Impact of Corporate Governance on Financial Risk of Omani Non-financial Companies Listed on the Muscat Securities Market

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Abstract--- Purpose: *Corporate governance and financial risk have been researched extensively especially after the 2008 global financial crisis. The emergence of corporate governance as key area of focus in various fields of research such as management, economics, law and business are due to corporate failures and scandals. Hence, this paper seeks to investigate whether corporate mechanisms have significant impact on non-financial companies, particularly those listed on Omani's Muscat Securities Market.*

Design/methodology/approach: *This study uses characteristics of corporate governance to investigate the financial risk activities of 116 companies listed on the Muscat Securities Market. The characteristics to be used as the independent variables (IV) are the companies' board composition and size, ownership concentration, regulatory compliance, executive compensation and information disclosure. The IVs will be used to examine whether corporate governance directly affects the dependent variables financial and investors' perspective risks when moderated by firm's profitability, size and risk management control. To test these variables, Generalized Method of Moments (GMM) for data analysis will be used as it allows equitable and reliable approximations whilst establishing corporate governance's link between with financial risk.*

Findings: *Findings from this study is hoped to fill the knowledge gap on corporate governance and financial risks among non-financial institutions in Omani context.*

Practical Implications: *Finance and making investment-related decisions whilst managing risk are strongly correlated. It is believed that the effectiveness of corporate governance process reduces risk with the purpose of benefitting leadership and ethical codes of conduct.*

Keywords--- *Corporate Governance, Non-financial Institutions, Oman, Muscat Securities Market.*

I. INTRODUCTION

Efficient corporate governance procedure is significant as it reduces risks with the intention of achieving evident advantages from ethical codes of conduct and leadership (Amico, 2016). This perspective corroborates the notion of associating risks with ideal corporate governance. The strong connection between finance and the choice to invest along with managing risk drew more interest to explore the corporate governance's impact on financial markets (Brezeanu et al., 2011).

Regarding corporate governance in the current business world, it is common to connect the theme to financial risk. Truong et.al. (2015) explained that financial risk are types of risk linked to possibility of losses caused by

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financial variables. The variables could be in different forms of risks such as fluctuating interest and foreign exchange rates, credit, liquidity and capital risks, which could incur internally. For non-financial institutions, unlike financial institutions, they are vulnerable to fragmented risks that are challenging to quantify or hedge (Carlton, 2014). As non-financial institutions are exposed to drastic financial changes stemming from fluctuating market rates, their cash flows are tied to the variables linked business operations linked to their institutions' income. Therefore, deciding to hedge potential financial risks would be complicated.

This study aims in investigating the effects of corporate governance attributes in various areas of financial risk of non-financial Omani companies listed on the Muscat securities exchange management practices and profitability. Accordingly, the study is based on a number of corporate governance theories such as the agency theory and stakeholder theory (Fama & French, 2004; Keasey et. al. 2005; Hillier et al. 2011; Parigi et. al. 2017).

II. CORPORATE GOVERNANCE AND FINANCIAL RISKS

Corporate governance's roots emanated from early 19th Century from the renowned agency theory dealing with the separation of functions between owners and firms' operations. This principle promoted the need to detach the firm's functions from those of owners, thereby preserving control in the manner the management performs (Panda & Lepsa, 2017). Corporate governance was initially defined based on the agency theory where significant connection was between the shareholders and the organization. Until the 1980s, the conflict of representation between shareholders and directors was a major issue in corporate governance.

Corporate governance is said to be connected to approaches to bring interest of investors and managers into line and ensure that firms are managed with the investors' best interest in mind (OECD, 2015). Zagoub (2016) stated that corporate governance comprises of structure, procedures, values and systems engendering to a successfully operated organization. Generally, it was accepted that the focus of ownership would reduce the representation issues, which would improve the company's performance. Keasey et.al (2005, p.87) investigated the relationship between ownership/control structure, with regards to shareholders' identity, and how the firms perform fundamentally testing the managerial/ agency theory propositions that different ownership/control structures give rise to opposing performance. Researchers justify this increased ownership concentration and show how it leads large investors to enter the corporate ownership structure. These investors have sufficient motivation and power to oversee the managers, and their supervision will lead managers to take on the company's continuing goals (Nguyen, 2011).

