

The Effect of Corporate Governance on Financial Performance of Listed Companies in Palestine Exchange (PEX)

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Abstract

Purpose: The purpose of this paper is to report the results of the study carried out to examines the relationship between the Corporate Governance and firms' performance of Palestine Stock Exchange (PEX). *Design/Methodology:* This study is cross-sectional and correlational. This study utilizes OLS regression models based on a sample of 32 firms listed on the Palestine Stock Exchange (PEX) during the period of 2008-2016. *Findings:* The correlation results indicate a negative and significant impact of board size on firm performance in ROA, ROE, and TobinQ. The study further finds that CEO duality negative, significant impacts on ROE, ROA and TobinQ respectively, whereas the independent directors found to have significant positive relation with firms' performance. *Research limitations/ implications:* the size of the sample is a limitation because the market in Palestine is small and was reduced from 48 firms to 32 firms, and this study does not examine the impact of board sub-committees for Palestinian companies because no data are available from annual reports concerning them, Therefore, further research may want to consider other components of ownership structure variables, such as government ownership *Originality/value:* In this paper, we provide the effects of Corporate Governance and firms' performance. In this study, find a negative and significant impact of board size on firm performance which means that reducing board size helps in avoiding any free rider problems or poor coordination and communications in Palestinian firms, As board size increases increased problems of coordination and communication result .

Keywords: Corporate governance, Palestine, board size, CEO duality, firm performance.

JEL Classification: G34, L25

1. Introduction

Corporate governance includes how an organization is managed by its corporate and other structures, such as- culture, policies and strategies, and the ways in which it deals with its various stakeholders, Barrett, (2002). However, the need for corporate governance occurs due to the separation of management and ownership in the modern corporations. In relation to, the positive theory of agency disputed that the managers may perform opportunistically to maximize their own welfare, (Shleifer, & Vishny, 1997 as cited by Merrett & Houghton, 1999). As a solution, it can be alleviated through the protections derived from good corporate governance structures, Okeahalam & Akinboade, (2003).

Broadly, corporate governance structures are related to the ownership structure, the composition of the board of directors, the size of the board and the independence of the board among others. Corporate boards are seen to engage in a critical role by offering direction and guidance to any corporate entity, kyereboah & Biekpe, (2007) while, the ownership structure has been identified as playing an imperative role in the governance of entities, Baysinger & Butler, (1985). Nevertheless, as

Denis and McConnell, (2003) stated that firm's resources should be utilized properly with the assurance of shareholders' value, which will allow enabling access to wealth and improving investor confidence to be successful corporate governance. Moreover, Gregory and Simms (1999) includes interior and exterior circumstances i.e. organization and market respectively. Therefore, firms' acceptance to external conditions depends on firm's management and the efficacy of firm's governance structure. Some researchers e.g. Rwegasira, (2000) have opposed that a good corporate governance can be defined when managers takes strong decision and well-organized management to prevent the elimination of company resources which ensure to get better share of company resources and improve the performance,

Much research related to corporate governance and its outcome of firm performance has been commenced predominately in UK and US markets, although in the Middle East countries where the diversity of culture and economic consideration prevail, the reflection of corporate governance is yet to embark on. However, in the decade (1990 to 2000), the government of Palestine built a significant effort to magnetize investors to aid the economy of the country at the global market. In current years, although we find a prolong discrimination among the Middle East countries, the growth in Palestine economy is quite delighted.

Due to the importance of corporate governance of companies which encourages people to invest their money, the researcher feels that it will be necessary to conduct research on corporate governance in Palestine. This study chiefly aims to contribute to the development of corporate governance in Palestine and presents an overview of the extent to which corporate governance exists in this country in comparison to international corporate governance practices. Moreover, it also assists in giving the investors a clear picture of the protection system that would encourage them to invest and recognize the safe area in which they may invest. The result of the study will hopefully make a useful contribution that enables the future research to enhance corporate governance and ownership structure practices and helps the regulators to develop effective corporate governance procedures and codes.

2. Literature Review

2.1 Firms' Performance

The current study emphasizes on the effect of corporate governance of firms' performance in Palestine. Much research has been found in Europe on it. First and foremost, the literature on executive compensation in public firms generally uses market-based measures of firm performance, frequently used: Tobin's Q Bebchuk & Peyer (2011) and measures of change in shareholder wealth Hartzell & Starks (2003). In public firms, both accounting and market-based measures of firm performance add incremental explanatory power when both are included in models of executive compensation Palmon & Wald (2006). A wide variety of measures of accounting performance has been used to proxy for firm performance in the compensation literature. However, Tosi, Katz, & Gomez-Mejia (2000) identified the use of 24 separate measures of accounting performance in a meta-analysis of the CEO pay-performance literature, although Return on Equity (ROE) and particularly ROA predominate.

As compare to, most studies applied ROA as the primary performance measure to find out the pay-performance relationship in private firms Michiels (2013). In the present study, lagged (by one year) it is expected that there may be a delay in directors' remuneration adjusting to performance as ROA is used as the performance measure. Bonus payments, for example, may be awarded based on historical firm performance. Inspection of the distribution of ROA revealed the presence of outliers in these variables. To address this, in the descriptive statistic, it was reported that ROA won at the 5th and 95th percentile.

Related to the current article, Daraghma and Alsinawi (2010) observed the effect of board of directors, management ownership and capital structure on the financial performance of the corporations listed in Palestine securities exchange. Within 2005-2008, 28 Palestinian corporations were selected. The statistical method that has been used in this literature study is (return on revenue; ROR), as a

consequence, it demonstrated that management ownership has positive effect on the financial performance. Moreover, they also found a significant positive result for the association of independent Chairman with ROA and ROE. The result depicted a higher proportion of independent non-Executive Directors are negatively associated with the firm's performances though.

