panel A indicates a positive relationship of family ownership proportion with ROA, a positive relationship of proportion of government ownership with total assets, a negative relationship of the proportion of individual ownership with ROA and ROE, a positive relationship of leadership structure and total assets, a positive relationship of executive directors on board with Tobin's q, a negative relationship of non-executive directors on board with Tobin's q, a negative relationship of board size with Tobin's q and a positive relationship with total assets and a positive relationship of financial experts in audit committees with total assets.

In the same Table 6.4, Panel B indicates a negative relationship of family ownership proportion with total assets, a positive relationship of foreign ownership proportion with total assets, a positive relationship of proportion of government ownership with ROA and total assets, a negative relationship of individual ownership proportion with total assets, a positive relationship of the proportion of non-executive directors on board with total assets, a negative relationship of the proportion of independent directors on boards with total assets and a positive relationship of board size with total assets.

In order to determine the causality between corporate governance practices and firm performance, a regression coefficient test was performed using the panel data of 2008, 2009, 2011 and 2012. A summary of the regression test is presented in Table 7.1. The data revealed a positive relationship of family ownership with performance, a negative relationship of government ownership with performance, a negative relationship of SSB



report on disclosure and the appropriateness of allocation of profit and loss between shareholders and IAH with performance, and a positive relationship of SSB accountability with performance.

Table 6.19 shows the comparison between the two UAE financial markets, the DFM and ADX, in terms of performance. The companies listed on the DFM outperformed companies listed on the ADX in terms of Tobin's q. However, companies listed on the ADX outperformed companies listed on the DFM in terms of both ROA and ROE.

## **8.4 Determinants of Firm Performance**

Some of the findings of this study and corporate governance literature indicated that good corporate governance can be an important factor in determining firm performance. Many corporate failures are due to an incapable board which cannot manage the challenges, which has an overall impact on a firm's performance.

Board structure and its relation to the process of decision-making needs to be properly articulated in a way that is best for sustainable and continuing performance as well as ensuring management of economic challenges and today's corporate complexities in a professional and effective manner. Consequently, governance structures need to be organised to ensure effective and efficient monitoring of the quality of board decision making processes (Laing & Weir 1999). Moreover, studies have indicated that for governance practices to have a positive impact on companies' market value, they need to fulfil two conditions. First, good governance practices must result in increased shareholder value and second, the stock markets must be appropriately efficient so that the shares prices reflect fundamental values (Bai et al. 2004). Such conditions may be fulfilled in mature markets better than in emerging markets such as the UAE. Accordingly, in the UAE share prices in the stock markets may be driven by speculative activities. In addition, UAE financial markets may also be affected positively by the entry of new investors especially those from regional countries that are experiencing political and economic instability such as Libya, Yemen, Egypt, Lebanon and Syria. The UAE is an attractive investment destination. The corporate governance rule of 2010 which is a mandatory requirement for listed companies is believed to have increased investor confidence as well as contributed positively to the overall corporate governance mechanism of the UAE stock markets.

Analysis of governance structures, as given in Figure 6.1, showed that listed companies have moved towards compliance with the governance rule of 2010 mandated by the UAE's securities and commodities authorities.

## **8.5 Findings of the study**

This study provides mixed results of positive, negative and no relationship between corporate governance structure and firm performance in the UAE.

The following section reports the conclusions from the results outlined in chapter 7 and obtained for verification of the hypotheses presented in Chapter 4.

H1: Ownership structure is associated with firm performance.

The first hypothesis of the study (H1) related ownership structure positively with the performance of listed companies of the UAE. Mixed and conflicting results were obtained among the five types of ownership structures. A statistically positive significant relationship between the proportion of family ownership and firm performance was obtained and the hypothesis was accepted in this case. No statistically significant relationship was obtained for the relationship of the proportion of institutional and foreign ownership with firm performance. Thus, the hypothesis was rejected in this case. A statistically negative significant relationship was found for the relationship of the proportion of government and individual ownership with firm performance. Although there was a relationship between these ownership structures and performance, the hypothesis is considered as rejected in these cases because a positive association is required for acceptance of the hypothesis. These findings partly supported agency theory. The theory argues that ownership structure would positively influence corporate performance through a reduction in or creation of agency cost. On the other hand, (Demsetz, H 1983) was the first to challenge agency theory assumptions, arguing that there should be no relationship between ownership structure and company performance; rather ownership structure should be thought of as an endogenous outcome of decisions that reflect the level of influence of shareholders. Yet, agency theory is of unique importance in the business world (Eisenhardt 1989b). Thus, in the case of ownership for which positive relationships were obtained, agency theory may be considered as validated and where it was negative or no relationship, agency theory may not be applicable. Therefore, agency theory was validated only in the case of family ownership.

