

## The Impact of Board of Directors and Audit Committees on Stock Return of Jordanian Financial Companies

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### ABSTRACT

This study examines the impact of Board of Directors and Audit Committee on stock returns. The Fama and French Three Factor model is used to estimate the stock return. Also, the board of directors and the audit committee are used to measure the corporate governance mechanisms. This study applies fundamental analysis on the financial Jordanian companies' listed on the Amman Stock Exchange (ASE) over the period 2007 to 2012. The results revealed that there is a statistical relationship between stock return and each of the board of directors and the audit committee. The researchers recommend the financial Jordanian companies to reduce the number of board of director's members, to adjust the proportion of the external directors and non-executive in each of the board of director and the audit committee.

**Keywords:** Corporate Governance, Stock Return, Board of Directors, Audit Committee.

### INTRODUCTION

Contemporary companies have widely scattered in their ownership and shareholders, which are not normally concerned about the management duties. Therefore, in these conditions the agent is responsible to achieve the daily operation of the firm. In addition, the difference between control and ownership generates the probability of interest conflict between principals (owners) and agent (manager), agency theory, which in turn makes it more costly to solve the problem which associated with these conflicts (Jensen & Meckling, 1976 and Eisenhardt, 1989).

Fama and Jensen (1983) assumed that companies should have a system that able to separate management decision from a control decision in order to limit the agency costs which are resulted from the separation of management and ownership. Accordingly, to limit or to reduce the effect of agency cost, the power of the agent

must be controlled and take the interest of shareholders into account. However, corporate governance mechanisms, both internal and external, help to reduce the managerial exploitation manner (Fama, 1980; Fama and Jensen; 1983; Williamson; 1988 and Shleifer and Vishny, 1986). Furthermore, this is consistent with McKnight and Weir, (2009) who found that the agency cost reduced by corporate governance mechanisms. Moreover, the agency theory supplies the fundamental internal and external firms' governance (Weir et al., 2002; Roberts et al., 2005). In addition, the governance mechanisms are constructed in order to ensure managers and ownership interest alignment, and reduce the agency cost (Davis et al., 1997).

Davis et al. (1997) supposed such alternative governance issues that used as controlling devices to reduce the agency cost, for example: audit committee and the nominations and remuneration committee. However, the audit committee can be the main portion of the decision control system for internal monitoring by boards of directors (Fama, 1980 and Fama and Jensen, 1983). As a matter of fact, corporate governance allows the

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shareholder to be able to monitor and control the managerial behaviour through such mechanisms like; boards of directors, audit committees, and external auditors.

Teoh et al. (1998) pointed out that the insiders have both the opportunity and motivation to manipulate earnings upward previous to an Initial Public offering (IPO). The motivation is clear. Insiders would like to release shares at the maximum price, as this would permit the firm to increase the essential capital through less dilution of earnings. Raising earnings lead to increase the prices of issue, as underwriters usually use the P/E ratios of other companies in the IPO Company's earnings and the IPO Company's industry to set the bid price. Thus, companies have a motivation to manipulate earnings upwards as increasing earnings lead directly to increasing prices and decreasing cost of capital. Furthermore, the most important change in profitability happened to the entrepreneurial companies after IPO.

Asian financial crisis events (1997) have resulted in discovering the weakness of corporate governance, which in turn causes a reduction in the value of Asian company's stock (Bae, et al, 2012). However, in recent years, corporate governance becomes more important, for the most companies, because its ability to serve the consistency of the stock price through issuing the rules and regulations that lead to increase the controlling and monitoring processes which in turn help to protect the shareholders' interest (Johnson, et al. 2000). For this reason, the investors are attracted to the firms which have good governance, and they are agreed to pay more premiums to acquire those companies' shares (McKinsey and Company, 2000).

Therefore, the primary purpose of this study is to examine the impact of corporate governance mechanisms (board of directors and audit committee) on stock return by utilizing a sample of financial companies listed in ASE for the period span from 2007 to 2012.

#### **The Importance of the study:**

In recent years, several studies have addressed the matter of corporate governance mechanisms (board of directors and audit committees) and stock return. The importance of the current study lies in the following:

1. The current study is expected to raise awareness about each of board of directors and audit committee for the financial statement users, which in turn making them able to take sound investment decisions.
2. The current study is expected to assist regulators and policy makers to clarify the most important corporate governance mechanism(s) which give(s) them a more significant role in controlling the work of the listed Jordanian companies.
3. It contributes to adjust corporate governance practices to be in line with the policies adopted in Jordan in order to cope with any future crises.

#### **Research Problem:**

There are several studies that have investigated the relationship between corporate governance and stock returns. However; according to the researcher's knowledge, no research has addressed the impact of corporate governance mechanism (board of directors and audit committee) on stock return in the financial Jordanian companies, what lead us to raise the following questions:

1. Do the corporate governance mechanisms (board of directors and audit committee) affect stock returns?
2. Which are the main corporate governance mechanisms (board of directors and audit committee) that affects the stock returns for the Jordanian firms?

#### **The Objectives of the study:**

This study aims to achieve several objectives in relation to the financial companies listed in ASE, including the following:

1. To investigate the relationship between corporate governance mechanisms (board of directors and audit committee) and stock returns, by utilizing a sample of financial companies which they are listed on the ASE

during the period that extend from 2007 to 2012.

2. To examine which corporate governance mechanisms (board of directors and audit committee) that affect stock returns.

### **Literature Review and Theoretical Framework:**

The next section attempts to give an overview of some previous studies that focus on the research's main variables; corporate governance and stock returns, and illustrate the definitions, equations, and relationships, which may give a general outlook to our research. So, this section will consist of two parts, the first exhibits the related literature review, and the second demonstrated the research's principal variables; corporate governance and stock returns.