In other studies, Velnampy (2013), examined that Corporate Governance and Firm Performance: A Study of Sri Lankan Manufacturing Companies, is initiated on “corporate governance and firm performance” with the samples of 28 manufacturing companies using the data representing the periods of 2007 – 2011. However, board structure, board committee, board meeting and board size including executive directors, independent non-executive directors, and nonexecutive directors were used as the determinants of corporate governance whereas Return on Equity (ROE) and Return on Assets (ROA) were used as the measures of firm performance. The study found that determinants of corporate governance are not correlated to the performance measures of the organization. However, Regression model showed that corporate governance doesn't control companies' ROE and ROA. In contrast to, Iturralde (2011), the empirical evidence proved that family firms are concerned the relationship between insider ownership and firm performance which may vary depending on which generation manages the firms.

2.2 The Relationship between Board of Directors and Firms' performance

The fundamental role of the board of directors is to scrutinize the managerial side of the firm and to curtail the problems inherent in the principal-agent relationship. Broadly, principals are the owners, agents are the managers and the board of directors acts as the monitoring mechanism. An agency problem occurs when the interests of the agent and the principal are misaligned. There is always a possibility of agency problems due to pursue their own objectives at the expense of the principals. Therefore, the principals appoint the members of board of directors as well as agents to ensure that the firm is working in the benefit of the owner. However, as Jensen and Meckling, (1976) elucidated that this divergence of interests and the need to oversee agents causes the firm to incur agency costs, including monitoring and bonding costs as well as residual losses. Eventually, the principals bear these costs; hence, the reduction of agency costs is part of the duty of maximizing shareholders' value. Consequently, the board of directors is an essential monitoring mechanism to protect principals' interests.

Moreover, the board of directors is the zenith of hierarchical corporate control systems. Therefore, agents' key role is to supervise the management on behalf of principals (shareholders) who select its members. As Liu and Fong (2010) mentioned that the managers (agents) have fewer opportunities of activities so they cannot make the best use of shareholder value due to over controlling of the board on manager. They further stated that an independent board is usually seen in favor as part of a competent governance system. This is because the ability of the board to implement its function of supervision the former on behalf of principals is enhanced by the autonomy from management. However, the three different mechanisms i.e. board size, CEO duality and independent directors) and their impacts on firm performance is conferred in the subsequent sections.

2.2.1 The Relationship between Board Size and Firms' Performance

The board size and firms' performance are also correlated to execute a better profit of the companies. As Jensen (1993) proposes that the effective function of the board depends on its size. The large boards expects to face high cost to monitor the firms if the figure of the members of the board exceeds seven or eight and get less effective function. However, a recent study Irshad (2015) conducted an Integrative approach where board effectiveness is measured by independent directors, and firm performance is measured by Marginal Q and ROA. As a result, he indicates a significant positive impact of board size on firm performance, where both board effectiveness and ownership structure measure its effect on firm performance.

Another similar study was conducted by using the same method. A random sample of 100 listed non-financial companies on Pakistani Stock Market was selected for the period ranging from year 2007 to 2012. The study revealed that board effectiveness is measured by independent directors, frequency of meetings, board size and CEO duality, while ownership structure is measured by ownership concentration, institutional ownership, managerial ownership, and firm performance is measured by Marginal Q and ROA.

The pragmatic evidence regarding the relationship between board size and firm performance is assorted. Ayorinde (2012) exposed a contrary study which mentioned a negative but significant relationship exists between board size and the financial performance measured by ROA and ROE. This secondary source of data was sought from published annual reports of the quoted banks. To examine the level of corporate governance disclosure of the sampled banks, a disclosure index was developed and guided by the Central Bank of Nigeria code of governance. Moreover, the Person Correlation and the regression analysis were used to find out whether there is a relationship between the corporate governance variables and firms performance.

Alike, Alias (2013) examined the interaction effects of firms' characteristics such as board structure and free cash flow on divided per share as a proxy of firms' performance. To find out the fixed effect regression, the researcher used a sample of 361 non-financial Malaysian listed firms over the period of 2002 to 2007. As a consequent, board size has a pessimistic effect on the use of free cash flow and performance.

2.2.2 The Relationship between CEO Duality and Firms' performance

Agency problems can be increased or reduced by depending on the board of director variable that may also occur due to the CEO duality. However, CEO duality delineates the board leadership structure to identify the distinctive or duality performance of CEO and the chairman. In order to study the impact of CEO duality on firm performance, the agency theory supports the idea of separation between the CEO and the chairman, to increase board independence from management, which (theoretically) results in better performance, better monitoring and overseeing, Jensen,(1993). If one person takes the responsibilities and decisions, this may facilitate greater understanding and knowledge of the company operations and better decision. Thus, it will reduce the agency costs and positive impact on firm performance, Arosa (2012).

