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## Article

# Corporate governance and financial performance in the emerging economy: The case of Ethiopian insurance companies

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## FINANCIAL ECONOMICS | RESEARCH ARTICLE

# Corporate governance and financial performance in the emerging economy: The case of Ethiopian insurance companies

Bayelign Abebe Zelalem<sup>1\*</sup>, Ayalew Ali Abebe<sup>2</sup> and Sitotaw Wodajo Bezabih<sup>2</sup>

**Abstract:** The function of the board in financial institutions differs from that of non-financial institutions because the board of directors' discretionary power would be limited, particularly in regulated financial systems where financial institutions must operate under legislative and prescriptive procedures, policies, rules, and regulations. As a result, the goal of this research was to look into the effect of corporate governance on the financial performance of Ethiopian insurance companies that are heavily regulated. The study used an explanatory research design with econometric panel data from nine insurance companies from 2012 to 2020. Random effect estimation technique was used to find out the most significant variable. Return on asset and equity were used to measure the financial performance and board size, management soundness, board remuneration, financial disclosure, debt and dividend policy as explanatory variables. The result revealed that board size, management soundness, board remuneration, and financial disclosure have a positive and significant effect on insurance company financial performance, whereas debt and dividend payout have a negative and significant impact on insurance company financial performance. Thus, the study concludes that all corporate governance measures have a significant impact on insurance companies' financial performance

### ABOUT THE AUTHORS

Bayelign Abebe Zelalem is a fulltime lecturer in marketing management at Mizan-Tepi University, Ethiopia. Along with teaching and community service engagements, he is interested in doing research in the areas of financial markets, corporate finance and governance, business strategy, e-marketing and entrepreneurship.

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### PUBLIC INTEREST STATEMENT

Insurance companies are essential stabilizers to smooth the financial volatility of businesses and to support the overall emerging economic growth and capital market development. Besides, corporate governance is vital because it creates a system of rules and practices that control how a company operates and how it aligns with the interests of all its stakeholders. Thus, this research was anticipated to survey the effect of corporate governance on the financial performance of insurance firms found in Ethiopia. The study revealed that management soundness and financial disclosure are significant in influencing the financial performance of insurance companies in Ethiopia. So as to increase financial performance Ethiopian insurance businesses should to improve their management soundness/quality and financial disclosure/transparency.

in Ethiopia as measured both by return on asset and equity. The study contributes to managers and stakeholders to improve the financial performance. Therefore, directors and other stakeholders should put in place proper governance frameworks to improve financial performance and regulators and policymakers develop policies and regulations to guarantee that businesses adopt proper governance structures in order to improve performance.

**Subjects:** Corporate Finance; Insurance; Financial Management; Corporate Governance; Business

**Keywords:** board size; corporate governance; disclosure; financial performance and insurance companies

## 1. Introduction

The structure used in governing and guiding organizations' is referred to as corporate governance (Jiang et al., 2012). It covers the board of directors' responsibilities as well as the relationship between the directors and the shareholders. By evaluating performance, providing resources, and giving advisory services, directors play a critical role in a company (Ntim, 2015). According to stewardship theory, a company's directors are supposed to behave as stewards and work toward accomplishing organizational goals (Davis et al., 1997). When the ownership and control of a firm are separated, however, directors (agents) tasked with carrying out the firm's activities may not behave in the best interests of the principals (owners; Berle & Means, 1932). According to the agency theory, directors (agents) are self-interested and will act opportunistically when their interests differ from those of the investors (principals; Jensen & Meckling, 1976).

The basic role of corporate governance lies in regulating the board's actions. It is a control and monitoring system in which the board of directors oversees the work of management to maximize shareholder value (Jebran & Chen, 2020). Corporate governance is one of the most important dimensions of ESG (environmental, social and governance) indices, revealing its capacity to ensure legitimacy (Brammer & Pavelin, 2008; Akhtaruzzaman et al., 2021; Buallay, 2019; Miralles-Quirós et al., 2019).

Corporate governance aims at facilitating effective monitoring and efficient control of business. Its essence lies in fairness and transparency in operations and enhanced disclosures for protecting the interests of different stakeholders (Arora & Bodhanwala, 2018). Moreover, corporate governance structures are expected to help the firm perform better through quality decision-making (Shivani et al., 2017).

Firms with better corporate governance procedures achieve organizational objectives and goals more consistently than those without (Bradley (2004)). According to Adams and Mehran (2003b), businesses with better processes and procedures are more likely to perform well. Better policies and procedures have been identified as a key factor in improving an organization's financial performance. Many authors argue that if an organization priorities having and following systems, it will be able to provide better returns to its shareholders (Matama, 2008; Gompers et al., 2003). Corporate governance is to ensure good business governance as well as compliance with all regulatory body governance requirements for the benefit of all stakeholders, including society. The board of directors plays a critical role in reducing the agency costs that come from firms' separation of ownership and decision-making control (Cheung & Chan, 2004). In general, corporate governance is considered to be a significant variable influencing growth prospects of an economy because best governance practices reduce risk for investors, improve financial performance and help in attracting investors (Spanos, 2005). (Monda et al., 2013) also documented that better corporate governance results in higher market valuation and financial performance measured by ROA for companies listed in France, Italy, Japan, the UK and the US.