H2: Leadership structure is associated with firm performance.

The second hypothesis (H2) related to separation of leadership positively with firm performance. There was no statistically significant relationship between leadership structure and firm performance and hence the hypothesis was rejected. The rejection of the hypothesis means that there is no relationship between separation of leadership roles and performance. The need for separation of leadership roles arises from agency theory (Dalton et al. 1998). Agency theory advocates that proper control mechanisms and monitoring are needed in order to protect shareholders from the agency cost of modern capitalism (Fama, EFa & Jensen 1983) which occurs as a result of separation of ownership and management. The results of the study do not support agency theory. However, they do support stewardship theory partly and indirectly. The theory argues that combining the roles of chairperson and CEO would positively influence corporate performance thorough diminishing the cost of monitoring, control and incentives. The partial or indirect support of stewardship theory is because no relationship of leadership separation with performance was demonstrated. Indirectly, it implies that combining leadership roles may be better

H3: A majority of non-executive directors is positively associated with firm performance.

The third hypothesis (H3) was that board independence is positively related with firm performance. Board independence depends on proportion of independent directors on boards t. The empirical results indicated no statistically significant relationship between having a majority of non-executive directors on boards and firm performance. This finding does not support agency theory which argues that a majority of non-executive directors on a board would positively influence corporate performance through better monitoring and control and protection of shareholders' interest (Fama, EFa & Jensen 1983) nor does it support stewardship theory which argues that insider directors are better equipped to understand and deal with complexities of business operations than the outsider's directors (Agrawal & Knoeber 1996; Bhagat, Sanjai & Black 2000; Yermack 1996). The hypothesis was therefore rejected.

H4: Board size is positively associated with firm performance

The fourth hypothesis (H4) was that the board size is positively related with firm performance. The hypothesis was proposed based on the argument that larger boards lead to inconsistency and ineffectiveness of decisions due to absence of cohesiveness among board members. The regression test did not indicate any statistically significant relationship

between board size and firm performance and therefore the hypothesis was rejected and the arguments of both stewardship theory and agency theory were found not to be applicable.

H5: Financial expert on audit committee is positively associated with firm performance

The fifth hypothesis (H5) was that the presence of a financial expert on audit committees is positively related with firm performance. Agency theory assumes that the presence of a financial expert on an audit committee would result in better quality assessment and evaluation of control processes, the production of quality financial reports and reduction in conflict between managers and shareholders and protection of shareholder interests. No statistically significant relationship was obtained between the presence of a financial expert on audit committees and firm performance. This finding does not support agency theory and the hypothesis was rejected.

H6: Sharia supervisory board is positively associated with firm performance

The sixth hypothesis was (H6) that the role and impact of a SSB is positively related with the performance of Islamic financial institutions. The existence of SSBs in the governance mechanism of IFI's operating in the UAE is mandatory to ensure that all transactions are conducted in accordance with Islamic principles. Part of the H6 that all companies comply with this Sharia was accepted.

However, with respect to the relationship of SSBs with performance, only assurance reports and accountability of SSB were related with some performance variables. Therefore, the hypothesis was partly validated.

This finding supports the Islamic perspective of corporate governance which argues that corporate governance is about justice and fair treatment for all related stakeholders, with the objective of everyone having a unity of purpose in his/her life that is to serve Almighty Allah (God) SWT (Kasri 2009). Such beliefs will result in mutual benefits and cooperation in addition to avoidance of conflicting interests and encourage better production and performance.

## **8.6 Implications of Study**

It is clear that in the UAE, the economy is picking up, driven by a recovery in the real estate sector, increasing investor confidence, rising population, easing debt and financing conditions for the major Dubai Inc., and the resumption of public and private project activity encouraged by Dubai's upcoming hosting of Expo 2020 whose infrastructure needs could

exceed \$40 billion. Such an international economic event is expected to boost economic activity to a high level encouraging local, regional and international companies to take part in this big business event. Abu Dhabi has strong support of oil revenue and sizable oil reserves for its economic stability. The UAE real estate market is improving because of the market recovery from the impact of the global financial crisis. In addition, the economic growth in the UAE includes large infrastructure projects mainly financed by local governments and large government-related companies. Stock markets in Dubai and Abu Dhabi performed well during 2013, posting gains of 108 per cent and 63 per cent respectively and continued to perform well. In such a business environment, a unique corporate governance mechanism is essential to ensure that a proper governance system is in place to protect not only shareholder interests, but also to protect and safeguard the country's assets and wealth.