However, from the most famous agency theory perspective, the chairman plays a significant role and duties monitoring the board and running board meetings. He also ensures that all the related issues of the company are listed in the agenda to be discussed in the board meeting, hiring and firing, and replacing the CEO if the latter is deemed to be negligent in serving the interests of the shareholders. In addition to, Fama and Jensen, (1983) stated that the implementation of the firm strategies and policies in company is mainly managed by the CEO. However, Jensen, (1993) illuminated that to this point of view, the chairman's duties and tasks inside the board reimbursing the CEO and managing the board. Therefore, while playing double roles, the person may feel burden which causes agency problems and weekend the effectiveness of monitoring the CEO. Similarly, Mallette & Fowler (1992) pointed out that if one person performs the duties of CEO and the chairman may stake rising the supremacy which can lessen the power of the board. In other words, the dual performance of CEO will entrench the role of managers or the CEO which can restrain the autonomous director's ability to monitor and to fulfill their governance role. Such activities raises the chances the discrepancy between the principal and agent as a consequence CEO duality is considered as a negative effect on the firm performance. Therefore, Lipton & Lorsch, (1992) and Van den Berghe & Levrau, (2004) suggested while splitting the two positions will provide the proficiency in work and balances over the managerial behavior which will ensure the board independence. Consequently, managers will avoid pursuing their profit and self-interests to the advantage of the shareholders. Nevertheless, Fama & Jensen (1983) argued that if the chairman and the CEO play the individual role, it may segregate the boundaries between the management's decision and control function. Empirically, Daraghma &

Alsinawi (2010) conducted a statistical study on 28 Palestinian corporations by using (Return on Revenue; ROR), as a consequence, their study indicated that the CEO-chairman separation does not have any significant impact but the financial performance.

On the contrary, Bozec (2005) inspected a sample study of 25 Canadian firms from 1976 to 2000. However, in his study he mentioned that there is no conflict on the sales, return on sales, assets revenue and sales competence. Likewise, Haniffa & Hudaib (2006) attempted a study on 347 Malaysian listed firms by using Tobin's Q. As a result, there is no significant relationship between the CEO duality and the firm performance. Correspondingly, Mangena & Chamisa (2008) also conducted a study of 81 South African listed firms from 1999 to 2005, where they mentioned a pessimist impact of CEO duality on the financial performance.

From the aforementioned studies, it is clear to state that the impact of CEO duality varies on the organization. It seems there is no such clear cut conclusion of positive or negative effects of CEO duality on the firm performance. Nevertheless, the perception of the agency theory delivered a negative impact of firm performance of CEO duality. It can cause various negative aspects, such as- CEO can control the board members which can intensify the agency problems, negligence in supervision of managerial opportunism and deflation the monitoring function. On the other investigation, CEO duality may perform as a benefit to the firms' performance as it may provide a unified leadership of the company i.e. the company can combine the information and understanding to take decisions and perform the functions.

2.2.3 The Relationship between Independent Directors and Firms' Performance

In current years, independent boards have received much attention from corporate governance regulations and academic research, (Chen, 2011). However, Agency theory suggests that independent boards have a greater capacity to limit managerial opportunism, (Jensen & Meckling, 1976); (Fama & Jensen, 1983); (Allegrini & Greco, 2013). An independent board has the capacity to protect shareholders and help reduce agency costs, (Chalevas, 2011). Moreover, Agency theory also predicts that the attendance of independent directors can trim down information asymmetry, (Allegrini & Greco, 2013).

Likewise, (Solomon, 2010) mentioned that it is convenient to build up well maintenance governance by the autonomous memberships if they provide a better sketch of stakeholders' interests. Furthermore, (Haniffa & Cooke, 2002) suggested that sovereign executives can support the board and committees by contributing their knowledge and experience as they are competent to monitor managers. In contrast, (Bozec, 2005) disagreed that a high proportion of independent directors on the board may lead to excessive managerial monitoring, which could potentially hinder managerial initiatives.

Empirical studies mainly indicate a positive association between of independent directors and firms' performance. Awan, (2012) examined the effect of board composition on firm's performance, specifically a case of Pakistani of 91 listed companies in Karachi stock exchange kse-100 index was randomly selected. In the research methodology, he chose group statistics and independent sample T-test to analysis data which is the most suitable instruments of the categorical variable board composition. The three hypotheses which have been used to find out the result shows greater return on assets (ROA), Return on Equity (ROE) and Tobin's Q. having the independent board members on their board of the listed companies of Pakistan showed greater firms' performance. Thus, it can be stated that having the autonomous directors in the board composition of the companies will have successful firm performance.

(Hussin & Othman, 2012) found a significant positive result for the association of independent Chairman with ROA and ROE. Although contradictory to the prediction of the agency theory, the result demonstrated that a higher proportion of independent non-Executive Directors are negatively associated with the firm's performances. The result of this study indicates that an elected independent chairman is an important factor for a company's financial performance. The study focuses on the

impact of good corporate governance mechanism and Malaysian Code of Corporate Governance (MCCG) on corporate performance in Malaysia-listed companies. Data are obtained from the top 100 constituent firms which comprised the FTSE Bursa Malaysia Index as of 2009, for the years ending 2007 to 2009. (Irshad et al. 2015) Pooled dummy regression model has been applied for analysis and the results indicate a significant positive impact of independent directors on firm performance.

On the other hand, (Alias, 2013), examined the interaction effects of firm's characteristics such as board structure and free cash flow on dividend per share as a proxy for firm's performance. The fixed effect regression used a sample of 361 non-financial Malaysian listed firms on the period of 2002 to 2007. The independent directors strengthen the insignificant positive effect of free cash flow on dividend payment. Overall, it can be surmised to suggest that larger number of independent directors on the board of directors benefit firms in the use free cash flow, leading to an increase in distributable income to shareholders but the existence of duality role does not benefit firms in the use free cash flow, leading to a decrease in distributable income to shareholders.