Financial institutions' corporate governance differs from that of non-financial institutions, due to the larger risk that financial enterprises provide to the economy. As a result, the regulator takes a more active role in establishing standards and rules to make management practices in financial institutions more accountable and efficient, and then, financial-sector regulators assign additional responsibilities to the boards of directors, which frequently result in detailed regulations governing their decision-making practices and strategic goals. Some academics believe that banking regulation is a substitute for corporate governance because of additional regulatory duties for management (Renee Adams & Mehran, 2003).

The persistence of business scandals and failures has prompted research into the efficiency of various corporate governance frameworks (Ntim, 2015). The studies' findings, on the other hand, are inconclusive and yield mixed results. Some studies show that corporate governance variables including board size, composition, diversity, and board independence have a positive impact on performance (Chen et al., 2005; Jackling and Juhl, 2009a; Khan and Subhan, 2019; Riyadh et al., 2019; Lozano et al., 2016; Schmidt & Fahlenbrach, 2017). Other studies, on the other hand, show a negative relationship (Afrifa & Taurigana, 2015; Conyon & Peck, 1998; Guest, 2009; Mak & Kusnadi, 2005; Malik & Makhdoom, 2016; O'connell & Cramer, 2010), while others show no relationship (Afrifa & Taurigana, 2015; Conyon & Peck, 1998; Guest, 2009; Mak 2005; Bhagat & Black, 2002; Ferrer & Banderlipe, 2012; Ghazali, 2010; Haji, 2014; Chabachib et al. (2019). Furthermore, because of cultures and corporate governance structure difference, most of these studies focus on developed countries and may not be applicable to other countries (Arora & Sharma, 2016; Tricker & Tricker, 2015).

Exploring the impact of corporate governance measures on the performance of insurance companies is highly intriguing in Ethiopia since the financial industry is restricted and subject to a strict regulatory regime. The existing literatures only explain the impact of corporate governance on business performance (Matama, 2008; Rashid, 2011). These studies attempted to explain the impact of corporate governance on firm performance in a relatively liberalized economy where the board of directors has more discretionary power to exercise it and make decisions that they believe are more beneficial to their companies. Furthermore, Afrifa and Taurigana (2015) and Abate (2012) investigated the determinants of insurance company performance in Ethiopia, although the study omitted corporate governance-related aspects that affect financial performance. Gardachew (2015), on the other hand, looked at the impact of corporate governance on the financial performance of the insurance industry by combining corporate governance-related variables with a limited number of corporate governance components. Moreover, Enyew et al. (2019) evaluated the financial distress condition and its firm-specific determinant factors in the Ethiopian insurance industry using data ranging from 2007 to 2016 and found that the financial health condition of the insurer's understudy was not in a safe condition and it shows continuous fluctuations. Therefore, this study is needed because studies on corporate governance are very limited in Ethiopia and contribute to the theories of corporate performance and financial performance and their effect on the profitability and for the perspective investors about investing in a particular corporate precise, effective and efficient investment decision.

The study adds to the body of knowledge on corporate governance in a variety of ways. First, the study tries to explain the role of the board of directors in Ethiopia's highly regulated insurance business, as well as the importance of corporate governance processes in the absence of capital markets in the country's closed financial sector. Therefore, this finding sheds light on the impact of corporate governance on financial performance in developing countries and presents an empirical evaluation on the effect of alternative governance arrangements, as well as recommendations for policymakers to use in assessing and reviewing corporate governance rules. Second, the study makes recommendations to managers and other stakeholders on how to improve the performance of insurance businesses by changing the board structure.

### 1.1. Objectives

The overall objective of this study was to measure the effect of corporate governance on the financial performance of Ethiopian insurance companies and it specifically aims to:

- (1) Assess the effect of board size on the financial performance of insurance companies in Ethiopia.
- (2) Examine the effect of management soundness on the financial performance of insurance companies in Ethiopia.
- (3) Investigate the effect of dividend policy on the financial performance of insurance companies in Ethiopia.
- (4) Determine the effect of debt on the financial performance of insurance companies in Ethiopia.
- (5) Identify the effect of board remuneration on the financial performance of insurance companies in Ethiopia.
- (6) Examine the effect of financial disclosure on the financial performance of insurance companies in Ethiopia.