Corporate governance mechanisms are meant to promote economic growth and improve corporate performance in a structured and sustainable manner through a balanced approach and application of good corporate governance standards. The findings of this study show that implementing good governance practices does not necessarily increase or improve firm performance in the short-term as other external economic factors have a direct impact on corporate performance. As a result, this study has significant implications for the corporate sector, investors, policy makers, international agencies, government and stakeholders, due to the importance of the corporate firms and of resource protection, continuity and success to the general economy of the country. This study investigated important relationships of corporate governance constructs of ownership structure, leadership structure, board composition, board size, financial experts on audit committees and the SSB with performance of Islamic and conventional firms that were promoted by UAE's Security and Commodity Authority (Al Mansouri 2009); (Al Nahyan 1985) on the local level, by the Australian Stock Exchange (Council, ACG 2007) on the international level, and by (AAOIFI 1991) on the Islamic financial institutions level.

Due to the recent global financial crisis, it was necessary for the UAE's regulatory agencies to build confidence among investors and other international agencies through reforms in corporate governance, financial reporting and corporate laws. As a result, the corporate governance rule was issued in 2009 and become mandatory for all listed non-financial companies in 2010. The corporate governance rule was issued to improve corporate governance practices and reassure the participants of financial markets that their interests are protected and the market is healthy, as the relevant reforms have been put in place.

While the findings of the study were not surprising; they were rather interesting in that they reflected the nature and the level of market maturity in term of responses of firms to the new rules. The findings also reflected the reaction of different market sectors to the new governance rules, including financial companies, non-financial companies, Islamic banks and conventional banks in addition to the findings related to the level of similarities and differences between both types of banks.

Corporate governance theories emerged in matured markets and these theories and perspectives may be more suitable for such markets than for immature or emerging country markets. Therefore, the implications of this study are significant. They offer a uniquely market-tailored governance paradigm in which culture, social structure, level of market maturity, market size, and mechanism and overall economic development strategy are considered. Such a mechanism needs also to ensure ethical behaviour and a high level of professionalism in addition to fair treatment of all relevant and related parties and to strike a balanced and sustainable governance approach. The findings of the regression and correlation tests showed a weak relationship between corporate governance theories and their assumptions and corporate performance which suggests that board members are not performing their duties diligently and their performance, efficiency, participation and effectiveness on boards are questionable. This is consistent with the results of the most recent survey conducted by the GCC Board Directors Institute with regards to the effectiveness of boards. The survey revealed that greater skill, diversity, contribution and evaluation was required to enhance board effectiveness in the GCC region (Institute 2015)

## **8.7 Summary of Methodology and Conceptual Framework**

### **8.7.1 Methodology of the study**

As discussed in Chapter 5, the relationship between corporate governance practices and firm performance in the UAE were tested with the total population of all listed companies in both the DFM and ASX for the years 2008, 2009, 2011 and 2012. Data was collected from secondary sources such as annual reports and websites of the listed companies.

The variables used to test the hypotheses were ownership structure, leadership structure, board composition, board size, a financial expert on audit committees and SSB. All independent variables were based on the mandatory corporate governance rules of 2010

issued by UAE's S&CA, except for ownership structure and SSB. Firm performance was measured using Tobin's q, ROE and ROA. SPSS statistical program was used to calculate the descriptive statistics, two-related-sample t-test, Spearman's correlation and regression analysis. The regulatory index was developed for sub-variables used for SSB, treatments were given and variables were transformed by taking a natural logarithm.

Similar methodologies were used in prior research and were appropriate for this study due to the size and characteristics of the data.

### **8.7.2 Conceptual Framework of the study**

The conceptual framework of the study presented in Chapter 4 was designed to find the relationship of ownership structures, board structure and SSB with firm performance of listed companies in the UAE.

The theoretical framework explained the theoretical perspective of the study based the agency theory, stewardship theory and the Islamic perspective of corporate governance in relation to firm performance. The conceptual framework presented in Figure 4.2 was the basis for developing the hypotheses for the study. The hypotheses were tested for validity using the methodology presented in Chapter 5. Results were presented in Chapter 6. Analysis and discussions of the hypotheses were reported in Chapter 7. The conclusions of the hypotheses tested are presented in this chapter.