Gompers et al. (2003) built a governance Index in order to proxy for the level of shareholder rights at about 1500 large companies in the U.S. during the 1990. They pointed out that the good governed companies in the United States beat a better portfolio than companies that have weak governance. The researchers afford two key descriptions for the anomaly. The first one is the poor governance lead to increase the agency costs. However, the investors underestimate these costs steadily. The second one is the poor governance is accidentally related to other issues that gain abnormal return.

Future studies in the United States conclude that after 1999, the abnormal governance return disappears (Core et al., 2006, and Bebchuk et al., 2013). Bebchuk et al. (2013) concluded that disappears in the abnormal governance is attributed to the increased attention to corporate governance by each of investors and academics because of the accounting scandals of the early 2000s (e.g., Enron, WorldCom). Moreover, Johnson et al. (2009) illustrated that the abnormal return reported by Gompers et al. (2003) becomes not important after adjusting for industrial properties. In total, most of the studies do not find abnormal governance returns in the United States stock market, particularly since 2000. According to the studies for non-U. S, studies have

different findings, For example: Bauer et al. (2004) build a governance portfolio for the European companies during the period 1997-2002, and they pointed out that the abnormal returns are insignificant. Aman and Nguyen (2008) stated that the portfolio of Japanese companies, which have weak governance has considerably higher risk and returns than a portfolio of strong governed companies. Moreover, Bauer et al. (2008) studied the Japanese market. However, they found different findings. They found that the portfolio of companies, which have good governance outperforms poor governance.

Jensen and Meckling (1976) demonstrated that the poor corporate governance can lead to increase the agency costs and the risk of confiscation by insiders at the shareholders' expense. Durnev and Kim (2005) showed that the managers and shareholders select the best level of diversion of assets through taking into account their personal wealth and the costs of confiscation. The external users pay more for organizations with good shareholder protection as they assume to obtain a higher amount of the company cash flows (La Porta et al., 2002). In addition, the shareholders may need to conduct a lower rate of return from well governed companies because firms, which have good governance decrease their controlling and auditing costs (Oxelheim, 2006). Furthermore, good governance leads to decrease the distorted information problems which in turn reduce the risk for outside investors (Merton, 1987, Easley and O'Hara, 2004). Finally, companies which have good corporate governance have the ability to decrease the cost of equity because confiscation risk is partly non-diversified (Durnev and Kim, 2005, Chen et al., 2009).

The previous part offers numerous opinions about how firms with poor governance lead to increase the risk for outside investors: particularly because of the increased in the distorted information problems and lower information dispersion (Merton, 1987, Easley and O'Hara, 2004), in addition to the increase in non-diversified confiscation risk (Chen et al, 2009). Durnev and Kim (2005), anticipates that companies with poor

governance have higher market risk. This is true; when all companies have better investment chances, the insiders of poorly governed will be appropriate less as the marginal benefit of saving the money with the company is higher. As a result, the residual cash flow of companies which have poor governance is more sensitive to the state of the economy. Garmaise and Liu (2005) demonstrated a formal agency model of the companies in which poor governance leads to increase the market beta of the organization.

There are many studies found a positive relationship between firm value and corporate governance. Love (2010) found that companies with good governance have higher market values as the companies have higher expected cash flows. Additionally, Chen et al. (2009) found that there is a negative relationship between the estimated discounted rates and governance scores in each of 2001 and 2002.

### **Stock Return:**

In recent years, the value of the firms took a great attention by the economists due to the variation in the value of the firm among the economic events, as a sequence, the previous studies constructed an easy method to determine the impact of the economic event on the value of firms by using the event study (Mackinla, 1997). In addition, the stock prices can reflect the true value of the company because the stock price can't be manipulated by insiders. Accordingly, the financial impact of a change in ownership, corporate policy and leadership can be measured effectively by the event studies (McWilliams and Siegel, 1997). The event study considered as an important issue in the financial economist's tools (Sorokina et al, 2013). The Fama, Fisher, Jensen and Roll (1969) market model that used in event studies witnessed several developments, including MacKinlay (1997) and Binder (1998) who is developing a common methodology for the modern study. In addition, event study considered as a tool that helps the researchers to assess the importance of the event by

taking into account the importance of the stock price and abnormal stock price (McWilliams and Siegel, 1997). Accordingly, the methodology of the event study investigates the performance of company stock prices. In order to estimate the stock return, the researchers have tried to form many models like the Capital Asset Pricing Model, Arbitrage Pricing Theory or Fama and French Three Factor Model. Although, these models are different in capturing the systematic risk in evaluating the average stock returns. However, Fama and French Three Factor Model are considered as the most suitable model, in the accounting literature that used to reflect the explanatory power of the stock return (Griffin, 2002). Accordingly, the Fama and French Three Factor Model will be used in this study.

Therefore, the following section will present the models which are used in estimating the stock return. However, to understand these models, the calculation of the stock return must be displayed, firstly, as below:

### **Calculation of returns:**

The abnormal return is the primary essential issue that used to study the impact of the event, which is mainly the actual return of the security over the event window minus the normal return of the firm through that window (Campbell et al., 1998). At that point, there are several dimensions over which the calculation of abnormal returns can be different. The first option, for calculating the return, is to use arithmetic return calculation or logarithmic return calculation (Strong, 1992), which they are presented as below:

#### **Arithmetic Returns:**

This option will be used in this study, and the equation of this option is presented as follows:

$$R_{i,t} = (P_{i,t} + D_{i,t} - P_{i,t-1}) / P_{i,t-1} \dots \dots \dots (1)$$

Where

$R_{i,t}$ : is the return of initial investment,  $P_{i,t}$ : is the price of the stock  $i$  at the end of period  $t$ ,  $P_{i,t-1}$ : is the price of the stock  $i$  at the end of period  $t-1$ ,  $D_{i,t}$ : is the dividends paid during period  $t$ .