## 2. Theoretical literature review

### 2.1. Stewardship theory

According to the theory, board members of a corporation behave as stewards, and will not prioritize their own interests over the company. Furthermore, the directors will carry out their responsibilities in a way that promotes collectivism or the accomplishment of organizational utility rather than individual gains (Davis et al., 1997). As the directors work to meet the organization's goals, their personal needs are met as well (Kluvers & Tippet, 2011). Regardless of the directors' personal interests, the directors act as honest stewards of the company and are devoted to the collective good of the company's stakeholders (Davis et al., 1997). The performance of the stewards, on the other hand, is contingent on whether the organizational structure allows proper action (Davis et al., 1997).

Stewardship theory assumes that when stewards align their interests with those of the principal, there will be no principal-agency problem (Chrisman, 2019). In essence, when the interests of the steward and the principle coincide, both parties achieve their long-term goals without conflicting interests. Moreover, the theory emphasizes the concept that a company's managers or executives operate as stewards, and so they should be on the board of directors. This viewpoint is supported by the existing literature, which suggests that executive directors should make up a percentage of the board (Coles et al., 2008; Harvey Pamburai et al., 2015; Mashayekhi & Bazaz, 2008).

### 2.2. Agency theory

The theory is based on Smith's (1776) that states if a company is run by people who are not shareholders, the managers may not be working in the best interests of the owners. When a shareholder (principal) hires another person (agent) to handle some tasks on their behalf, an agency relationship is formed. If the principal and the agent are both maximizing utility, the agent may not always act in the shareholders' (principal) best interests (Jensen & Meckling, 1976). According to Berle and Means (1932), distinct risk preferences and actions exist among groups and individuals within an organization. The principal invests their money in a company and accepts risks in exchange for financial gain. Managers (agents), on the other hand, are risk averse and want to maximize their profits. As a result, the agent's and principal's risk tolerances are not in sync, resulting in agency conflict. When the managers or executives opt to behave in a manner that drives them towards self-motivation, goal attainment and self-actualization, they will naturally align their ambitions with the organization's goals (Schillemans & Bjurström, 2020).

Therefore, agency theory stated that non-executive directors should be included on the board of directors to oversee managers' performance. The board should also be structured in a way that ensures decision-making independence, by including independent directors to avoid conflicts of interest and Malik and Makhdoom (2016), found that independent board of directors has a significant impact on a company's performance.

### **2.3. Resource dependency theory**

The theory postulates that the board of a firm is critical because it provides resources to the managers who in turn utilize them to achieve organizational objectives (Hillman & Dalziel, 2003; Hillman & Dalziel, 2003). The theory recommends the board to provide support to the executives, finance, human, and intangible properties. Board members with expertise and professional should provide training and mentoring to executives to help them improve their skills and performance. Board members can also connect the organization with their personal networks, bringing in vital resources. According to the theory, CEOs should be permitted to make the majority of the firm's decisions, with some being presented to the board for approval. In the case of the banking industry, stakeholder theory consists of satisfying depositors, owners, and other relevant stakeholders based on an effective governance structure that enhances trust and transparency (Vicente-Ramos et al., 2020).

The resource-based view thus promotes the inclusion of professionals on a company's board of directors, emphasizing the importance of outside directors who bring best practices and connections from other companies. The theory also advocates for a larger board of directors to accommodate more directors with a wide range of experience and knowledge. Non-executive directors and professionals with a wide range of experience and skills should be included on a company's board of directors Ghazali (2010), Ujunwa (2012), Francis et al. (2015), and Mori (2014).

### **2.4. Literature review and hypothesis development**

#### **2.4.1. Board size**

By providing policy direction and strategic guidance, the board of directors plays an important role in an institution. According to PfefferJ and Pfeffer's (1972), an institution can gain enormous and valuable resources from its board of directors, reducing its reliance on the environment. Resource dependency theory states that companies with a large board of directors can access more resources from the outside world. Ciftci et al. (2019), Jackling and Johl (2009a) and 2019 investigated the impact of corporate governance practices on insurance companies' financial performance in Nepal and found that large board can improve board independence and diversity, resulting in improved firm performance. Moreover, Schillemans and Bjurström (2020) conducted a study on the impact of corporate governance on the performance of insurance companies, and discovered that board size has a beneficial impact.

#### **2.4.2. Debt**

Creditors, such as banks, have made significant investments in the company and want to see their money back. Their power stems in part from a range of control rights they obtain when companies default or breach debt covenants (Clifford & Jerold, 1979), and in part from the fact that they often lend for a limited period of time, requiring borrowers to return for further funds at frequent intervals. As a result, banks and other large creditors are similar to large stockholders in many ways.

et et al. (2020) looked into the corporate governance and financial performance of Pakistani insurers. The findings suggest that debt has a detrimental impact on insurance performance. Jebran and Chen (2020) investigated the influence of corporate governance on the financial performance of Ethiopian insurance companies and discovered that leverage has a significant negative impact on return on investment. Furthermore, Afrifa and Taurigana (2015) and Abate (2012) indicate that leverage has a negative and considerable influence on insurance company profitability in Ethiopia.