3. Hypotheses Development

On the ground of the former studies as discussed above, the researcher investigated the following hypotheses to answer the question of what is the effect of corporate governance on performance of Palestinian listed firms. Since the CEO/of duality, board size and independent directors' direction of effects are inconclusive in light of the discussed theories, it is hypothesized as follows:

CEO/Chairman duality is concerned with the considerable concentration of power which imposes the roles of chairman and chief executive is combined (duality).

In such circumstances, the supervising function of the board of directors get weekend because of the lack of independence (Patton & Baker, 1987). However, Duality also promotes CEO entrenchment which may bring a negative relation between duality and firm performance. On the other hand, duality can be seen as an advantage to the firm because it facilitates a unified firm leadership (Finkelstein & Aveni, 1994).

A key recommendation in codes of best practice is, therefore, to be a separation between the chair and CEO position, which will lead to more independent boards. The Cadbury Code of Best Practice Cadbury Report, (1992) for example, recommended that 'there should be a clearly accepted division of responsibilities at the head of the company, which will ensure a balance of power and authority, such that no individual has unfettered powers of decision.' The suggestion of separating the CEO/Chairman roles is consistent with agency theory (Eisenhardt, 1989), which assumes that the separation of ownership and control of corporations can guide to self-interested actions of the managers, and conflicts of interest in their role as agents of the owners. Agency theory, therefore, suggests that CEO duality (the situation where the CEO is also the Chairman of the Board) reduces the monitoring effectiveness of the board over management, and supports separation of the CEO/Chairman roles.

Several studies examined the separation of CEO and chairmen posit that agency problems are higher when the positions are held by the same person. Using a sample of 452 firms in the annual Forbes magazine rankings of the 500 largest USA public firms between 1984 and 1991, (Yermack, 1996) depicted that firms are more valuable when the CEO and board chairs are separated. The empirical study by (Rechner & Dalton, 1991) also supported the separation. The hypothesis is as follow:

H1. There is a relationship between CEO/of duality and firms' performance.

(Rose, 2005) used a sample of Danish listed firms and the results depicted that board size, proportion of insiders, and positions held by board members have insignificant influence on firms' performance. In addition to, (Basu, 2007) analyzed 174 large Japanese corporations and find a negative relationship between board size and subsequent accounting performance. Contrary, to the literature above, there has been a positive relationship between board size and Tobin's Q, (Adams & Mehran,

2002).(Haniffa & Hudaib, 2006) found that board size and top five substantial shareholdings have significant relationship with market and accounting performance measures.

The results of the effect of board size on corporate performance are miscellaneous; however, it could be argued that this effect is generally negative. The hypothesis is to be tested is as follows:

H2. Board size has a negative significant relationship on firms' performance.

Independent directors are those directors who are not working in a current company and do not have any business interest. The greater proportion of independent non-executive directors improve the performance of the company because they reduce the business in decision-making and bring transparency (Denis & Sarin, 1999; Zubaidah, 2009).(Dahya, 2008) also suggested that percentages of independent directors are positively associated with firm performance along with governing investors and countries with the lower protection of investor rights. Based on this discussion, the hypothesis is as follow:

H3: There is a positive relationship between independent directors and firms' performance.

4. Design of Research

4.1 Sample Chosen

This study consists of all companies listed on exchange Palestine securities with data available on all Corporate Governance of firms and financial variables of interest from the years of 2008 to 2015. Following Demsetz & Villalonga (2001), the researchers combine regulated and non- regulated firms in their sample. This study excluded only firms that have missed data, and this had left them with a final sample of 32 firms out of 48. They transformed variables that have extreme values to reduce the potential effect of outliers on an estimate of coefficients Tabachnick & Fidell, (1996). Table 1 presents the selection measure, and Table 2 shows the distribution of sample companies according to sector classification.

Table 1: Sample chosen

Standards	N
All firms listed on the exchange Palestine securities from 2008 to 31 December 2015:	481
firms that stopped trading at the market :	2
firms with missed full data about their ownership structures for period of study:	14

Table 2: Sample distribution

No	Sector	No. of firms	Percentage
1	Service	7	21.875%
2	Industry	9	28.125%
3	Investment	7	21.875%
4	Banking	5	15.625%
5	Insurance	4	12.5%
	Total	32	100%

¹ + MEAN POSTIVE

- NEG

5. Model

Model 1

$$ROA = \beta_0 + \beta_1 CEO_{it} + \beta_2 BSIZE_{it} + \beta_3 in_director_{it} + \beta_4 FS_{it} + \beta_5 L_{it} + \beta_6 G_{it} + \beta_7 I_{it} + \varepsilon_{it} \quad (1)$$

Where:

ROA: dependent variable (i=Firms , t= Time)

β_0 = Constant

Independent variables are CEO/of duality (CEO) , Board size BSIZE and independent directors (in_director). Others variables in the model are control variables, namely, Firm size, leverage, Growth and Industry (dummy variables), and ε - Error term.

Model 2

$$ROE = \alpha_0 + \alpha_1 CEO_{it} + \alpha_2 BSIZE_{it} + \alpha_3 in_director_{it} + \alpha_4 FS_{it} + \alpha_5 L_{it} + \alpha_6 G_{it} + \alpha_7 I_{it} + \varepsilon_{it} \quad (2)$$

Where :

ROE: dependent variable (i=Firms, t= Time).

α_0 = Constant.

Independent variables are CEO/of duality (CEO), Board size BSIZE and independent directors (in_director). Others variables in the model are control variables, namely, Firm size, leverage, Growth and Industry (dummy variables), and ε - Error term.