#### **Logarithmic Return:**

$$R_{i,t} = \text{Log}((P_{i,t} + D_{i,t} - P_{i,t-1}) / P_{i,t-1}) \dots \dots \dots (2)$$

Where  $R_{i,t}$  : is the log-return for security  $i$  in period  $t$ ,  $P_{i,t}$  is the price of the stock  $i$  at the end of period  $t$ ,  $D_{i,t}$  is the dividends paid from the company  $i$  during period  $t$  and  $P_{i,t-1}$  is the price of the stock  $i$  at the end of period  $t-1$ .

In the last decades, the researchers used the monthly stock return in the event study, but in the middle of 1980 the researchers turn to use the daily stock return in the event study because of the growth of technical chances and increasing the knowledge of researchers (Sorokina et al, 2013).

After explaining the two options of return calculation above, there are two main approaches that used to calculate the normal return, statistical and economic models. The statistical models, stems from a statistical assumption which take into account the direction of the return of the assets. The economic models depend on the assumption that take into account the behaviour of the investors. However, the economic models are more preferable in practice and more comprehensive than the statistical models because of the accuracy of the results that can be conducted by using the economic models. In addition, the economic model depends on each of the economic events and statistical assumptions (Campbell, et al., 1997 and MacKinlay, 1997). The Market Model and Market Adjusted Model are some examples of the statistical models. While, The Capital Assets Pricing Model (CAPM), Arbitrage Pricing Theory (APT) and Fama and French a Three-Factor Model, are some examples of the economic models.

**Fama and French a Three-Factor Model:**

In 1992, Fama and French initiated a model that includes the systematic risk of three factors, which are size, market and book to market ratio. This model is called Fama French Three Factor model. Further, Fama and French used these ratios to explain and estimate the stocks return. Therefore, the Fama and French a Three-Factor Model, emerge as below:

$$E(r_{i,t}) = R_{f,t} + \beta_{i,1}x[R_{m,t}R_{f,t}] + \beta_{i,2}xSMB(t) + \beta_{i,3}xHML(t) + ei(t) \dots (3)$$

Where  $R_{f,t}$  is the return on a risk-free security in period  $t$  (usually used the return on Treasury Bills),  $R_{m,t}$  is the market return for month  $t$ ,  $SMB(t)$  is the difference between the returns on diversified portfolios of small stocks and big stock,  $HML(t)$  is the difference between the returns on diversified portfolios of high book-to-market equity ratio of stocks and low book-to-market equity ratio of stocks, and  $\beta_{i, 1,2,3}$  is the sensitivity of the stock  $i$  to each factor.

Fama and French (1992, 1993, 1995, 1996 and 2004) classified stocks according to their market capitalization, as a proxy for size, and the book to market equity ratio (Bo/Ma) as a proxy for size momentum. However, Fama and French developed six portfolios, which consist of stocks that sorted based on market capitalization and book to market value together.

They practiced the six portfolios, in order to take into account the systematic risk that stems from size and momentum. They split stocks into two groups, small and big, based on median of size. Where, the stocks that exist above the median classified as a big size. While, the stocks that exist below the median classified as a small size. On the other hand, they separate firm stocks into three book-to market equity ratio groups based on these cut off points; the top 30% (High), the middle 40 % (Medium), and bottom 30% (Low) of the ordered values of book to market equity ratio.

Fama and French (1992 and 1993) clarified that the book-to-market equity ratio has a more substantial part in average stock returns than size. For this reason; they are sorted firms into three groups on book to market equity ratio and only two groups on market capitalization.

Then, they produced six portfolios (S/L, S/M, S/H, B/L, B/M, and B/H) from the crossings of the two market capitalization and the three books to market equity ratio groups. For instance, the B/H portfolio contains the stocks in the big market capitalization group that are also in the high book to market equity ratio group, and the S/L portfolio contains the small-market capitalization stocks that also have low book to market equity ratio.

The portfolio SMB is the difference between the returns on small- and big-stock portfolios at the same weighted-average book-to-market equity. SMB (small minus big), is the difference between the simple average of the returns on the three small-stock portfolios (S/L, S/M, and S/H) and the simple average of the returns on the three big-stock portfolios (B/L, B/M, and B/H) each month, is intended to simulate the risk factor in returns that associated with size.

The portfolio HML (high minus low), intended to simulate the risk factor in returns associated to book-to-market equity. HML is the difference between the simple average of the returns of the two high book to market equity ratio portfolios (S/H and B/H) and the average of the returns of the two low book to market equity ratio portfolios (S/L and B/L). The two components of HML are: the average returns on high and low book to market equity ratio portfolios with the same weighted-average size each month.

### **Corporate Governance:**

Corporate governance is the system by which we could direct and control the corporations. The governance structure is mainly tasked with the process of distribution of rights and responsibilities among different participants in the corporation such as; the board of directors, stakeholders, managers, creditors, auditors and regulators. It is likewise requested to lay down the rules and procedures for making decisions in their affairs (OECD Principles of Corporate Governance, 2004). However, the main goal of corporate governance is not to directly enhance the company performance, but it is also to reduce the agency cost problem through controlling and monitoring the behaviour of the agent (Demsetz and Lehn, 1985). Accordingly, the agency theory discussed as follows:

### **Agency Theory:**

One of the main crucial things that create the agency theory is; the managers are mainly induced by their own

gain and they work to invest their own personal interests rather than considering shareholders' interests. So the agency theory depends on the relationship between owners and managers. Accordingly, the separation that exists between ownership and management in the modern firms leads to create the agency theory. The agency theory begins when the aims of the owners and managers are conflicted and costly for the owners to make sure what the managers is actually doing (Eisenhardt 1989). However, Leuz et al. (2003) demonstrate that management has a stimulant to administrate the firms reporting earnings in order to maximize their own benefits. Accordingly, that lead to create an information asymmetry, which in turn reduces the reliability and relevance of reported earnings, therefore managers can practice the discretionary accruals. Davidson et al. (2005) conclude that earning management as a type of agency cost that can be emerging when the managements provide inaccurate financial information.