#### **2.4.3. Management soundness**

Good operational systems, control systems, organizational discipline, and culture are typically used to measure sound and efficient management. Ratios such as operating expense to total expense and total spending to total income are important indicators of good management. According to Athanasoglou et al. (2008), the amount of operating expenses is defined by the quality of management, which has an impact on profitability.



Buallay (2019) investigated the factors influencing the performance of 20 short-term insurance businesses in Zimbabwe. The study's findings imply that a company's managerial soundness has a negative and significant impact on the performance of insurance businesses. In the same way, Afolabi (2018) investigated the impact of claim payouts on insurance company profitability in Nigeria and the study discovered that return on asset has an indirect link with loss ratio and net claims but a direct association with expense ratio.

#### 2.4.4. Board remuneration

Ekundayo (2018) investigated the impact of motivation on employee performance in a number of Nigerian insurance firms. Motivation was found to be the most important factor affecting employee performance. Furthermore, the research revealed a direct, robust, and beneficial link between employee motivation and performance. Dube et al. (2017) looked at the effect of encouraging front-line staff in Jordanian retail businesses on organizational commitment and found that front-line staff motivation has a major impact on organizational commitment.

Obikeze (2016) investigated the impact of motivation on sales force performance of mobile telecommunication network in Nigeria. The study used a survey approach that included both primary and secondary data, and the study found that incentive tactics encourage salespeople to focus on prospects that are most likely to yield higher returns on their efforts.

#### 3.4.5. Financial disclosure

The financial disclosure index was created using an unweighted approach. This method is best used when no special attention is paid to any one user group (Alexandrina Stefanescu, 2013). Following the creation of the disclosure list, a grading sheet was created to evaluate the amount of insurance companies' voluntary corporate transparency. If the insurance company gave information on the item on the list, it received a score of 1, and if it did not, it received a score of unlike weighted scores, which were rarely utilized earlier, most prior studies aiming at generating such an index of disclosure support approach (Barako et al., 2006). Arora and Bodhanwala (2018) investigated the impact of corporate governance disclosure on Nepalese insurance performance and found that corporate governance has an impact on the performance of insurance companies. Ciftci et al. (2019) investigated corporate governance disclosure and firm performance in developing market evidence from Turkey and found that financial disclosure has an effect on performance.

#### 3.4.6. Dividend policy

Financial transfers to shareholders in the form of dividends may be beneficial in reducing agency issues. Lintner and Gordon (1956) proposed that there is a direct relationship between firm's dividend policy and its market value, in support of dividend relevance theory. The bird in the hand argument, which indicates that current payouts are less hazardous than future dividends or capital gains, is central to this argument. Dividend policy and financial performance of insurance businesses registered on the Nairobi Securities Exchange in Kenya, Akhtaruzzaman et al. (2021). The study found that paying out dividends has no impact on the performance of insurance businesses listed on the Nairobi Stock Exchange. Afrifa and Taurigana (2015) looked at the relationship between dividend policy and insurance company performance, and found that dividend policy has no impact on the firm's success. Furthermore, dividend irrelevance theory suggests that dividend payment has an indirect link with performance, contrary to dividend relevance theory.

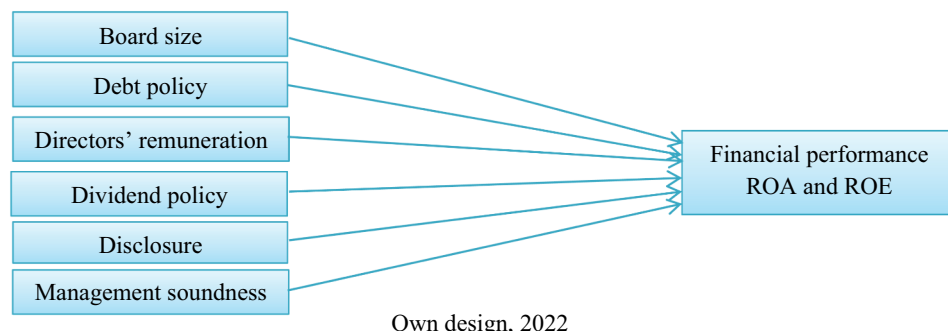
As a result of the review of previous studies, the following hypothesis was designed and the relationship between independent and dependent variables has been shown below on the conceptual framework in Figure 1:

**H1:** Board size has a significant and positive effect on the financial performance of insurance companies in Ethiopia.



**Figure 1. Conceptual framework.**

Own design, 2022



**H2:** Debt has a negative and significant effect on insurance company's financial performance in Ethiopia.

**H3:** Management soundness has a negative and significant effect on insurance company's financial performance in Ethiopia.