Model 3

$$\text{Tobin's Q} = \gamma_0 + \gamma_1 CEO_{it} + \gamma_2 BSIZE_{it} + \gamma_3 in_director_{it} + \gamma_4 FS_{it} + \gamma_5 L_{it} + \gamma_6 G_{it} + \gamma_7 I_{it} + \varepsilon_{it} \quad (3)$$

Where :

Tobin's Q : dependent variable (i=Firms , t= Time).

γ_0 = Constant.

Independent variables are CEO/of duality (CEO) , Board size BSIZE and independent directors (in_director). Others variables in the model are control variables, namely, Firm size, leverage, Growth and Industry (dummy variables) , and ε - Error term.

6. Variables Measurement

6.1 Performance Variables

Previously, various measurements have been used in order to examine the firm performance by different studies, (Cochran & Wood, 1984; Ittner & Larcker, 2003). Most of the studies examined the firm performance using a diversity of financial measures such as Tobin's Q (Dwaikat & Queiri, 2014; Connelly, 2012; Irshad, 2015, Alkhatib & Harsheh, 2012, Shabbir 2014), ROA (Dwaikat & Queiri, 2014; Ongore & K'Obonyo, 2011; Ayorinde, 2012; Velnampy, 2013) ROE (Awan., 2012, Hussin & Othman, 2012, Velnampy, 2013, ROI Boyd, 1995; Adjaoud, (2007) and net profit margin Bauer et al., (2004).

The above measures can be categorized into two groups: market-based and accounting-based measures. On one hand, Daily & Dalton (2003) suggested that the accounting-based measures consider the current financial performance of the company whereas market-based measures consider the investor perceptions of the company potential performance. Nevertheless, each group has been criticized by different researchers.

(Haniffa & Hudaib, 2006) argued that there is no consensus of measure which can be considered as the best financial performance. Furthermore, they reported that every measure poses strengths and weaknesses, thus, there is no specific measure to be the best proxy for financial performance.

According to agency theory, managers are more likely to misuse the firm assets by working for their own interests leaving less return for the firms. However, accounting based measure such as ROE, ROA and Tobin's Q are directly associated to management's ability to efficiently utilize the firm assets. A lower ROE, ROA and Tobin's Q will indicate inefficiency. Therefore, both of these measurements are essential to view of the measure of the firm performance. In this study ROE, ROA and Tobin's Q have been selected as proxies for firm performance from the accounting based measures.

Return on assets is an indicator of how profit a company is or how efficient is the management as using its assets to generate earning, and is sometimes referred to as Return on Investment. It is calculated by dividing a company net income by its total assets:

$$\text{Return on Assets (ROA)} = (\text{Net Income}) / (\text{Total Assets}).$$

Return on Equity measures the profit of the company by revealing how much profit the company generates regarding to the amount of the money invested by the investor. It is calculated by dividing a company net income by its total equity. It is also known as Return on Net Worth:

$$\text{Return on Equity (ROE)} = (\text{Net Income}) / (\text{Total Equity}).$$

Tobin's Q is the most frequent measure in empirical corporate governance research. Many other studies exploited this measure as the dependent variable in research on the effectiveness of corporate governance mechanisms and Ownership structure of firms' performance. The Tobin's Q ratio is a measure of firm assets in relation to a firms' market value.

$$\text{Tobin's Q} = (\text{Total Market Value of Firm} + \text{Total Liability}) / \text{Total Asset Value of Firm}$$

All the financial information that related to ROE, ROA and Tobin's Q variables were extracted from the balance sheet that provided by annual reports.

6.2 Corporate Governance Variables

Board Size

The empirical findings in previous studies are assorted regarding the relationship between board size and firm performance. Some studies e.g. (Ayorinde, 2012, Irshad 2015, Jensen, 1993; Alias 2013; Yermack, et.al 1996) found evidence consistent with the view of agency costs: that small boards are related with better firm performance. The previous studies argued that as board size increases, the problems of coordination and communication increase, thus, decreasing the ability of board members to monitor management behavior and thereby increasing the agency problem and resulting in lower firm performance. In the same vein, large boards will reduce the monitor and control function of the board by giving managers space to pursue their own interests rather than those of the principals. Large boards are more likely to be controlled by the CEO rather than the board controlling management, leading to a negative impact on firm performance. However, some studies (Hillman & Dalziel, 2003), (Lehn, 2009) found that large boards affect firm performance positively, consistent with the view of resource dependence theory, due to improved linkages to the external resources (Hillman & Dalziel, 2003). In addition, large boards allow directors to exchange more highly qualified counsels and present extra scope for the possibility of correlation with different external linkages and access to resources. These resources could include access to new and better technologies, access to markets and access to raw materials among other things. Large boards also play an important role in improving and enhancing the outcomes of decisions, because of diversity in educations, sharing of ideas, contributions and industry experience, which might lead to high quality advices and thereby better firm performance (Lehn 2009).

In consequence, from the mixed results, there is no consensus as to whether larger or smaller boards are better. Therefore, the current study will investigate the relationship between the board size and the firm performance. Following (Yermack, 1996), (Ahmed, 2006) and (Bennedsen et al. 2008), board size (labeled as BSIZE) is defined as the number of directors who are on the board, as shown below in Table 3. The number of directors was extracted from annual reports.

CEO Duality

Agency scholars such as (Berle & Means, 1932), (Jensen & Meckling, 1976) argued for separation of ownership and control in order to reduce agency problems and to improve firm performance. The agency theory supports the notion of separation between the CEO and the chairman, to increase board independence from management, which (theoretically) results in better performance due to better monitoring and overseeing,(Jensen, 1993). Moreover, (Brickley (1997) claimed that CEO duality will help in reducing the incomplete communication between the chairman and the CEO, hence reducing inconsistencies and conflicts in decision making.