The rigid controlling and monitoring by the owners or their delegate like boards, over the manager, is very important in order to protect shareholders' interests from the agent who are attempting to maximize their own interest.

The Sarbanes-Oxley Act (2002) supposed that corporate governance should affect shareholders' ability to understand the information that exists in accounting earnings reports. As a sequence, the attention of researchers in studying the corporate governance had increased. Also, they studied empirically the impact of corporate governance on any firm manipulation. (Beasley, 1996; Dechow, et al., 1996; McMullen and Raghundan, 1996; Peasnell et al., 2000; Bedard et al., 2004; Xie et al., 2003; Park and Shin, 2004; Peasnell et al., 2005; Kim and Yi, 2006; Chen et al., 2006; Huang et al., 2007 and Jaggi et al., 2009).

After reviewing the genesis of corporate governance in the above section, the following paragraphs present the corporate governance definitions, advantages and the mechanisms which relate to this study.

### **Corporate Governance Definitions:**

Recently, in the accounting literature, the corporate governance took a great attention by researchers for the following reasons: most firms in these days have tended to the privatization which in turn specified how the new firms should be controlled and owned. Also, corporate governance affected by active investors due to the growing proportion of household savings through pension funds. Further, the importance of corporate governance, increased for companies that merged or separated. In addition, the integration and growth in capital market considered as the main issues in corporate governance. Moreover, corporate governance plays an important role in reducing the business nasty and problems (Becht, et al, 2003). Accordingly, the definition of corporate governance emerges as follows:

The Organization of Economic Cooperation and Development (OECD) defined corporate governance as “The system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance” (OECD, April 1999). The appropriate application of corporate governance resulting in improving the company's performance. Accordingly, the next section shows some of the main advantages that resulting from the application of corporate governance as follows:

### **Stock Price Consistency:**

Asian financial crisis events (1997) have resulted in discovering the weakness of corporate governance, which in turn causes a reduction in the value of Asian company's stock (Bae, et al., 2012). However, in recent years, corporate governance becomes more important, for

the most companies, because its ability to serve the consistency of the stock price through issuing the rules and regulations that lead to increase the controlling and monitoring processes which in turn help to protect the shareholders' interest (Johnson, et al. 2000).

### **Decreasing the Cost of Equity Capital:**

Corporate governance may have a negative relationship with cost of equity capital in emerging markets, especially in countries that have a poor legal protection, however, shareholders protection and corporate governance mechanisms can be considered as the two factors that decrease the cost of equity (Chen, et al. 2009).

After displaying the corporate governance definitions and advantages which relate to this study, the following part will show the main mechanisms of corporate governance that will be used in this study will be taken into consideration.

### **Boards of Directors:**

One of the main responsibilities of the board of director is to guarantee that the financial statements are prepared in accordance with the accounting standards and complained with regulations (Saleh et.al, 2005). In addition, the board consists of individual team who are concerned about the firm's shareholder's and stakeholder's interest (Abdullah, 2006). In this study, each of the board independence, board size and Chief Executive Officer (CEO) duality will be used as a measurement of the board of directors. So the next section will display these features as follows:

### **Board Independence:**

The board is one of the main mechanisms in corporate governance that make the financial reporting system and firms, accounting characterized by integrity when the composition of the board is balanced (Hutchinson, et. al., 2008). However, the composition of the boards includes members who are independent from the shareholders and

management. Also, the board should not be controlled by board members with executive power. Therefore, the board of directors should include independent members which are external directors and executive (Hutchinson, et. al., 2008). Executive directors are the board of directors who have the authority to make the financial decision in firms. However, the inside directors have more knowledge about the organization than the outside director (Saleh, et. al., 2005). Outside directors can improve the performance and reduce the agency conflict because they are considered as the independent monitoring mechanism over the board process (Craven & Wallace, 2001).

#### **CEO Duality:**

Usually, the role of chairman should be dissociated from the CEO role. However, when the CEO makes the tasks of the chairman of the company then the duality will be a rise. While, the Jordanian Code recommends, in order reducing the duality, the CEO should not have any power to demonstrate his credibility to make the daily business with efficient way. Furthermore, the CEO can get direct access to the financial reports and manipulate the financial data if he has much more power in the company. (Finkelstein and D'Aveni, 1994). Accordingly, the separation between the chairperson and CEO is recommended in order to create an effective monitoring system in the company.

#### **Board Size:**

The size of the board is also considered as a crucial factor in board features that might affect earnings management (Abdul Rahman and Ali, 2006). Jordanian Code supposed that the number of the board members must be confined between five and thirteen in order to perform the function of the company. Xie, et al. (2003) explained the advantages and disadvantages of the size of the board (large and small). As for the smaller board size may be more efficient in achieving functions and become less correlated with bureaucratic problems which in turn

make the smaller board size monitoring the financial report in an efficient manner. Whereas, the largest board size may have a wide range of experience.

#### **Audit Committee Characteristics:**

The Jordanian Code recommended establishing an audit committee in order to improve the performance of firms. One of the main purposes of the audit committee is to provide an emphasis on financial issue through increase the accountability, financial analysis and the ability to utilize resources in a better way. The audit committee is used as a tool that enhance the reliability of the internal control in companies, if the audit committee established by independent individuals, indeed, that can create a positive effect on the ability of the firm to perform its function in a transparent and effective technique (Birkett, 1986; Abbott, et al., 2004). However, audit committee size, independence and activity (meeting during the year) considered as a measurement of audit committee mechanism in this study, which are displayed in the next section as follows:

#### **Audit Committee Size:**

Abbott et al. (2004) demonstrate that the audit committee must consist of three directors at least in order to provide a better quality in controlling and monitoring. Yermack (1996), conclude that the higher quality of monitoring is positively related to the smaller board, he also found that firms with smaller board of directors have the ability to shape the CEO to give executives a lower level of total compensation. When the size of the audit committee is large, the individual members are more likely to be under pressure and affected by other views or opinion. In contrast, when the size of the audit committee is small, the discussion between members will be more applicable which lead to discover potential errors in the financial reporting. Xie, et al., (2003) shows that the amount of the number of audit committee specifies the size of the audit committee. While, (Anderson et al, 2004.) conclude that the larger size of the audit



committee has the ability to control the financial reporting and the internal control system. In addition, Archambeault and DeZoort (2001), demonstrate that firms with the larger size of the audit committee are more likely to have lower costs of debt.