**H4:** Board remuneration has a positive and significant effect on insurance company's financial performance in Ethiopia.

**H5:** Financial disclosure has a positive and significant effect on insurance company's financial performance in Ethiopia.

**H6:** Dividend policy has a significant and negative effect on the financial performance of insurance companies in Ethiopia

### 3. Materials and methods

This study attempted to investigate the effect of corporate governance on the financial performance of insurance companies in Ethiopia. In light of the research objective and the quantitative nature of the data, this study employed a quantitative approach to identify the effect of corporate governance on insurance companies' financial performance. Accordingly, this study adopted an explanatory research design to examine the cause and effect relationships between financial performance and the corporate governance.

In Ethiopia, there are now 17 insurance companies in operation, and 9 insurance companies that have 9 years of audited financial data from 2012 to 2020 were included in the sample purposively. The study used secondary data, which included the audited annual financial reports of insurance companies under study. The data were strongly balanced panel types, which captured both cross-sectional and time-series behaviors.

#### 3.1. Model and measurement of variables

To test the hypothesis and explain the association between corporate governance characteristics and financial performance measures, a multi-panel linear regression model was utilized. The independent variables were board size (BS), debt (DEBT), dividend policy (DP), management soundness (MS), board remuneration (BR), and financial disclosure (FD), whereas the dependent variables were return on asset (ROA) and return on equity (ROE).

**Table 1** summarizes the study variables used in the empirical analysis of this research.

The following model was used to determine the relationship between the variables:

#### Model 1:

$$Y = f(BS, DEBT, DP, MS, BR \text{ and } FD) \quad (1)$$

$$ROA = \alpha + \beta_1 i, tBS + \beta_2 i, tDEBT + i, t\beta_3 i, tDP + \beta_4 i, tMS + \beta_5 i, tBR + \beta_i, tFD + \sum i, t \quad (2)$$

#### Model 2:

$$Y = f(BS, DEBT, DP, MS, BR \text{ and } FD) \quad (3)$$

$$ROE = \alpha + \beta_1 i, tBS + \beta_2 i, tDEBT + i, t\beta_3 i, tDP + \beta_4 i, tMS + \beta_5 i, tBR + \beta_i, tFD + \sum i, t \quad (4)$$

Where

ROA is return on asset, ROE is return on equity, BS<sub>i,t</sub> is board size of insurance company *i* at time *t*. DEBT<sub>i,t</sub> is debit of insurance company *i* at time *t*, DP<sub>i,t</sub> is dividend policy of insurance company *i* at time *t*, MS<sub>i,t</sub> is management soundness of insurance company *i* at time *t*, BR<sub>i,t</sub> is board remuneration of insurance company *i* at time *t*, FD<sub>i,t</sub> is financial disclosure of insurance company *i* at time *t* and  $\sum$  is error term.

## 4. Results and discussions

### 4.1. Descriptive statistics

Table 2 shows the descriptive results of corporate governance and financial performance. The mean value of return on asset and return on equity was 0.0995158 and 0.086215, respectively, with standard deviations of 0.06508771 and 0.5612661. The return on asset has a minimum and maximum value of -0.015 and 0.37, respectively. The minimum and highest return on equity values are -0.014 and 0.29, respectively. The mean and standard deviation of board size are 7.580247 and 1.082407, respectively, with minimum and maximum values of 6 and 9. Debt has a mean and standard deviation of 0.4848272 and 0.1375172, respectively, with a minimum and maximum of 0.204 and 0.852. The dividend payout ratio has a mean and standard deviation of 0.4177914 and 0.1961695, respectively, with a minimum and maximum of 0.082 and 0.87. Management soundness has a mean and standard deviation of 0.3700211 and 0.1168021, respectively, with a minimum and maximum value of 0.113896 and 1.3307. The mean and standard deviation of board remuneration are 0.5118765 and 0.1244464, respectively, with minimum and

**Table 1. Variable definition and measurement**

Variables	Symbol	Measurements
Dependent variables		
Return on asset	ROA	Net profit to total asset
Return on equity	ROE	Net profit to total equity
Independent variables		
Board size	BS	Number of board members
Debt	DEBT	Total liability to total asset
Dividend policy	DP	Total dividend paid to total net income
Management soundness	MS	Total expense to total net income
Board remuneration	BR	Log of board remuneration
Financial disclosure	FD	Maximum possible obtainable score of insurance

**Table 2. Descriptive statistics of variables**

Variable	Obs	Mean	Std .Dev	Min	Max
ROA	81	0.0995158	0.06508771	−0.015	0.37
ROE	81	0.086215	0.05,612,661	−0.014	0.29
BS	81	7.580247	1.082407	6	9
DP	81	0.4177914	0.1961695	0.082	0.87
DEBT	81	0.4848272	0.1375172	0.204	0.852
MS	81	0.3700211	0.1168021	0.113896	1.3307
BR	81	0.5118765	0.1244464	0.25	0.729
FD	81	0.6888049	0.107064	0.059	0.87