According to the Palestine PEX (2012), the CEO and the chairman have different responsibilities, and accordingly, to avoid any conflict interests and maintain effective supervision of management, these two positions should be separated from each other. Different studies e.g.(Daraghma & Alsinawi, 2010; Irshad 2015; Haniffa & Cooke, 2002; Haniffa & Hudaib, 2006; Gilh & Mathur, 2011; Sheikh 2012) measured CEO duality as a dummy variable. However, in the current study CEO duality is a dummy variable, which will be created based on the CEO being chairman taking the value of one; otherwise the value of zero would be taken, as shown in Table 3 above. This information was extracted from the Osiris database. However, the variable will be investigated whether separating the two roles of chairman and the CEO affects the performance of the Palestinian companies positively or negatively.

Independent Directors

The percentage of independent directors, in director, was used as the proxy for the participation of independent directors on boards. The literature loosely defined independent directors (outside or external directors) of a firm as the people who have never been previously employed by that firm(Dore, 2005) and who serve on the board of directors to do independent monitoring task and to be impartial advisors to CEO. This study is rested upon Bloomberg's definition of independent directors. This variable, in director, is defined by the percentage of independent directors on board membership following (Beasley Rashid's, 2014) study that employed the percentage of outside directors as the proxy for board independence.

Table 3: Measurement of Corporate governance variables

Variables Labeled	Definition
BSIZE	The number of directors who are on the board.
CEO Duality	Is the CEO also Chairman? (YES=1, No=0).
in_director	the percentage of outside directors as the proxy for board independence.

6.3 Control Variables

Firm Size

Much research reported an unclear relationship between the firm size and firm performance. Such as- Alkhatib & Harsheh, (2012); Himmelberg (1999), Nenova, (2003), Short & Keasey (1999) and Joh, (2003) argued that bigger firms have performance in creating and making funds internally and access outside assets than smaller one. Moreover, larger firms can be profitable from financial systems of scale by creating entry barrier with a positive effect on firm performance. Furthermore, Jensen, (1986) pointed out that firm size may be used as a substitute for the agency problem. He also reported that if the managers run high quantity of assets, they are highly motivated to enlarge the firm size beyond the target which eventually indicates more power. Fama & Jensen, (1983) and Boone et al. (2007) argued that larger firm size portrays the natural complexity of company i.e. the firms grow to diversity. In the other word, larger firms require more advice on the board. Moreover, larger firms are interrelated with multifaceted operations in order to pursue the company strategies more competently. Serrasqueiro & Nunes, (2008) proposed that having larger firm size create better opportunity to lift the funds and more

diversified plans. In addition it has wide variety of expertise management. Black, (2006) elucidated that the firm size optimistically influences firm performance.

Opposed to this, other researchers e.g. Nenova, (2003) and Garen, (1994) reported that large firms are focused to more assessment and analysis. Henceforth, Nenova (2003) found it lavish for the controlling family to get extra income. Following, Agrawal & Knoeber, (1996) informed firm size and firms performance does not depend on each other. They argued that larger firm is not as competitive as smaller firm similar way, if the reduction is controlled by management over strategic and operational activities. Garen (1994) added that interference of public media can cost high for the larger companies as compare to smaller firm unless the cost of complying with cooperate governance codes requires. Finally, Jensen & Meckling, (1976) elucidated that the rising of agency cost depends on the increasing the firm size because of the need for more control that resulted from managerial prudence and opportunism. Moreover, the growth of the firm will result in increasing the internal control tools for forecasting and designing. This will elevate the need for aligning the interest of the managers and the shareholders Jensen & Meckling, (1976). With the view of prior studies, e.g., Muth & Donaldson, (1998); Elsayed, (2007); Al-Matari, (2012) TA was used as a substitute for firm size, however, the current article analyzed the firm size by using the natural logarithm of total assets (LOG TA), which is shown on the result.

Leverage

Many researchers have disputed about the positive or negative effectiveness of leverage on firm performance. As a result, it may obtain a positive effect for monitoring by lenders. Jensen & Meckling, (1976) found that leverage play a vital role in extenuating agency problem as an internal corporate governance mechanism especially free cash problems. Jensen (1986) argued that increasing the external debt will constrain managerial discretion which is the outcome of a positive effect. Thus, he further reported that as managers are obligated to pay periodic repayments of interest and principal, they will carefully utilize the company free cash flows for non-profitable investment (opportunistic managers) because of the high levels of debt. Stiglitz, (1985) illustrated that lenders are chiefly capable to control than shareholders. Similarly, Ross, (1977) argued that increasing the leverage might be a good indicator for the company ability to serve large amounts of debt. Moreover, (Modigliani & Miller, 1963) expect positive association between leverage and the firm performance computed by tax shields. Agrawal & Knoeber, (1996) pointed that the debt in financing can heave up the firm performance while pursuing the supervising by lenders.

On the contrary, Myers, (1977) disputed that the firm performance can be violated by loft amount of leverage. However, low investment can be problematic if the leverage is amplified which can hinder the ability of the company to raise new debt and losing any possibilities to acquire any investment opportunity. Furthermore, Myers, (1977) and Stulz, (1988) reported that the abundant leverage will influence the market value of stocks, consequently, it will produce higher financial menace. Moreover, they argued that from the governance viewpoint, high amounts of leverage will create excessive interest and closer monitoring which will hamper the firm performance. With the similar point of view, Andrade & Kaplan (1998) illustrated that if the firm leverage is low, it lows the chances of financial distress, as compare to the higher financial leverage. As Leverage is described as prolong debt to total assets, it was extorted directly from the balance sheet presented by annual reports.