After the 1997 Asian crisis, the focus is on corporate governance in the companies. After the onset of the worldwide fiscal crisis in the summer of 2007, OECD was the first organization to step up a corporate governance corridor focusing on corporate governance in companies in four principal areas that are service compensation, risk management, the role and the duties of the board of directors and observance of shareholders' responsibilities. Strong corporate governance in companies is the most crucial tool for preventing corruption. Studies on corporate governance showed that the weakening of corporate governance led to an increase in financial corruption and a decrease in domestic and foreign direct investment that results negatively on the overall economy (Aebi, et al., 2012; OECD, 2015; Zagorchev, 2015; Amico, 2016).

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III. CORPORATE GOVERNANCE ISSUES IN OMAN

Regionally, Oman is said to be 'the second-best governance performer' and the country was also said to be pioneering the development of Corporate Governance codes in the Gulf Cooperation Council (GCC) in 2002. Oman's Capital Market Authority (CMA) consistently enhance and expand the existing Corporate Governance policies from time to time (Pillai & Al-Malkawi, 2016). However, previous research results for the Gulf Cooperation Council (GCC) countries revealed three types of risks in the member states ranging from political risk to economic and financial risk. The studies revealed that Oman had the highest economic risk (Ramady, 2013).

Reports of manipulation of accounts and loans in the financial sector in Oman (Oman Observer, 2018) demonstrate financial fraud and financial risks which put Corporate Governance to test in Oman. Firm corporate governance in corporations is the most important tool for preventing corruption. Therefore, according to the stated issues, this research seeks to study risk and bankruptcy problems by examining the corporate governance structure of company and risk management. Good corporate governance means fewer negative net present value projects and fewer missed opportunities (Manzaneque et al., 2016); less fallacious or self-serving statements by managers in financial statements or to the press and other filings (Kachouri & Jarboui, 2017). Good corporate governance also means greater credibility and/or transparency of the firm (Fung, 2014). Through all of this, the amount of reliable available information should be increased and uncertainty in the market should be decreased. This should decrease the market's perceived risk of the firm. Through strong governance, managers should assume a suitable level of risk for the firm and declare that private benefits are decreased (Panditharathna & Kawshala, 2017).

Existence of a corporate governance gap in the region is widely accepted and according to the accessible indicators, implementing the principles and standards is quite behind in companies and countries of the Middle East and North Africa (MENA) Region, in relation to the benchmark of the OECD Corporate Governance Principles and practice in industrialized countries (Amico, 2016). The reports on several topics (for instance payment systems, dissemination of data, and banking supervision in the case of Lebanon) have been accepted and completed by some countries (such as Egypt and Lebanon) but these reports have not been accessible widely or published (Pillai & Al-Malkawi, 2016).

Studies conducted in the region revealed the weaknesses of corporate governance increased financial corruption, followed by domestic and foreign direct investment, government spending, and declining economic growth (OECD, 2015; Zagorchev, 2015 ; Amico, 2016). Therefore, according to the stated issues, this research seeks to study risk and bankruptcy problems by examining the corporate governance structure of companies and how they undertake risk management.

IV. FINANCIAL RISKS AND NON-FINANCIAL INSTITUTIONS

A non-financial institution is a financial institution without a full banking license and do not accept public deposits (Jeffrey and Pomerleano, 2002). These institutions alternatively provide but not limited to investment services, risk pooling, financial consultation, money transmission and brokers for stock markets. These non-financial institutions are still at risk of facing financial and operational risks. Non-financial institutions have the tendency of putting varying emphases on the types of risks faced. Carlton (1999) explained that non-financial businesses

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normally focuses on physical positions of specific cash flow patterns instead of positions' values. These characteristics are relevant when defining how corporations reveal exposures and risk management practices (Carlton, 1999).

According to Dey, Hossain, & Rezaee (2018), financial risks can be categorised into interest rate, wealth structure, exchange, liquidity and credit risks. Non-financial companies' management of risks is diverse for example:1) operating leverage (mixed fixed and variable costs) to respond to volatile markets; 2) shifting production location to a foreign country responds to foreign exchange exposure caused by competitive imports; 3) adjusting production volumes responding predicted market prices' variations; 4) modifying business portfolio by screening projects, abandoning projects or divestment can commenced to influence company's risk profile; and 5) diversifying portfolio with the intention of absorbing risk.