#### **Audit Committee Independence:**

There are two definitions of the audit committee independence: the first one: the independence is asserted if the director is a non-executive director, however, this definition is not clear because the non-executive director may have another relation to others who are interested in the firm's business, so that may lead to crush the meaning of independence. The second definition is: the non-executive director must have no relation with the company; these definitions are consistent with (Vafeas, 2000). Moreover, Carcello and Neal (2000) concluded that the independence of the audit committee can assist the external auditor to preserve the tasks entrusted to him without influence from any directors. Core et al, (1999) found that if the committee members have any relation with the firm or top management that may lead the audit committee members to feel a strong sense of assignment toward the management. As a sequence, the associate members may become unable to discover the potential errors in the financial statements.

#### **Audit Committee Activity**

The audit committee must be more functional or active in order to obtain more effective mechanism in the company because the level of activity represent the highest level of government through promoting the reliability of the financial reporting. However, the Jordanian code, recommend the audit committee to conduct their meeting three times per year at least, in order to avoid the problems early and to coincide with the annual report and the audit cycle. While, the accounting literature supposed that the number of board meetings depend on operating complexity. Further, they also assumed that the increasing in the number of board

meeting lead to reduce the cost of debt, which in turn improve the performance of the company (Anderson et al. 2004).

#### **What distinguishes this study?**

Previous studies revision reveals that researchers examined the relationship between corporate governance and stock return. However, this study focus on the two mechanisms of corporate governance, which are (board of directors and audit committee). Accordingly, the current study is distinguished from previous literature due to several reasons, namely:

1. It is the first study-as far as the researcher knows- that investigates the relationship between corporate governance mechanisms (board of directors and audit committee) and stock return in the financial Jordanian firms.
2. It is the first study that investigates the corporate governance mechanisms (board of directors and audit committee) that affect stock return in the financial Jordanian firms.

#### **The Research Hypotheses:**

The main objective of this research is to examine the relationship between corporate governance mechanisms and stock return. Through this study, the following hypotheses will be tested

**H<sub>01</sub>:** The Board of Directors has no significant effect on the stock return.

**H<sub>02</sub>:** The Audit Committee has no significant effect on the stock return.

#### **Population and Sample:**

The study population consists of all financial companies listed on the ASE during the period 2007-2012. The study sample consists of financial companies that have available data, which is related to corporate governance mechanisms (board of directors and audit committee) and stock return. The study covers the period from 2007-2012. This period was chosen as the ASE website has issued a new classification for all companies

after 2006, including (Banks, Insurance, Diversified financial services and Real estate). Also, after 2012 there are many companies becomes delisted from ASE, which in turn affect the sample size.

Various data obtained from the year 2006 to compute the average monthly stock price. The firm-year observation that meets the following conditions was included in the study sample:

- Financial companies must be listed on the ASE during the period 2006-2012.
- The annual reports, financial reports and daily closed stock price must be available for each company from 2006 to 2012.

Table (1) illustrates the process sampling and data collection. Further, Table (1) shows the number of companies that existed in each of 2012 and 2007 individually. In addition to the number of companies which lasted from 2007 to 2012 and exist from 2006. Moreover, Table (1) shows the total number of firms-year's observations that included in the sample.

#### Data Sources:

Published Financial statements, Company guide and the annual reports were obtained from the ASE and the Jordan Securities Commission websites. The researcher also spent more efforts to get the information that was unavailable on the Internet, by visiting each of the Central Bank of Jordan and ASE.

#### Statistical Techniques Used:

In order to understand the effect of the corporate governance mechanism(s) on the stock return, each of the descriptive statistics, correlation and regression of the study variables were analysed and examined.

#### Study Models:

This section illustrates the main models that used to understand the influence of corporate governance mechanisms on stock return. Whereas the dependent variable is the stock return. The independent variable will be the corporate governance mechanisms. Firm size and performance are included as a control variable. Accordingly, the main variables of this study; corporate governance, stock return, and the control variables emerge as below:

#### The Independent Variables:

Based on (Abed, et al., 2012 and Hamdan, et al., 2013) the measurement of the Board of Director (BOD) and Audit Committee (AC), which they are considered as the main mechanisms of corporate governance (CG) in this study, emerges as below:

The Board of Director measured by each of the following:

- CEO duality.
- Board Size.
- Board Composition.

**Table (1)**  
**Sampling and Data Collection**

	<b>Banks</b>	<b>Insurance</b>	<b>Diversified Financial Services</b>	<b>Real Estate</b>	<b>Total</b>
Firms listed in 2012.	15	25	33	33	106
Firms listed in 2007.	15	27	29	32	104
Firms which lasted from 2007-2012.	15	24	26	28	93
(-) Not exist from 2006.	-	2	6	5	13
Firms which lasted from 2007 to 2012 and exist from 2006	15	22	20	23	80
(-) Unavailable data (daily closed stock price)	-	-	5	2	7
Total number of firms that included in the sample.	<b>15</b>	<b>22</b>	<b>15</b>	<b>21</b>	<b>73</b>
Total number of firms- years observations that included in the sample = Total number of firms × 6	<b>90</b>	<b>132</b>	<b>90</b>	<b>126</b>	<b>438</b>

The Audit Committee measured by each of the following:

- Audit Committee Size.
- Audit Committee Composition (Independence).
- Audit Committee Activity.