Table 4: Measurement of Control Variables

Variables	Definition
Firm size	Total assets
Leverage	long term debt to total assets.
Growth	The market-to-book assets ratio (MTB).
Industry	The value of 1 is used if the firm is in the industry or 0 otherwise.

Growth

Consistent with a number of earlier studies (Carcello, 2004; Abbott, 2004 & 2000; Beasley, 1996, Dimitropoulos & Asteriou 2010), the present study controls the effect of company growth. As it is essential to control a firm's pace of development all along of rapid growth, a company may experience pressure to maintain or exceed anticipated growth rates. The pressure to achieve a targeted rate of growth, or alternatively to mask downturns, may create an incentive for management to engage in, EM (Carcello, 2004).

Skinner & Sloan, (2002) found evidence that growth stocks have significantly greater negative market responses to earnings disappointments than do value stocks. This result implies that growth firms have greater incentives to avoid negative earnings surprises. Furthermore, (Matsumoto, 2002) documents that a rapidly growing firm is more likely to manage earnings. Among other studies that find growth is related to EM are those of (Abdulahman & Ali, 2006; Huang, 2008 and Dimitropoulos & Asteriou, 2010).

Based on (Myers, 1977) and (Gaver, 1995) definition of growth opportunities as the difference between a firm's value and existing assets, this study measures growth (GROWTH) as the market-to-book assets ratio (MTB). MTB utilizes the market value of assets as a proxy for a firm's value and the book value of assets as a proxy for existing assets. A higher MTB represents greater growth opportunities. The information required to populate the variable is sourced from Annual reports.

Industry

Haniffa & Cooke, (2002), Lim, (2007) and Elsayed, (2007) et.al investigated that corporate governance performs according to the use of capital structure, intricacy of operations, ownership levels and channel in business in different industries. Moreover, the global markets and development of economic compete varies depending on industries. Furthermore, based on survey by CLSA (2000), corporate governance values differ across different industries in rising markets Following Hanifia & Cook, (2002), Foroughi, (2011), Mandaci (2010) mentioned that the industry variable is used as the dummy variable. To evade the dummy variable trap, one industry is excluded five main economic sectors; banking and financial services, insurance, investments, industry, and services according to PEX classifications. The value of 1 is used if the firm is in the industry or 0 otherwise.

7. Results

7.1 Descriptive Statistics

Table 5: Descriptive statistics

	N	Minimum	Maximum	Mean	Std. Deviation
ROA	32	-.1943486	.2251992	.0282383	.0655775
ROE	32	-.2830618	.3178167	.0601	.092927
TobinQ	32	.3721267	1.953769	.9857576	.2944754
BFSIZE	32	5	15	9.54902	2.26679
in_director	32	0	1	.7352794	.2667757
Logasset	32	6.105274	9.444857	7.663554	.7114962
Leverage	32	.0155414	1.061415	.4055357	.2689653
Growth	32	-.2445706	.4284663	.0617829	.1210384

Table 5 above reports the descriptive statistics of the dependent variables. The table shows that the ROA ranges from a minimum of -.1943 to a maximum of .2251 with the Mean of .2823 for the overall sample. The ROE ranges from a minimum of -.2830 and maximum of .3178 with the Mean of .0601. The Tobin Q ranges from a minimum of .3721 to a maximum of 1.953 with Mean of .985.

The average board size in Palestine similar in Egypt and Malaysia is eight or nine directors Elsayed, (2007); Haniffa & Hudaib, (2006), while the average board size in the US is 12.25 Yermack, (1996). However, the board size is significantly smaller in Australia, averaging 6.6 Kiel and Nicholson, (2003). As shown above in table 5, the results show that on average of Independent directors (in director) is .7352794 with minimum of 0 to a maximum of 1. The CEO duality variable is used as the dummy variable. To avoid the dummy variable trap, one CEO duality is excluded. the results show that The frequently of duality is 248 and the percentage is 96.88% and the frequently of non-duality is 8 and the percentage is 3.13%. In Palestine, particularly in family-controlled businesses, it is common that the chairman holds the position of CEO, especially if he was the founder of the firm.

Table 5 presents the descriptive statistics of the control variables. Logarithm of total assets (Logassetl) range from a minimum of 6.105274 to a maximum of 9.444857 with an average of 7.663554. The average of debt ratio (leverage) and Growth is .4055357 and .0617829 respectively. The industry variable is used as the dummy variable. To avoid the dummy variable trap, one industry is excluded two main economic sectors; Financial and non-financial. The frequently of Financial sector is 176 and the percentage is 68.75% and the frequently of non-financial sector is 80 and the percentage is 31.25%.

7.2 Coefficients and Significant Paths

Table 6: Board of directors variables results

	ROA	ROE	TobinQ
Board size	-.0068124 (0.000)***	-.0108159 (0.000)**	-.0048316 (0.021861)**
Independent directors	.1120431 (0.000)***	.0622372 (0.000)***	.1971217 (0.011)**
CEO duality	-.0272347 (0.207)**	-.0323062 (0.298)**	-.4189905 (0.000)***
Firm size	.0337516 (0.000)***	.0489234 (0.000)***	-.0014409 (0.965)
Leverage	-.1099913 (0.000)***	-.0585735 (0.014)**	.1230461 (0.115)
Growth	.1359289 (0.000)***	.2768459 (0.000)***	-.0918385 (0.542)
Industry	.0238754 (0.006)***	.0276826 (0.027)**	.0909847 (0.038)**

Note. ***P < 0.01; ** P < 0.05; *P < 0.1.