**Table 3. Correlation analysis**

	ROA	ROE	BS	DP	DIP	MS	DR	CGD
ROA	1.0000							
ROE	0.1103	1.0000						
BS	0.1208	0.1104	1.0000					
DP	−0.022	−0.0522	0.0588	1.000				
DEBT	−0.164	−0.0523	−0.1669	−0.124	1.0000			
MS	0.1718	0.1611	0.1782	−0.116	−0.1651	1.0000		
BR	0.1079	−0.1623	0.4122	−0.1584	−0.3440	0.2488.	1.0000	
FD	0.2553	0.1521	−0.0951	−0.1828	−0.0842	0.1610	0.1972	1.0000

maximum values of 0.25 and 0.729. Financial disclosure has a mean and standard deviation of 0.6888049 and 0.1070674, respectively, with a minimum and highest value of 0.059 and 0.87.

#### 4.2. Correlation resul

Table 3 below shows that the correlation between board size, managerial soundness, financial disclosure, and board remuneration shows that they are all positively connected with ( $r = 0.1208$ ,  $0.1718$ ,  $0.2553$ ,  $0.1079$ ). Furthermore, debt, dividend payout ratio, and board remuneration are all adversely associated with ( $r = -0.164$  and  $-0.022$ , respectively).

#### 4.3. Test results for the classical linear regression model assumptions

##### 4.3.1. Errors have zero value

The assumption of the classical linear regression model indicates that the mean of error terms is zero. It means that the distribution of the error term must have an expected value of zero. An error term, which has a mean other than zero, will influence the estimated coefficients. If a constant term is included in the regression equation, this assumption will never be violated (Brooks, 2008). Since the model of this study has a constant term, the assumption was not violated.

##### 4.3.2. Multi-collinearity test

Table 4 shows that there is no tolerance value below 0.1, and the value of VIF is less than 10; thus, multicollinearity is not a problem for this study.

##### 4.3.3. Heteroscedasticity test

The assumption of homoscedasticity states that the variance of the errors is constant. According to Gujarati (2004), given the value of  $X$ , the variance of  $u_i$  is the same for all observations. If the errors do not have a constant variance, it is said that the assumption of homoscedasticity has been violated, and this violation is termed heteroscedasticity. In this study, the Breusch–Pagan test was

**Table 4. Tests for multicollinearity**

Variables	VIF	1/VIF
BS	4.94	0.287364
DP	3.48	0.646430
DEBT	1.81	0.626785
MS	1.61	0.202392
BR	1.55	0.552011
FD	1.43	0.669342
<b>Mean 2.47</b>		

**Table 5. Breusch–Pagan test**

Model1	Model2
chi2(1) = 119.63	Chi2(1) = 52.36
Prob>chi2 = 0.954	Prob>chi2 = 0.48

**Table 6. Normality test Shapiro**

Variables	Obs	W	V	Z	Prob>z
Model 1	81	0.98118	1.305	0.584	0.27956
Model 2	81	0.14523	1.954	0.425	0.32642

**Table 7. Autocorrelation test**

	Durbin Watson test
Model 1	Statistics(9, 81) = 1.882207
Model 2	Statistics(9, 81) = 1.792101

used to test for the existence of heteroscedasticity across a range of explanatory variables. If errors do not have a constant variance (not homoscedastic), they are said to be heteroscedasticity (Brooks 2008). The p-values of 0.0954 and 0.48, respectively, for model 1 and model 2 are obtained from Breusch–Pagan test and shown under table 5 below. Since the p-value is greater than 5%, there is no heteroscedasticity problem in the study.

#### 4.3.4. Normality test

Brooks (2008) pointed out that in order to conduct a hypothesis test about the model parameter, the normality assumption must be satisfied. The normality assumption about the mean of the residuals is zero. Accordingly, the study used the Shapiro–Wilk test for normal data. Based on this test, if the p-value is less than 0.05, then the null hypothesis that the data are normally distributed is rejected. The p-value for the Shapiro–Wilk test in the study was 0.27956 and 0.32642, respectively, for model 1 and model 2. The assumption was not validated because the p-value was greater than 5% as shown in table 6 below.

#### 4.3.5. Autocorrelation test

This assumption states that the errors are linearly independent of one another (uncorrelated). If the errors are correlated one another, they are auto-correlated. According to Brooks (2008), DW has 2 critical values, an upper critical value (du) and a lower critical value (dl), and there is also an intermediate region leveled inconclusive. It is the region where the null hypothesis of no auto-correlation can neither be rejected nor not rejected. Hence, the Durbin–Watson Statistics (DW stat.)

shows from the regression result that 1.882207 and 1.792101 are nearer to 2, and there is no evidence for the presence of autocorrelation as shown below on [table 7](#).