V. PREVIOUS STUDIES ON CORPORATE GOVERNANCE AND FINANCIAL RISKS

Previous studies discussing corporate governance and financial risks are summarized in the table below:

Table 5.1: Previous Studies on Corporate Governance and Financial Risks

No	Author/ Year	Sampling	Independent variables	Dependent Variables	Research Methods	Findings
1	Su & Lee (2013)	314 public listed family-owned firms (family ownership exceeding 5% of the firm's total ownership)	Corporate Governance	risk-taking behaviour in family firms	Quantitative	The findings revealed that external directors are responsible in reducing family involvement and risk-taking. Nevertheless, the effects are negative for firms that became public after institutional reforms.
2	Zhong, Gribbin, & Zheng (2007)	2167 non-financial, non-utility, US incorporated firms listed on NYSE	Blockholders' Ownership	NYSE earnings management	Quantitative	The findings showed that there is a positive correlation between blockholders' ownership and unrestricted additions.
3	Tsorhe, Aboagye, & Kyereboah -Coleman, (2011)	26 banks in Ghana	Board size influence and stakeholder behaviours	management of bank capital risk, credit risk, and liquidity risk	Quantitative	The findings showed that management efficiency helps banks to hold less capital
4	McNulty, Florackis, & Ormrod, (2013)	141 companies with complete data collected from company chairs on both board structure and process	Board behaviours and director features	financial risk management	Quantitative	The findings revealed the strength between board process and financial risk
5	Nyakoe (2012)	42 commercial banks, operating in Kenya for at least five years.	corporate governance	risk management practices among commercial banks in Kenya	Quantitative	The findings showed the correlation between corporate governance and Kenyan banks risk management practices
6	Salhi & Boujelbene , (2012)	10 Tunisian banks from 2002 to 2009	Ownership Structure	Bank Risk	Quantitative	The findings showed that there is a positive link between board size and bank risk
7	Truong et. al. (2015)	26 joint-stock Vietnamese commercial banks in the period of 2009-2013	Corporate Governance	financial risk	Quantitative	The findings showed that corporate governance factors' statistics have notable influence on financial risks
8	Bourakba & Zerargui, (2015)	12 different banks from UAE, Qatar, Bahrain, Kuwait, KSA	corporate governance	credit risk in Islamic banks	Quantitative	The findings showed that non-performing loans ratio and composition of board of directors, the size of board of directors, board committees, concentration of ownership, along with the Sharia supervisory board size are negatively correlated while the bank's size is positively linked to non-performing

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						loans ration.
9	El-Masry, (2016)	900 banks from the Gulf countries	GCC banks' corporate governance	risk management	Quantitative	There is a positive link between Islamic banks and risk management measured by capital adequacy ratio
10	Al-Hadi et al, (2017)	GCC financial firms between 2007 and 2011	royal family membership and governance structure's strength	risk reporting practices	Quantitative	Transparency is improved by corporate governance and can be utilized to curb negative influences from politically inclined board members
11	Krishnamurti et al, 2018	123 public listed companies	corporate social responsibility (CSR)	firm-level corruption risk	Quantitative	CSR has significant impact on corruption risk
12	Nakpodia and Adegbite (2018)	Interview three elitist groups – political, cultural and religious	corporate governance mechanisms	elitist interventions	Qualitative	The findings revealed that elites can instigate, evade and corrupt institutions.
13	Sayari and Marcum (2018)	US firms, cross-listed American Depository Receipt companies (ADRs) and non-cross listed emerging market (EM) firm	corporate governance	Risk reduction	Qualitative	Governance risk taking standard do no digress from the cross-listed ADRs
14	Alam & Shah (2013)	106 Pakistani firms over a time of six years (2005-2010)	Corporate governance	Firm risk	Quantitative	Family and bank controls negatively impact firm risk. However, ownership structure and duality roles of chairman or CEOs assert positive impact with risk
16	Pearl-Kumah, Sare and Bernard (2014)	board of directors, senior risk management officers staff from selected banks	corporate governance	risk management practices	Quantitative	The findings reported that banks involved in the studies manage risks effectively. The directors, management and staff are also efficient in active risk management.

The previous studies highlighted on roles corporate governance play in managing risk in both financial and non-financial institutions. It is discovered that governmental ownership is positively linked to managing risks. The studies revealed that role duality and size of the board are negatively correlated with administration of risks. On the other hand, there is an inconsequential connection between board non-executive members' percentage. The authors have shown existing connection between corporate governance and a firm's success. A number of studies investigated the existence of corporate governance impact on financial risk (Alam & Shah, 2013; Bourakba & Zerargui, 2015; Truong et al, 2015; Venuti & Alfiero, 2016; Ahmed, Khamis, & Syed 2017).

