THE EFFECT OF CORPORATE GOVERNANCE ON THE FINANCIAL PERFORMANCE OF SME LISTED COMPANIES IN EGYPT

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Abstract

The aim of this paper is to examine the effect of corporate governance on the organizational performance of domestic small and medium-sized enterprises (SMEs) in the industrial, construction, distribution, and mining sectors listed on the Nilex stock market in Egypt. Using an empirical analysis this study examines the effect of board size, board composition, chief executive officer (CEO) duality, and the existence of the audit committee on the performance of the listed companies. This study exploits corporate performance by accounting-based measures (return on assets, ROA). The study's findings about listed SMEs provide some interesting information. It demonstrates a negligible association between board size and company performance in Egypt as well as a negative association between the proportion of executive directors on the board and company performance. A positive correlation between CEO duality and business performance is also present. A reverse relationship between the existence of the audit committee and the performance of the companies. The paper provides empirical evidence that applying corporate governance practices is still not mature in the Egyptian SMEs listed on the Nilex stock market. Considering the enforcement of corporate governance practices in 2017, this paper considers one of the fewest that contributes to the literature on corporate governance and SMEs performance in Egypt by introducing empirical findings for the period from 2018 to 2021.

Keywords: Corporate Governance, Board of Directors, CEO Duality, Audit Committee, Board Independence, Board Size

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1. INTRODUCTION

The purpose of this paper is to analyze how corporate governance affects the organizational performance of small and medium-sized enterprises (SMEs) listed on the Nilex stock exchange in Egypt and to outline the characteristics of these businesses and their boards. Although much attention has been paid to the relationship between applying corporate governance practices and firm performance, particularly in emerging economies, the empirical evidence is often contradictory. Thus, this paper examines two main research questions:

RQ1: Are the domestic SMEs listed on the Nilex stock market applying corporate governance practices?

RQ2: What is the effect of corporate governance practices on its financial performance?

Through an empirical analysis of the domestic listed companies' data in the industrial, construction, distribution, and mining sectors, this paper answers these questions by studying the effect of board size, board composition, chief executive office (CEO) duality, and the existence of audit committees on the listed companies' performance. This study exploits corporate performance by accounting-based measures (return on assets, ROA).

The study is based on Nilex listed companies in 2022 and the data collected from 2018 to 2021; however, a large sample and multiple-year data are required.

The paper structure covers a literature review of corporate governance and measures SMEs performance by ROA in Section 2. The research hypotheses are driven from this review, and then these hypotheses are examined through analysis of the data set given in Section 3 representing 46% of the market size in SMEs in the Egyptian stock market. Section 4 presents the results of the analysis. Section 5 discusses the research results and Section 6 provides the conclusions and our recommendations.

2. LITERATURE REVIEW

Various definitions have been given to corporate governance. As per Mayer (1997), corporate governance is worried about approaches to bringing the interests of investors and directors into line and guaranteeing that organizations are run to achieve investors' benefits. Corporate governance is worried about the connection between the interior administration systems of partnerships and society's origination of the extent of corporate responsibility (Deakin & Hughes, 1997). It has additionally been characterized by Keasey et al. (1998) to incorporate "the structures, processes, cultures, and systems that engender the successful operation of the organization" (pp. 390–391). Corporate governance is likewise viewed as the entire arrangement of measures taken inside the social element that is a venture to lean toward the financial specialists to partake in the useful cycle, to produce some hierarchical excess, and to set up fair dissemination between the accomplices, thinking about what they have brought to the association (Maati, 1999). The Committee on the Financial Aspects of Corporate Governance (1992) characterizes corporate governance as "the framework by which organizations are coordinated and controlled" (p. 15).

Corporate governance, on the other hand, is a system of management and control. It provides a framework for ensuring that the company objectives are being met. Best governance practices create financial backer confidence, increasing the firm's value. Measures of corporate governance are important for publicly traded companies, and SMEs need commonly accepted metrics. Over the past 15 years, the phrase "corporate governance" has gained significant traction in the business and financial worlds (Keasey et al., 2005).