In the table 6 it is shown a negative report and highly significant impact of board size on firm performance in ROA, ROE and Tobin Q. the result of the investigation of most previous studies was either positive or negative relation to the impact of board size on firm performance. As Lipton & Lorsch (1992), Jensen (1993), Yermack (1996) and Gertner & Kaplan (1996) depicted a negative impact of larger board, where as small board size does not cause any problems or poor coordination and communications. Eisenberg (1998) further illustrated that if the board size enlarges, it also carries problem of coordination and communication, which can fragile the ability of the board to control management, thus creates agency problems. Therefore, having petite board size is easy to control and make decision which helps to have an effective in monitoring management and consequently maximize the value of shareholders, whereas large board causes different opinions which is constrain to make any effective decision.

The results shown in table 6 reports a positive and significant impact of independent directors on firm performance in ROA, ROE and Tobin Q, Most prior studies that investigated the impact of independent directors on firm performance found a positive relationship. For example, Alias (2013) the results of this study may be surmised to suggest that larger number of independent directors in the board of directors benefit firms. Irshad (2015) found significant positive impact of independent directors, frequency of meetings and board size on firm performance.

With respect to the effect of the CEO duality, the results shown in table 6 indicate negative significant and highly significant impacts on ROE, ROA and Tobin Q respectively. This indicates that for firms operating in Palestine, the performance enhanced when the CEO perform as the board chairman, as that increases the ROA and ROE. However, this contradicts with the corporate

governance principles that promote for separating the CEO's role from that of the board chairman, as the CEO duality often increases the possibility of conflict of interest and agency problems, and limit the efficiency of the board to provide monitoring and control over the top management.

The effects of the control variables on firm performance have different results across the performance variables (ROE, ROA and Tobin Q). TA is used as a proxy to measure the firm size. In line with earlier studies, total asset (TA) is transformed into logs, to reduce their skew or kurtosis and mitigate influence of the outlier data points. Table 6 above reports a positive and strong statistically significant effect of the firm size on ROA, ROE. This positive result indicates that large firms may benefit from economies of scale and scope Joh (2003).

The measure of leverage that used in this study is the percentage of long-term debt to total assets. The results shown in table 6 reports a negative and highly significant affect only on ROA and ROE: higher levels of debt will cause a decrease in firm performance. In other words, the results indicate that the higher the debt ratio, the lower the ROA and ROE. It might be that firms face higher levels of debt due to the increasing cost of operations, which might reflect their ability to fulfill their obligations to pay higher interest rates Dechowetal (1996). Higher levels of debt might limit firms'ability to raise new credit, resulting in losing valuable investment opportunities. This means that high levels of debt have a negative influence on the amount of dividends paid, because firms with high levels of debt will pay lower dividends in order to avoid external resources of finance.

The results shown in table 6 reports a positive and highly significant affect of growth only on ROA and ROE. We use the market-to-book ratio as a proxy for firm growth. We find companies that are growing more rapidly to face greater pressure to maintain high growth rates. This pressure may increase the likelihood that management would engage in a fraudulent practice to maintain the appearance of rapid company growth. The variable of industrial was found to have a significant relationship with firms performance of ROA. This implies that, in Palestine, regulated firms performed better than unregulated firms. Haniffa & Hudaib (2006) indicate that the trading sector performs better than the industrial sector. Demsetz Villalonga (2001) found a different relation between sectors and firms performance and indicates that media sectors are positively related with the performance and with financial sectors negatively. Omrana et al. (2008) found, in four Arab countries, that sectors have a significant relation with performance (negative for the financial sector and positive for manufacturing) Carcello (2004).

8. Limitations and Further Studies

The current study has few limitations which suggest further studies. First and foremost, the study is limited to the firm's size as the market in Palestine is not very popular; therefore, the size of sample was reduced from 48 to 32 firms. Next, the study could not examine the impact of board sub-committees of Palestine companies as there was no such data found from annual reports related to it. Moreover, the researcher strived to conduct the interviews through call and email to gather the information regarding the existence of committees and their compositions. Nevertheless, out of 32 companies, only 12 responded and the rest unresponsive companies were accredited that these committees do not exist on the board. Finally, the study includes only there variables of board structure to analysis the data i.e. the board size, independent directors and CEO duality. To find the best result, the researcher attempted various methods to contact the companies, as it was mentioned previously there was a weak response rate, though a broader understanding of the characteristics of a board could be gleaned from an appreciation of the education level, gender and nationality of its members.

The current study used OLS regression to examine the relation between ownership structure, corporate governance and firm performance. Therefore, future studies may use 2 OLS regression models (instrument variable) in order to address the endogeneity issue (i.e., relation between Non-executive directors (NEDs) and firm performance). Secondly, further research is required to investigate the impact of the role of the board of directors on firm performance, particularly to

investigate the effect of the level of education, the gender, experience and the age of board members upon firm performance.

Public Interest Statement

This study examines the relationship between the Corporate Governance and firms' performance of 32 firms listed on the Palestine Stock Exchange (PEX) during the period of 2008-2016. The results revealed that a negative and significant impact of board size and CEO duality on firm performance in ROA, ROE, and TobinQ, while the independent directors found to have significant positive relation with firms' performance (Tobin's Q, ROE and ROA).

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