## **8.8 Limitation of the study**

There were some limitations of this study that should be considered when reading, analysing and interpreting its results. The data used for this study were derived from the total population of 123 listed companies in the UAE. Only secondary data was used for this study and this limited the opportunity for obtaining some special information needed in analysing certain information such as shareholders, perceptions of CEOs, chairpersons, board members, members of the SSB and staff about the governance mechanisms of the listed companies on both the ADX and the DFM. Regression analysis was performed to analyse the impact of governance on the variations of performance of listed companies and the model did not reveal consistent statistically significant strong relationships between and among the governance independent variables and performance dependents variables used in this study. Had qualitative components been included in designing the research, it might

have provided more insight into the ownership structure, leadership structure, board composition and SSB of the Islamic banks in the UAE context.

The failure to establish the relationship of corporate governance mechanisms with performance might be due to the short term of 2011-2012, the post-governance period used in this study. The period might have been insufficient for the firms to realise the full benefits of corporate governance practices as they were on a learning curve. The number of Islamic banks was only four. Had there been more Islamic firms, better results could have been obtained.

## **8.9 Contribution of the study**

The findings highlighted the impact of ownership structure, independent board structure and SSB on profitability and market value of firms in an emerging active market. This study indicated mixed evidence between positive, negative and no relationships between corporate governance independent variables and firm's performance. There had been no prior research on corporate governance and firm performance in developed or emerging markets during highly volatile economic periods. UAE's market is active in nature. However, during the financial crisis it become volatile and its behaviour become hard to read or predict. Moreover, the impact of the governance rule of 2010 on the SSBs and their performance or the level of differences and similarities between Islamic and conventional banks have never been investigated in previous studies using similar variables and panel data.

This current research contributes to the body of knowledge on corporate governance on how board structures may affect firm performance positively or negatively in an active emerging market. Additionally, the study contributes to the body of knowledge on Islamic corporate governance practices and encourages further research opportunities.

However, the findings of the study did not show consistent significant relationships between internal governance mechanisms and firm performance. Such a range of mixed findings may be related to the endogeneity problems with the variables of the study, such as joint-endogeneity (Adams, R, Hermalin & Weisbach 2008); ) reverse causality (Kole 1996) and unobserved heterogeneity (Himmelberg, Hubbard & Palia 1999). Judging from the mean and standard deviation values, the coefficient of variation was very high. This may argue for a different analytical approach to the data. The inconsistent and mixed results of the study indicate the need to carefully analyse and take into account all important variables and



appropriate operational measures in this type of investigation as proposed by (Gelb & Zarowin 2002) and (Gietzmann & Ireland 2005).

## **8.10 Recommendations for Regulatory Organisations**

Based on the above research, there are some recommendations that may enhance and improve performance of companies in the UAE.

The overall findings of the study suggest that corporate governance theories, agency and stewardship theories in particular, have not been reflected in the corporate governance mechanisms and therefore the study found in most cases no statistically significant results, except for a limited extent. It is recommended that regulatory agencies ensure that corporate leaders are fully aware of the significance of governance theories and mechanisms so they can put forward a strategy for ensuring that the concepts of governance theories are understood and practised by all those holding positions as board members or sub-committee members. Ownership structure, board composition, leadership structure, audit committee composition and board size are all highly significant in the corporate governance literature and therefore corporate leaders need to reflect on such significance in their actions and behaviour if they are to achieve the best possible success for their organisations.

Future suggestions are:

- Compliance with the governance rule of 2010 seems to be functioning. However, it is recommended that compliance with the governance rule by listed companies should not be the aim in itself and become a matter of ticking a box; rather it should be implemented diligently and should reflect the true intention for which it was developed particularly regarding the capabilities, competencies, skills, experiences and educational backgrounds of corporate directors and corporate leaders. The corporate leadership should know how to translate the governance practices into successful business strategies to reflect business advantage in terms of performance. This has not been reflected clearly in the findings of this study.
- A comply or explain corporate governance mechanism may be worth considering by UAE Securities and Commodities Authorities and other related regulatory agencies similar to The DIFC which applies the best practice of comply or explain governance

approach. Moreover, all Islamic financial institutions listed in Nasdaq Dubai under the DIFC are required to comply with the AAOIFI unlike the DFM and the ADX.