From these criteria, it is very well possible to infer that different corporate governance frameworks would, for the most part, capture what are considered to be true lines of responsibility by defining the relationship between the organization and major corporate voting.

Thus, corporate governance frameworks may be viewed as essential elements for outlining the concept of ownership and management of organizations within an economy. Corporate governance systems are sound financial and legal foundations that can occasionally be improved upon through the political cycle in this particular circumstance (Shleifer & Vishny, 1997). Organizational regulation is shaped and molded by successful corporate governance frameworks, coupled with other forms of guidelines (including stock trading posting requirements and bookkeeping standards). The impact of guidelines on corporate governance is shown in how they affect how companies are governed, how they are owned, and how ownership and control changes take place over time (Jenkinson & Mayer, 1992).

Organizational regulations define possession, defining property privileges, and revenue streams of those having interests in or against the company endeavour (Deakin & Slinger, 1997). The definition of "proprietorship" in this context is dangerous (Njoya, 1999). Contrasting origins of ownership fundamentally influence different forms of control, which in turn influence how a corporate system is defined and implemented (Deakin & Hughes, 1997).

The performance of SMEs can be understood from both a quantitative and qualitative perspective, including efficiency, financial results, level of production, number of customers, market share, profitability, productivity, dynamics of revenues, costs, and liquidity (Gupta & Batra, 2016; Zimon, 2018), among other factors (Anggadwita & Mustafid, 2014), as well as goals achievement, leadership style, employee behavior (Anggadwita & Mustafid, 2014), and customer. In their study, Marri et al. (2017) looked at a total of 14 indicators, including reputation, productivity, employee satisfaction, profits, sales, prompt order delivery, sufficient working capital, effectiveness in operations of production, product quality, achievement of targets, clientele, ease of supervision, decrease in product cost, and product diversification, to assess how well SMEs performed.

According to Abor and Adjasi (2007), there is concern about the application of corporate governance in SMEs on a global scale. Rules for a public organization should be reasonable for SMEs, focusing less on complexity and more on using a strong administrative structure. Business visionaries who emerged from SMEs and were on the verge of becoming major enterprises would see the benefits of the implementation of excellent corporate governance in SMEs. SME development requires more resources, such as capital and innovation. SMEs also require constructive feedback on business tasks, a good method, and formal recognition of effective business practices. The split between proprietorship control and the requirement for specialists as a chief increase as SMEs grow. In these circumstances, corporate governance systems become essential (Abor & Adjasi, 2007).

By definition, SMEs have relatively tiny board sizes. Large boards, according to Jensen (1993) and Lipton and Lorsch (1992), are less effective and simpler for the CEO to oversee. An overly large board is hard to coordinate and frequently causes issues. Smaller boards also strengthen the responsibility of individual directors and lessen the chance of free riding. Despite these objections, there is still a compelling reason for SMEs to have more members on their boards than the customary two to four. One of the most crucial transitions an SME may make is from being an owner-manager to a business with a broad board.

Based on the above discussion, the following hypothesis is proposed:

H1: There is a positive relation between board size and SME performance in the Egyptian SMEs listed on the Nilex stock exchange?

The majority of definitions of corporate governance include boards of directors as crucial components. They highlight the official connection between owners and their managers in charge of the SMEs' daily operations.

Therefore, it is impossible to overstate the importance of the board for SMEs. However, the majority of SMEs are privately held and owner-managed, and the owners often have greater direct access to and understanding of the company's internal operations (Cowling, 2003). As a result, the control role of most SME boards is nonexistent and just exists on paper.