### The Control Variables:

This study follows these studies (Waweru and Riro, 2013; Abed, et al., 2012; Hamdan, et al., 2013, and Mouselli, et al., 2014) by using firms size and company performance as a control variable that might influence the stock return.

Where:

Firm Size: the natural logarithm of total assets for the firm *i* in year *t*.

Company Performance: return on equity (ROE).

The Dependent Variable:

The dependent variable of this study is the stock return. Accordingly, the measurement of this dependent variable is presented as below:

Stock return, is measured by Fama-French three factor (FF) model (Fama and French, 1995) as below:

$$R_{i,t} = R_{f,t} + \beta_{i,1} \times [R_{m,t} - R_{f,t}] + \beta_{i,2} \times \text{SMB}(t) + \beta_{i,3} \times \text{HML}(t) + \epsilon_i(t).$$

Where

$R_{i,t}$ : is the annual stock return of the firm *i* in the year *t*.

$R_{f,t}$ : is the return on a risk-free security in period *t* (usually used the return on Treasury Bills).

$R_{m,t}$ : is the market return for year *t*.

SMB (*t*): is the difference between the returns on diversified portfolios of small stocks and big stocks at year *t*.

HML (*t*): is the difference between the returns on diversified portfolios of high book-to-market equity ratio of stocks and low book-to-market equity ratio of stocks at year *t*.

$\beta_{i,1,2,3}$ : is the sensitivity of the stock *i* to each factor.

**Variables Measurements and Calculations:** This section shows the calculation of all variables used in this study as follows:

Based on (Abed, et al., 2012 and Hamdan, et al.,

2013) the calculation of the board of directors, the audit committee, firm size and the firm performance emerged as below:

- CEO duality: is a dummy variable equal to one if the roles of chairman and CEO are combined and zero otherwise.

- Board Size: is the total number of board members.

- Board Composition: is the percent of independent outside directors on the board.

- Audit Committee Size: is a dummy variable coded (1) for firms that have more than three directors on the audit committee and (0) otherwise.

- Audit Committee Composition (Independence): is a dummy variable coded (1) for firms that compose of all independent directors during the year and (0) otherwise.

- Audit Committee Activity: is a dummy variable coded (1) for firms which meet at least four times during the year and (0) otherwise.

- Firm size= LOG (Total Assets).

- **Firm performance (ROE)** = (Net income pertain to shareholders) / (Total shareholders' equity).

Based on (Fama and French, 1993) the calculation of the variables of the Fama French three factor model will be as follows:

- $R_{f,t}$ = the average of treasury bills three months in year *t*.

- $R_{m,t}$ = (weighted average of general market in year<sub>*t*</sub> - weighted average of general market in year<sub>*t-1*</sub>) / weighted average of general market in year<sub>*t-1*</sub>.

- **SMB**:(small minus big), is the difference between the simple average of the returns on the three small-stock portfolios (S/L, S/M, and S/H) and the simple average of the returns on the three big-stock portfolios (B/L, B/M, and B/H) each year is calculated as follows:

$$\text{SMB} = ((S/L + S/M + S/H) - (B/L + B/M + B/H)) / 3.$$

- **HML**: (high minus low), is the difference between the simple average of the returns of the two high

book to market equity ratio portfolios (S/H and B/H) and the average of the returns of the two low book to market equity ratio portfolios (S/L and B/L) each year is calculated as follows:

$$HML = ((S/H + B/H) - (S/L + B/L)) / 2.$$

$\beta_1$ ,  $\beta_2$  and  $\beta_3$  are the systematic risk of stock  $i$  depend on the market index. To follow out the Fama French model each of  $\beta_1$ ,  $\beta_2$  and  $\beta_3$  parameters must first be calculated. The predicted return is then given by:

$$R_{it} = R_{ft} + \beta_{i,1} [R_{m,t} - R_{ft}] + \beta_{i,2} \text{SMB}(t) + \beta_{i,3} \text{HML}(t) + e_i(t).$$

Where:

- $R_{i,t}$  = the return of the firm  $i$  in the month  $t$  is calculated as follows:

$$R_{i,t} = ((P_{i,t} - P_{i,t-1}) + D_{i,t}) / P_{i,t-1}.$$

Where:

- $P_{i,t}$  = the average daily closing price of the stock (i) at month (t).
- $P_{i,t-1}$  = the average daily closing price of the stock (i) at month (t-1).
- $D_{i,t}$  = the dividend of stock (i) at month (t) is calculated as follows:

The dividend = total dividends / 12 month.

- $R_{ft}$  = Treasury Bills three months.
- $R_{m,t}$  = (weighted average of general market in month<sub>t</sub> - weighted average of general market in month<sub>t-1</sub>) / weighted average of general market in month<sub>t-1</sub>.
- **SMB:** (small minus big), is the difference between the simple average of the returns on the three small-stock portfolios (S/L, S/M, and S/H) and the simple average of the returns on the three big-stock portfolios (B/L, B/M, and B/H) each month is calculated as follows:

$$\text{SMB} = ((S/L + S/M + S/H) - (B/L + B/M + B/H)) / 3.$$

- **HML:** (high minus low), is the difference between the simple average of the returns of the two high book to market equity ratio portfolios (S/H and B/H) and the average of the returns of the two low book to market equity ratio portfolios (S/L and B/L) each month is calculated as follows:

$$HML = ((S/H + B/H) - (S/L + B/L)) / 2.$$

**Theoretical Model:** The model of this study

illustrates the relation between corporate governance mechanisms and stock return as shown below:

**General Models:** In order to achieve the main purposes of this study, each of the following models will be examined to attain the goal of the hypotheses:

To examine the first hypothesis ( $H_1$ ) the following two models will be examined:

$$R_i = a_0 + a_1 \text{BOD}_i + a_3 (\text{FIRM SIZE})_i + a_4 (\text{ROE})_i + e_i$$

To examine the second hypothesis ( $H_2$ ) the following two models will be examined:

$$R_i = a_0 + a_2 \text{AC}_i + a_3 (\text{FIRM SIZE})_i + a_4 (\text{ROE})_i + e_i$$

### Empirical Findings:

This section shows the results of the study. It illustrates the results of the descriptive statistics, correlation, multicollinearity and regression analysis. In addition, this section shows the regression analysis of corporate governance mechanisms, which are board of directors and audit committee, and stock return with control variables. Descriptive statistics, correlation matrix and multicollinearity for study variables which are corporate governance, stock returns and control variables shows as below:

### Descriptive Statistics for the Study Variables:

The descriptive statistics of the stock return and the continuous independent variables used in the sample are shown in Tables (2) panel A and the dichotomous variable used in the sample is shown in Tables (2) panel B. As shown in Table (2) panel A, the magnitude of stock return has a mean value of (-0.1424). This result is consistent with (Sorokina et al, 2013) where the average stock returns among Italian companies are (- 0.16). As in Table (2) panel A, the range between the maximum value for the Board Size was (13) and the minimum value was (5), this shows that the financial Jordanian companies committed to the general rules of corporate governance that issued by the ASE. Also, the mean value of the board composition was (0.309) which indicates that the

financial Jordanian companies in the study meet the ASE requirements of having at least one third of the members as independent. Furthermore, panel a shows that the mean value of the audit committee size was

(3.452) which indicates that the financial Jordanian companies in the study have less than four directors on the audit committee.

**Table (2)**  
**Descriptive Statistics for the Study Variables**

Panel A: Continuous Variables					
Variable	Mean	Median	SD	Min	Max
Stock Return	-0.1424	-0.1082	0.361	-1.282	2.717
Board Size	8.658	9.0	1.999	5	13
Board Composition	0.309	0.314	0.075	0.083	0.429
Audit Committee Size	3.452	3	0.498	3	4
Return On Equity	0.0343	0.0294	0.525	-3.1996	6.272
Log Assets	7.670	7.3542	0.877	5.9206	10.379
Panel B: Dichotomous Variables					
Variable	Frequency of 1's	Frequency of 0's	#.Obs		
CEO Duality	66 (15.1%)	372 (84.9%)	438		
Audit Committee Composition	235 (53.7%)	203 (46.3%)	438		
Audit Committee Activity	331 (75.6%)	107 (24.4%)	439		

**Table (3)**  
**Correlation Matrix between SR, CG and Control Variables**

Variables	Stock Return	Board Size	CEO Duality	Board Composition	Audit Committee Size	Audit Committee Composition	Audit Committee Activity	ROE	Log Assets
Stock Return	1								
Board Size	-.037	1							
CEO Duality	-.104*	-.062	1						
Board Composition	.021	-.433**	.008	1					
Audit Committee Size	.023	.039	-.062	.090	1				
Audit Committee Composition	-.050	.189**	-.108*	-.167**	.320**	1			
Audit Committee Activity	-.003	.185**	-.191**	-.070	.228**	.271**	1		
ROE	.239**	.084	.016	-.099*	.010	.085	.043	1	
Log Assets	-.128**	.553**	.012	-.136**	.353**	.090	.056	.059	1

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

**Table (4)**

Multicollinearity between Independent Variables

Variables	Collinearity Statistics	
	Tolerance	VIF
Board Size	.512	1.952
CEO Duality	.955	1.047
Board Composition	.776	1.289
Audit Committee Size	.696	1.437
Audit Committee Composition	.801	1.249
Audit Committee Activity.	.847	1.180
Return On Equity	.982	1.018
Log Assets	.552	1.812

**Table (5)**

The Results of Multiple Regression between SR and BOD Models.

Variable	$\beta$ Coefficients		t	Sig.
	Unstandardized	Standardized		
<b>(Constant)</b>	0.280		1.607	0.109
<b>Board Size</b>	0.008	0.042	0.685	0.494
<b>CEO Duality</b>	-0.105	-0.104	-2.248	0.025
<b>Board Composition</b>	0.208	0.043	0.836	0.404
<b>Return On Equity</b>	0.173	0.251	5.429	0.000
<b>LOG ASSETS</b>	-0.066	-0.159	-2.861	0.004
<b>R</b>	0.301			
<b>R-square</b>	0.090			
<b>Adjusted R-square</b>	0.080			
<b>F-statistic</b>	8.591			
<b>F-significance</b>	0.000			

As shown in Table (2) panel B, (84.9%) of the financial Jordanian companies in the study, separate between the position of chairman of the board and chief executive officer as opposed to only (15.1%) of the firms don't meet the requirement of ASE. Further, panel B shows that the 91.1% of Jordanian companies in the study have held more than four regular meetings during the year.

#### Correlation Analysis of the Study Variables:

Table (3) illustrates the correlation matrix between stock return, corporate governance and control variables.

The results reveal that there is a negative correlation

between stock return and each of CEO Duality and the logarithm of total assets. Whereas, the highest correlation is between stock return and ROE ( $r = 0.239$ ). This indicates that the high level of ROE leads in enhancing the level of stock returns.

#### The Multicollinearity between Independent Variables:

The multicollinearity test between the independent variables examined. It can be seen from the table (4) that the VIF values are near to (1) and does not exceed (10) which indicates the collinearity is not a problem in this research's regression model (Gujarati and Porter, 2010; and Abdul Rahman and Ali, 2006).