However, there has been little attention given to studies investigating corporate governance and financial risk particularly in relation to non-financial institutions. Most studies have looked at risk in relation to banks and insurance firms. Hence, current study aims in filling this gap with the intention of enriching related studies by conveying strong financial risks evidence involving Muscat Securities Market-listed non-financial companies.

VI. METHODOLOGY

This investigation views corporate governance as set of processes, customs, policies, laws, and institutions influencing how a firm is managed and controlled (Rouf, 2011). The formulation of this study's hypotheses is based on the direct effect of corporate governance, moderated by firm's profitability, size and risk management control, on components of corporates' internal financial risks and investors' perspective risks. Based on the discussions, the formulated hypotheses investigate causative relationships clarifying the connection between these constructs.

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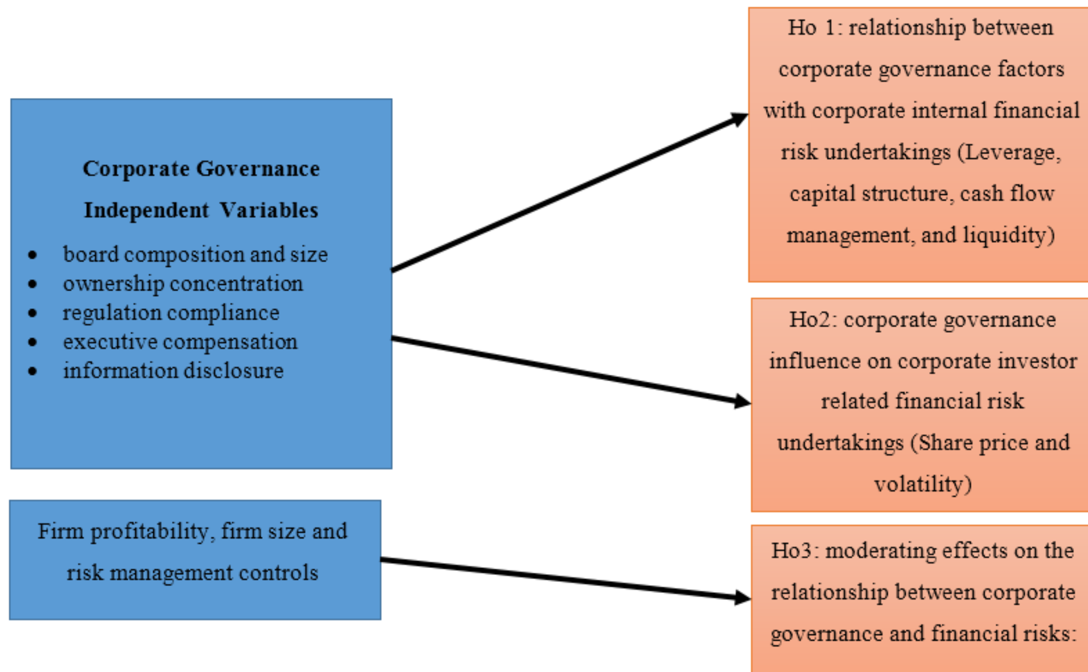

Figure 1: Hypothesis Framework

This study will be carried out quantitatively as it investigates corporate governance of 116 companies listed on the Muscat Securities Market (MSM, 2019). Corporate governance data of 79 non-financial companies out of the total 116 MSM listed firms to be used in the study will be collected from the individual firms' annual reports and available documentation for the past five-year period from 2013 till 2018. The collected data will be analysed using Stata software to help visualize the findings using panel analysis and multivariate regression. Since the study involves establishing relationships between corporate governance and financial risk, it is necessary to undertake multivariate regression analysis to establish these relationships between the dependent and independent variables.

Panel dataset is used as part of the design as it investigates similar cross-sectional units over time (cross-sectional and time series combination). With the aim of attaining impartial and reliable estimates, dynamic generalized method of moments (GMM) panel will utilize an approximation method by Holtz-Eakin, Newey and Rosen (1988) and Arellano and Bond (1991).

VII. Summary

In all, this concept paper had aimed to describe issues and factors related to corporate governance and whether it has a specific impact of non- financial companies' financial risk. The study has identified and discussed corporate governance and financial risks in the context of Oman. The use of quantitative measurements will enable the data to be used to establish the significance of corporate governance in handling financial risks.

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