However, there are also cases of SMEs having active boards with outside participants, where the board serves as a tool for developing strategy (Pettigrew & McNulty, 1995). While insiders may perceive the board's work as an extension of their managerial responsibilities, outside members often see the board's functions as being clearly distinct from and complementary to those of management (Klapper & Love, 2004). Since the outside board members are not involved in the SME's daily operations, they are more likely to consider the strategic options available to the SME with greater freedom (Forbes & Milliken, 1999).

Based on the above discussion, the following hypothesis is proposed:

H2: There is a positive relation between board composition (executive and non-executives) and SME performance listed in the Egyptian SMEs listed on the Nilex stock exchange?

H3: There is a positive relation between board independence and SME performance in the Egyptian SMEs listed on the Nilex stock exchange?

There are two different board systems: the setup where the CEO also serves as board chairman and the setup where the CEO and chairman roles are split between two people. It has been noticed that the CEO while serving as board chairman creates leadership conflicts of interest and worsens agency issues (Brickley et al., 1997). According to Yermack (1996), businesses are more valued when the CEO and board chairman roles are distinct. According to Sanda et al.'s (2005) research, the separation of the CEO and chairman roles is associated with better business success. In contrast, several empirical pieces of research reached a different outcome. No correlation between CEO dualism and success in entrepreneurial enterprises was discovered by Daily and Dalton (1992). According to Brickley et al. (1997), CEO dualism is not linked to subpar performance.

Based on the above discussion, the following hypothesis is proposed:

H4: There is a relation between CEO duality and SME performance in the Egyptian SMEs listed on the Nilex stock market?

The Cadbury Committee urged businesses to form important board committees for the following areas: nomination (a formal and transparent process for the appointment of new directors to the board); audit (composed of non-executive directors, responsible to the board); remuneration (responsible to the board for recommending remuneration of directors); and finance committee. However, in the case of SMEs, the cost justification has been used to argue against the formation of board committees. However, the number, independence, and experience of the board members are more of a problem than an expense. A committee of specialists cannot be a part of a board that lacks expertise in terms of size or makeup.

Based on the above discussion, the following hypothesis is proposed:

H5: There is a positive relation between the existence of the audit committee and SME performance in the Egyptian SMEs listed on the Nilex stock market?

Finally, most economies rely heavily on SMEs, especially those in emerging nations where they create 45% of all new jobs (Ayyagari et al., 2014). Between 4 and 40% of the gross domestic product (GDP) in Arab economies is contributed by SMEs. According to estimates from the International Finance Corporation, IFC (Saleem, Hommes, & Sorokina, 2017) and the Arab world, micro, small, and medium-sized businesses (MSMEs) make up about 80% to 90% of all companies in the Middle East and North Africa (MENA) area (Nasrallah & El Khoury, 2021). The backbone of employment and innovation is the thriving SME sector, particularly start-ups and young businesses (Haltiwanger et al., 2013). These businesses also contribute to productivity, growth, and economic diversity. In response, the Arab countries' authorities have launched programmes and policy measures to assist the growth of SMEs (Stepanyan et al., 2019; Ben Naceur et al., 2007; Merza Radhi & Sarea, 2019).

3. RESEARCH METHODOLOGY

The methodology simply refers to the techniques utilized to gather information in relation to the specified issues and issues as well as the goals of the study (Frankfort-Nachmias and Nachmias, 1996). As a result, the methodology describes the procedure used to conduct this research. For this investigation, the data of the listed companies in the Nilex stock exchange will be used.

In order to determine and explain the effect of corporate governance practice on SME performance in Egypt, the population of our study is the companies listed on the Nilex stock market, the total number of listed companies is twenty-six companies. Our sample size contains thirteen companies out of twenty-six companies listed in the Egyptian Nilex stock market in July 2022 with a sample size of 50% of the Nilex stock market. The statistical study for each company takes into consideration governance reports for these companies from 2019 to 2021. We choose this sample as it will be an indicative sample. The data is not available on the Nilex stock market website, so we obtained it from the Mubashir site as well as obtained the governance reports for the thirteen companies.