- To ensure proper compliance with Sharia principles, a higher Sharia Supervisory Board needs to be established. This would act on the federal level and should have the power, structure and the resources that allow its members to audit, investigate and ensure that SSBs on individual organisational levels strictly comply with Sharia requirements. In addition, it should have the power to approve or reject any proposed Islamic banks products.
- Investment Account Holders (IAH) of Islamic banks need to be treated fairly and should have a representative on the board of directors, to ensure that their investments are truly Sharia compliant, profit and loss is fairly recognised and appropriate allocation of profit and loss between IAH and shareholders are maintained in accordance with Sharia principles.
- SSB members and the chairperson of the Sharia board need to sign a report on the adequacy, effectiveness and efficiency of the Sharia governance system and internal controls (similar to the requirement of Section 302 of the Sarbanes-Oxley Act of the US for the CEO and the CFO) and be personally liable for any irregularities and noncompliance with Sharia principles. This is to ensure strict Sharia compliance, with the right balance between compliance and innovation and growth and performance.
- Legal provisioning needs to be considered to limit the existing heavy multiple directorships of the SSBs. If there is a shortage of adequately qualified persons for SSB membership, courses and training programmes may be organised appropriately.
- The UAE is an emerging and promising market. There is strong investment in the real estate sector as well as in the stock markets. It is therefore worth considering protective legal tools to stabilise these sectors so that financial crises can be avoided and their negative market impacts caused by speculators can be minimised.
- A blend of Islamic and conventional perspectives of corporate governance on the local, regional and international levels is worth considering (in particular Islamic ethics and values and the conventional high level of professionalism and codes of conduct). Such a blend could produce a new and unique governance mechanism that is ethical in self-governance and professional in generating values.
- Standardization of accounting and governance practices for IFI is worth considering.

## 8.11 Future Research

This study adopted a quantitative research approach using objective data, statistical methods of analysis and measurement to test the relationship between corporate governance independent variables including Islamic banks and performance of the listed companies in the UAE context. Further research needs to be performed in this area since relatively little has been done by researchers on corporate governance and performance including Islamic financial institutions and comparative studies on Islamic and conventional financial institutions. The suggestions for future research are:

- i. The scope of this study should be expanded by extending its framework and testing more aspects that are related to corporate governance and firm performance such as accountability and disclosure, and similarities and differences between Islamic and conventional banks on the operational and processes levels. This can provide a broader understanding of the nature of the relationship between corporate governance and performance and an insight into the similarities and differences between Islamic and conventional banks.
- ii. The sample of the study should be extended to include non-listed companies, including family-owned companies, and longer post-governance periods. This would determine whether similar or different results could be found from those non-listed companies and stabilise the results obtained with regard to the impact of implementation of the rules.
- iii. The study could be replicated by conducting similar research in other countries with similar social and geopolitical systems such as Qatar, KSA, Oman and Kuwait. This would be of particular value and would be an important addition to the literature on both Islamic and conventional corporate governance.

## 8.12 Conclusion

This concluding chapter has discussed corporate governance and firm performance in the UAE, which leads to the central argument of the research and the importance of corporate governance practices to the success of businesses. Ownership structure, board structure and the SSB in Islamic financial institutions were considered important for effective corporate governance practices as well as for enhancing performance of companies in an emerging active market. It was found that the proportion of family ownership had a positive impact on

firm performance, board structures had no significance relationship to firm performance, accountability of SSBs had a positive significant relationship to Islamic bank performance and no statistically significance difference was observed between Islamic and conventional banks. The overall findings resulted in a mixed outcome, which is believed to be valuable to shareholders, potential investors and to policy makers. The study also discussed the appropriateness of the research methodology and the conceptual framework. It was proposed that future research should be undertaken and include qualitative aspects, and the conceptual framework could be replicated and used in other similar geopolitical environments.

For regulatory organisations on corporate governance, several valuable points have been recommended to improve and enhance corporate governance of both Islamic and conventional businesses.

Finally, the study made a number of recommendations for regulatory organisations on local and international levels to consider. These included an extended corporate governance paradigm that would not only consider the long-term interests of the shareholders but also the self-enforced ethical values of all related stakeholders, with particular emphasis on high professional conduct that would encourage the establishment of a balanced and sustainable firm performance culture and help avoid unprofessional and unethical business conduct, and consequently help to prevent corporate governance-related crises.

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