To investigate the effect of corporate governance mechanisms individually, which are the board of directors and audit committee mechanisms, on stock return? The results of the multiple regression analysis of stock return and each of the board of directors and the audit committee mechanisms are shown as below:

**Stock Return and Board of Directors Mechanisms:**

The multiple regression analysis was conducted in order to examine the impact of the board of director’s mechanisms on stock returns. Table (5) represents the model summary of the relationship between the stock return and board of directors. It can be seen from the table (5) that the value of adjusted R<sup>2</sup> is (0.080). The results show that the F-value is (8.591) and they are significant at (0.05).

Table (5) also shows the results of multiple regression analysis between stock return and the models of the board of director’s mechanisms that were conducted in order to examine the impact of the board of director’s mechanisms on stock return. In order to test the hypotheses of the study, the overall effect of the board of

directors mechanisms on stock return can be seen from the table (5), which find no support for H<sub>01</sub>. This indicates that there is a significant effect on stock return on board of director’s mechanisms.

As seen from Table (5), that there is a negative statistical relationship between CEO Duality and stock return. Table (5) also reveals that there is a positive statistical relationship between the return on equity and stock return. Whereas, there is a negative statistical relationship between the logarithm of total assets and stock return.

**Stock Return and Audit Committee Mechanisms:**

The multiple regression analysis was conducted in order to examine the impact of the audit committee mechanisms on stock return. Table (6) represents the model summary of the relationship between the stock return and audit committee mechanisms. It can be seen from the Table (6) that the value of adjusted R<sup>2</sup> is (0.080). The result shows that the F-value is (8.619) and they are significant at (0.05).

**Table (6)**  
The Results of Multiple Regression between SR and AC Model.

Variable	β Coefficients		t	Sig.
	Unstandardized	Standardized		
(Constant)	0.201		1.235	0.218
Audit Committee Size	0.082	0.112	2.145	0.033
Audit Committee Composition	-0.066	-0.091	-1.822	0.069
Audit Committee Activity.	-0.005	-0.006	-0.119	0.905
Return On Equity	0.177	0.256	5.546	0.000
LOG ASSETS	-0.072	-0.175	-3.554	0.000
R	0.301			
R-square	0.091			
Adjusted R-square	0.080			
F-statistic	8.619			
F-significance	0.000			

Table (6) also shows the results of multiple regression analysis between stock return and the model of the audit

committee mechanisms that were conducted in order to examine the impact of the audit committee mechanisms

on stock return. In order to test the hypotheses of the study, the overall effect of the audit committee mechanisms on stock return can be seen from the tables (6), which find no support for H02. This indicates that there is a significant effect between stock return and audit committee mechanisms.

It can be seen from Table (6) that the audit committee mechanisms that included in the model and have a significant effect on stock return, which is the audit committee size. As seen from Table (6) that there is a positive statistical relationship between stock return and each of audit committee size and return on equity. Whereas, the negative relationship is between the logarithm of total assets and stock return.

#### **Conclusions and Recommendation:**

This study examined empirically the impact of corporate governance mechanisms (board of directors and audit committee) on stock return for the financial sectors during the period 2007-2012. In addition, this study examined the impact of the board of directors and the audit committee individually on the stock return. The result revealed that there is a statistical relationship between stock return and each of the board of directors and the audit committee mechanisms. Also, the study found that there is a negative statistical relationship between CEO Duality and stock return. This result is consistent with the study of (Teoh et al., 1998) which reported that, the managers have both the opportunity and motivation to manipulate earnings which is reflected into the firm's stock price. Furthermore, the study results reveals that there is a positive statistical relationship between the return on equity and stock return. Whereas, there is a negative statistical relationship between the logarithm of total assets and stock return. These results indicate that the high performance of small companies,

which have no dual role of the chief executive officer, has a high level of stock returns. Also, there is a positive statistical relationship between stock return and each of audit committee size and return on equity. Whereas, the negative relationship is between the logarithm of total assets and stock return. These results indicate that the high performance of small companies, which have big size of the audit committee, has a high level of stock returns.

Based on the study results, the researchers recommend the financial Jordanian companies to reduce the number of board of director's members in order to increase the function of monitoring and to assess the company performance which in turns increase the firm's value. This is consistent with (Yermack's, 1996) results. Further, the researcher recommends including the external directors and non-executive in the board of director to reduce the agency conflict over the board process. This recommendation is supported by the result of (Craven & Wallace, 2001; Hutchinson, et. al., 2008). In addition, the researchers recommend that the size of the audit committee should be small in order to make discussion between members more applicable which lead to discover potential errors in the financial reporting.

Further, this study recommends the policy makers and regulators in Jordan to introduce binding policies to apply the corporate governance principles and impose penalties on companies that do not comply with corporate governance principles.

The researchers suggest the future research to take into account the industrial and service sectors and to include more mechanisms of corporate governance like ownership structure and board compensation committee. Also, the researchers recommend future studies examining modern periods because the application of corporate governance principles is just started in recent years.



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## أثر مجلس الإدارة ولجنة التدقيق على عائد السهم للشركات المالية الأردنية

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### ملخص

تبحث هذه الدراسة أثر مجلس الإدارة ولجنة التدقيق على عائد السهم . استخدم نموذج (Fama and French Three Factor model) لتقدير عائد السهم. أيضاً، تم استخدام مجلس الإدارة ولجنة التدقيق لقياس آليات حوكمة الشركات. وتطبق هذه الدراسة التحليل الأساسي على الشركات الأردنية المدرجة في سوق عمان المالي خلال الفترة 2007 إلى 2012. وأوضحت نتائج الدراسة إلى أن هناك علاقة ذات دلالة إحصائية بين عائد السهم وكل من مجلس الإدارة ولجنة التدقيق. يوصي الباحثان إلى التقليل من عدد أعضاء مجلس الإدارة في الشركات الأردنية المالية، وضبط نسبة المديرين الخارجيين وغير التنفيذيين في كل من مجلس الإدارة ولجنة التدقيق.

الكلمات الدالة: حوكمة الشركات، عائد السهم، مجلس الإدارة، لجنة التدقيق.

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