Due to the unavailability of data for SME sectors in Egypt because of many reasons like the business community culture to keep the information on company performance unpublished, the characteristics of this sector that most of it are family-owned companies, and the fact companies are not committed to applying corporate governance practices unless it is listed. So, we had to check the data available for the companies listed in the stock market. We had a problem getting data for all companies. We had a representative sample of about 46% of the market. The dataset is for domestic listed companies working in the industrial, construction, distribution, and mining sectors in Egypt.

Due to the asymmetry of information in Egypt, we limit our choices to an important performance measure which is return on assets (ROA) following Adams and Santos (2006).

This study uses a panel regression model, which pools observations from a cross-section of units over a number of periods and yields findings that cannot be obtained from pure cross-sectional or pure time-series investigations. The double subscript linked to each variable in the panel regression equation sets it apart from a typical time-series or cross-section regression (Abor & Adjasi, 2007). The model will study the impact of each variable on the ROA for the company. For measuring the ROA:

$$ROA\ (Return\ of\ assets) = Net\ income/Total\ assets \tag{1}$$

$$\text{Company performance } (ROA)\ Y = c + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + \beta_7 X_7 + \varepsilon \tag{2}$$

where:

- c is constant;
- $\beta_1, \beta_2, \beta_3, \beta_4, \beta_5, \beta_6, \beta_7$ are the regression coefficient;
- X_1 is the board size according to the official corporate governance reports;
- X_2 is the number of non-executive directors according to the official corporate governance reports;
- X_3 is the number of executive directors according to the official corporate governance reports;
- X_4 is the number of independent directors according to the official corporate governance reports;
- X_5 is the existing CEO duality according to the official corporate governance reports where (0); means existing and (1) not existing.
- X_6 is the existence of audit committee members according to the official corporate governance reports;
- X_7 is the number of board meetings yearly according to the official corporate governance reports.

4. RESEARCH RESULTS

We applied the above equations to the chosen dataset and study its behavior for each independent variable, we had results shown in the below tables.

Table 1 presents the descriptive statistics for all the variables. The average (median) *ROA* is -1.3% where the maximum is 22.8% and the minimum is –28.77%. The average *board size* for this sample of SMEs is about 5.42 where the minimum was 3 and the maximum was 7. The board composition is given as the average number of the *non-executive director* is 2.22 where the average number of *executive directors* is 2.14 and the average of *independent directors* is 1.06. Most (83%) of SMEs have the CEO also acting as chairperson on the board. At least (36%) of SMEs have of *audit committee existence* in their governance structure. The average *number of board meetings* is 5.83 per year which is above the average of one per quarter.

Table 1. Descriptive statistics

Variables	*Minimum statistic*	*Maximum statistic*	*Mean statistic*	*Std. Error*	*Variance statistic*
ROA	-28.771637	22.8799433	-1.31023593	2.00629248	144.908
Board size (X_1)	3	7	5.42	0.184	1.221
Non-executive directors (X_2)	0	5	2.22	0.243	2.121
Executive directors (X_3)	1	5	2.14	0.183	1.209
Independent directors (X_4)	0	3	1.06	0.182	1.197
CEO duality (X_5)	0	1	0.83	0.063	0.143
Audit committee existence (X_6)	0	1	0.36	0.487	0.237
No. of board meetings (X_7)	0	10	5.83	0.344	4.257

Table 2 presents regression results for regression analysis used to investigate the relationship between measures of corporate governance and *ROA* for all the variables, except *non-executive directors (X_2)*.

According to the findings of the regression model, 42.6% of the variance in the companies' performance *ROA* may be attributed to their independent variables. The estimation of the models is supported by the F-statistics. Table 3 shows the correlations between the independent and dependent values.