#### 4.4. Random effect (REM) and fixed effect model (FEM)

There are broadly two classes of panel estimator approaches that can be employed in financial research: these are fixed effect model (FEM) and random effect model (REM; Brooks, 2008). To check which of the two (FEM or REM) models provide consistent estimates for this study, Hausman test was employed and the following hypothesis was developed:

**H<sub>0</sub>.** Random effect model is appropriate.

**H<sub>1</sub>.** Random effect model is not appropriate.

The p-value for the Hausman test in [Table 8](#) is (23.3) and (24.11) percent for model 1 and 2, respectively, which indicate that the null hypothesis was not rejected. Accordingly, random effect model (REM) was employed to estimate the relationship between the dependent and the independent variables.

#### 4.5. Regression results and discussion

[Table 9](#) reveals that board size has a significant effect on Ethiopian insurance business performance at 5% significance level, with coefficients of 0.024 and 0.04550 evaluated by both ROA and ROE. Meaning, taking other explanatory variables constant, a 1% increase in board size resulted in a 2.4% and 4.550% increase in insurance company's financial performance evaluated both by ROA and ROE. The positive result implies that expanding the board of directors increases the company's financial performance as evaluated by the ROA and ROE. The finding of this study is in line with that of Subdi (2018), Ciftci et al. (2019), and Johl (2009), who claim that a larger board of directors can improve board independence and diversity, hence improving firm performance. Furthermore, resource dependency theory contends that boards of directors, with their high level of connections to the external environment, support the

**Table 8. Random and fixed effect model**

Model 1	FE	RE	Difference	S.E.
BS	-0.062123	0.321452	-0.383575	0.621456
DP	0.0121451	-0.002145	0.0142901	0.365242
DBT	0.0014521	0.0042154	-0.00276	0.004213
MS	0.0213651	0.0321454	-0.010780	0.021456
BR	0.0124521	0.0123651	0.0008700	0.325164
FD	0.0325141	0.0021451	0.030369	0.012456
Prob>chi2 = 0.23				
Model 2	FE	RE	Difference	S.E.
BS	0.162312	0.415623	-0.253311	0.326581
DP	0.021321	0.002145	0.019176	0.014256
DBT	0.065214	0.062514	0.0027	0.002146
MS	0.023541	0.014526	0.009015	0.014569
BR	0.025632	0.011213	0.014419	0.465241
FD	0.013265	0.015847	-0.001154	0.023651
Prob > chi2 = <b>0.2411</b>				

**Table 9. Random effect model regression results**

	Coef.			Std.Err.			Z		P > t		95% Conf. interval			
	ROA	ROE		ROA	ROE		ROA	ROE	ROA	ROE	ROA	ROE	ROE	ROE
BS	0.024	0.0450		0.00708	0.1254		3.45	2.124	0.050**	0.047**	0.01054	0.0382	0.9024	1.629
DP	-0.1399	-0.1242		0.06599	0.04215		-2.12	0.921	0.040**	0.022**	-0.26939	-0.0106	-2.452	-1.43
DEBT	-0.1038	-0.2023		0.03681	0.32145		-2.82	0.123	0.050**	0.041**	-0.17601	-0.0316	-0.3458	0.124
MS	0.12940	0.32146		0.06578	0.56871		-1.97	1.245	0.049**	0.03**	-0.02583	-0.0004	0.1245	0.1245
BR	0.00201	0.01123		0.01977	0.0012		-0.10	0.124	0.091***	0.082***	-0.04347	258	-0.1452	0.8564
FD	0.14766	0.01352		0.05317	1.2453		2.78	1.252	0.05**	0.02**	0.00664	0.0062	-0.2356	0.1326
Con	-0.1206	-0.1762		0.2025	5.1245		-0.6	3.12	0.551	0.175	-0.51773	0.2764	-7215	14.12

\*\*and \*\*\* indicate the significance level at 5% and 10%, respectively.

outcome. As a result, the hypothesis that there is a positive relationship between board size and insurance firm financial performance in Ethiopia is accepted.

The finding also revealed that debt has a negative and significant impact on Ethiopian insurance companies' financial performance, with a 5% significance level and coefficients of 0.1038 and 0.2023 evaluated by ROA and ROE, respectively. Meaning taking other explanatory variables constant, a 1% rise in debt resulted in a decline in insurance company financial performance by 10.38% and 20.23%, respectively, as evaluated by ROA and ROE. et et al. (2020), Jebran and Chen (2020), Al-Hawaly (2012), Afrifa and Taurigana (2015), and Abate (2015) all support the study's negative association between leverage and financial performance. As a result, the hypothesis that debt has a negative association with insurance companies' financial performance in Ethiopia is accepted.