Table 2. Coefficients

	Unstandardized coefficients		*Standardized coefficients*	*t*	*Sig.*
	B	*Std. Error*	*Beta*		
(Constant)	8.316	14.198		0.586	0.563
Board size (X_1)	0.638	1.707	0.059	0.374	0.711
Executive directors (X_3)	1.043	2.053	0.095	0.508	0.615
Independent directors (X_4)	-0.58	2.03	-0.053	-0.286	0.777
CEO duality (X_5)	-20.279	5.385	-0.637	-3.766	0.001
Audit committee existence (X_6)	-7.347	3.657	-0.297	-2.009	0.054
No. of board meetings (X_7)	0.78	1.022	0.134	0.763	0.452

Table 3. Correlations

		ROA	X_1	X_2	X_3	X_4	X_5	X_6	X_7
Pearson correlation	***ROA***	1.00	0.04	0.26	0.18	0.12	0.56	0.12	0.33
	Board size (X_1)	0.04	1.00	0.54	0.14	0.43	0.10	0.11	0.13
	Non-executive directors (X_2)	0.26	0.54	1.00	0.61	0.17	0.40	0.13	0.39
	Executive directors (X_3)	0.18	0.14	0.61	1.00	0.34	0.47	0.21	0.34
	Indepentant directors (X_4)	0.12	0.43	0.17	0.34	1.00	0.05	0.16	0.31
	CEO duality (X_5)	0.56	0.10	0.40	0.47	0.05	1.00	0.28	0.33
	Audit committee existance (X_6)	0.12	0.11	0.13	0.21	0.16	0.28	1.00	0.05
	No. of board meetings (X_7)	0.33	0.13	0.39	0.34	0.31	0.33	0.05	1.00
Sig. (1-tailed)	***ROA***	.	0.41	0.07	0.14	0.25	0.00	0.25	0.02
	Board size (X_1)	0.41	.	0.00	0.20	0.00	0.28	0.27	0.22
	Non-executive directors (X_2)	0.07	0.00	.	0.00	0.16	0.01	0.23	0.01
	Executive directors (X_3)	0.14	0.20	0.00	.	0.02	0.00	0.11	0.02
	Indepentant directors (X_4)	0.25	0.00	0.16	0.02	.	0.40	0.18	0.03
	CEO duality (X_5)	0.00	0.28	0.01	0.00	0.40	.	0.05	0.03
	Audit committee existance (X_6)	0.25	0.27	0.23	0.11	0.18	0.05	.	0.38
	No. of board meetings (X_7)	0.02	0.22	0.01	0.02	0.03	0.03	0.38	.

5. DISCUSSION OF THE RESULTS

The statistics shows that there is a small relation between board size and SME performance in the Egyptian SMEs listed on the Nilex stock market, so *H1* is rejected, while correlation results show that only 4% is applicable for this hypothesis. This indicates that there is a small relation between board size and SME performance. Adopting a broader board membership structure is anticipated to increase the firm's access to a wider range of skills and organizational connections. Our finding disagrees with those of earlier empirical investigations by Wynarczyk et al. (1993) and Goodstein et al. (1994). While Lee and Filbeck (2006) agree with our results as they study the relation between board size and firm performance. In the case of small firms, their study showed that a large number of directors on a board might be detrimental to the success and value of the company. Furthermore, it seems that a company's profitability increases with size. Our finding is also supported by studies of Yermack (1996), who proved that there is a negative relation between the board size and company performance in large US firms. In a discussion of corporate governance, Lipton and Lorsch (1992) claim that bigger groups or boards are less effective because people are likely to be less open in debates about company policy. In bigger gatherings, people are prone to being more reserved and courteous. Members of the board who behave in this way are less successful in their function of managerial oversight.

As well, the regression results showed that no positive relation between board composition of executive directors and SME performance while the relation between the non-executive and SME performance was excluded because of collinearity statistics tolerance, so *H2* is rejected. These results can be interpreted that the number of non-executive directors in the board composition in the Egyptian listed SMEs does not impact SME performance, this agrees with Wie Leong, Paramasivam, Sundarasen, and Rajagopalan (2015), who stated that the level of independence and non-executive directors do not seem to improve performance of companies. When studying the correlation between company performance and the number of executive directors on the board, we notice that most of the executive directors in our sample own shares in the company. The result showed a reverse relation of 18%, which means that the excessive existence of the executive directors in board composition has a negative impact on company performance. This result supported the entrenchment argument hypothesis (Fama & Jensen, 1983), which contends that board ownership and business performance are negatively correlated. Therefore, it is advised that the percentage of shares owned by board members be decreased in order to enhance both the board of directors' corporate governance and business performance.

The regression results showed no positive relation between board independence and SME performance, so *H3* is rejected. While the correlation showed reverse relation of 12%, which indicated that the increase of independent directors on board composition impacts negatively the SME performance due to their poorer knowledge about the company. This result agreed with Agrawal and Knoeber's (1996) and Yermack's (1996) studies indicating that firms with a majority of the board outside directors have poorer performance. This result appears to contradict the assumption that outside directors have important monitoring, advising, and networking functions and in contrast justifies the presence of insider directors in firms in the sample.

The results showed a relation between CEO duality and SME, company performance was impacted negatively by CEO duality, so *H4* cannot be rejected. It is a reverse relationship with 56%. This can be explained by dominating of decision-making processes by the same person and the absence of corporate governance practices. This result agreed with Gill and Mathur (2011), Ujunwa (2012), and Chen et al. (2008).

Finally, the results show no positive relation between audit committee existence and SME performance in the listed SMEs. It is worth mentioning that 64% of the companies did not have an audit committee as the shareholders are represented on the board. Most companies provided their data to the chairman who is the CEO of the companies. The descriptive result showed only 36% of the companies had an audit committee. There is a negative relation between audit committee and company performance and it may interpret by the effectiveness of the audit committee members. In contrast to expectations, the latter discovery was made. However, it could be the case that outside members of audit committees lack the necessary knowledge and competence about the firm's operations as well as the power of their audits on the decision-making process as 83% of the sampled companies had CEO duality. This finding agrees with Kyereboah-Coleman and Amidu's (2008) study on the link between governance practices and SMEs performance in Ghanaian SMEs.

6. CONCLUSION

Considering the enforcement of corporate governance practices on the listed companies in 2017, this paper considers one of the fewest that contributes to the literature on corporate governance and SMEs performance in Egypt by introducing empirical findings for the period from 2018 to 2021.

Upon our work to examine the corporate governance practices in the SMEs listed on the Nilex stock market, we found a lack of application in many practices of corporate governance as well as the limitation of data availability for these companies despite their being listed.

We recommend further obligations for the corporate governance practices of listed companies as well as closer monitoring by the Egyptian regulator for employing these practices. Also, we recommend that more Egyptian researchers study the impact of corporate governance practices on the sectorial base of SMEs to boost the Egyptian economy.

The findings of this study generally imply that Egyptian SMEs will be significantly impacted by the adoption of corporate governance structures. By introducing better management practices, stronger internal auditing, more growth opportunities, and new strategic outlooks through non-executive directors, corporate governance can significantly help the SME sectors. By ensuring that the interests of the companies are served, boards of directors in SMEs are likely to exert much-needed pressure for improved performance. Access to funding from investors and financial institutions is made easier as a result of an effective corporate governance system. Due to issues with information asymmetry, it has generally been observed that SMEs have more difficulties in obtaining financing and ensuring proper internal control and accounting procedures.

Making sure that the SME has proper accounting procedures, internal control systems, and adequate information disclosure will probably increase investor confidence in the company, lessen the issues caused by information asymmetry, and make the SME less risky to invest in. By discouraging business owners from using borrowed money to fund investments in unapproved projects, the presence of external supervisory parties and monitoring systems may also reduce the issue of sole decision-making processes.

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