Moreover, the study revealed a statistically significant negative link between insurance companies' dividend payout ratio and insurance companies' financial performance in Ethiopia, as evaluated by ROA and ROE, with coefficients of 0.1399 and 0.1242, respectively, and with 5% significance level. The negative relationship between dividend policy and insurance companies' financial performance indicates that dividend payments, lower a company's investing power, resulting in greater financial strain. The finding of this study is in line with that of Pandy (2012), who claims that a low payment leads to better growth. Moreover, the finding of this study is consistent with dividend-irrelevance theory. As a result, the hypothesis that there is a negative association between dividend payout and insurance company financial performance in Ethiopia is accepted.

The findings again revealed that management soundness has a significant and positive relationship with the financial performance of Ethiopian insurance companies, with a coefficient of 0.12940 and 0.32146 measured by ROA and ROE, respectively. Meaning, taking other explanatory variables constant, a 1% increase in management soundness resulted in 12.940% and 32.146% ROA and ROE, respectively, in the same direction. The findings of this study agree with those of Shobor and Batra (2016), who found that effective management of operating expenses and income has helped Ethiopian insurance companies improve their profitability. As a result, the hypothesis that there is a negative relationship between management soundness and insurance company financial performance in Ethiopia is rejected because insurance companies' management is operationally cost-efficient during the study period that is supported by the finding of Athanasoglou, et al (2008) and Efficiency theory, respectively, which suggests lowers operating costs leading to good profit.

Furthermore, at 10% significance level, the results revealed that board remuneration had a significant and positive link with insurance company financial performance, as measured both by ROA and ROE with coefficients of 0.00201 and 0.1123, respectively. Meaning, a 1% increase in board remuneration enhances the financial performance of Ethiopian insurance businesses by 0.201% and 1.123% in the same direction. The finding of this study is in line with those of Ekundayo (2018), Husam and Dia (2017), and Obikeze (2016). As a result, the hypothesis that board remuneration has a significant and positive association with insurance company financial performance in Ethiopia is accepted.

Finally, the findings revealed that financial disclosure has a strong and positive link with the financial performance of insurance companies in Ethiopia, with coefficients of 0.14766 and 0.01352 assessed using both ROA and ROE, respectively. The positive link demonstrated that financial information disclosure aids insurance business managers in their operations and serves as a source of knowledge for investors. The finding of this study is in line with those of Schillemans and Bjurström (2020) and Ciftci et al. (2019). As a result, the study accepted the existence of a significant and positive association between financial disclosure and the financial performance of Ethiopian insurance companies.



## 5. Conclusions and policy implications

The impact of corporate governance on firm performance has become such a hot research issue that it has piqued academics' and researchers' interest. Despite the existence of empirical literature, the results of such investigations have remained inconclusive. Few studies have shown that financial institutions' corporate governance differs from that of non-financial institutions, limiting the directors' discretionary power, particularly in regulated financial systems where financial institutions are required to operate under legislative and prescriptive procedures, policies, rules, and regulations. As a result, the purpose of this research is to investigate the effect of corporate governance on the financial performance of a tightly regulated Ethiopian insurance firm. A random effect model was used to evaluate nine years of panel data from nine insurance companies.

The dependent variables are return on asset and return on equity, while the explanatory variables are board size, debt, board remuneration, dividend policy, management soundness, and financial disclosure. The finding revealed that the size of the board of directors had a considerably favorable impact on the financial performance of Ethiopian insurance businesses, as evaluated both by return on asset and return on equity. This suggests that insurance businesses with a larger board size ratio outperform their peers.

The findings also revealed that management soundness and financial disclosure had a positive and significant impact on the financial performance of Ethiopian insurance companies assessed by both return on asset and return on equity. As a result, the study finds that improving the financial performance of Ethiopian insurance businesses through improving management soundness and financial disclosure. Similarly, debt and dividend payments have a negative link with insurance businesses' return on assets and equity in Ethiopia. This indicates that insurance businesses with a higher dividend ratio will perform poorly. Therefore, insurance companies should employ debt financing rather than stock financing.

Finally, the findings revealed that board remuneration has a significant positive effect on Ethiopian insurance companies' financial performance, as evaluated both by ROA and ROE. The findings imply that the higher the board remuneration, the better the insurance company's financial performance. Therefore, Ethiopian insurance companies should boost board remuneration. Thus, the study concluded that all of the corporate governance proxies employed in the study had a significant impact on insurance businesses' financial performance, as assessed both by return on asset and return on equity.

### 5.1. Policy implications

Based on the findings of the study, the following significant policy and operational directions are forwarded. In order to improve financial performance, directors and other stakeholders should put in place proper governance frameworks. The study also suggests that regulators and policymakers develop policies and regulations to guarantee that businesses adopt proper governance structures in order to improve performance. Finally, future research may focus on data from industries other than insurance firms, such as banks, microfinance institutions, and cooperative unions, and other governance variables like gender diversity, age, board education, and shareholding can also be investigated by future studies.

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