

The Effect of Corporate Board Structure on Foreign Share Ownership Listed Companies in Gulf Cooperation Council (GCC) Countries

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Abstract

This study empirically examines the effect of corporate board structure on foreign share ownership in Gulf Cooperation Council (GCC) countries. Specifically, it examines the effect of the financial expertise of the board of directors, board size, board independence and board meeting on foreign share ownership. The analysis is spanned the period of 2012-2015 for 142 non-financial listed companies on the GCC stock markets. The results demonstrate that foreign share ownership is positively related to the financial expertise of the board of directors, board size and board independence. The implication of this study may help users in making better public policy decisions, and provide guidance for corporate managers on the needs of foreign investors.

JEL classification: G34, F21

Keywords

Corporate board; board's financial expertise; foreign share ownership; GCC countries.

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Introduction

There is a consensus among the fiscal analysts that the effectiveness of corporate governance' practices have affected the investment decisions of the foreign investors. Due to the recent financial crises¹, it has displayed an important role in the financial studies (Agrawal & Chadha, 2005; Bokpin, Isshaq and Nyarko, 2015; Mangena & Tauringana, 2007). Foreign share ownership has become more significant in the developing countries, where the participation of foreign investors in the domestic financial markets has increased (Ramaswamy & Li, 2001; Waqas, Hashmi & Nazir, 2015). It has been proven that for firms to develop and grow, they must expand their businesses, and to do so, firms need to attract foreign investment. On the other side, investors need to be ensure that the business is secure and stable, is generating profit and is sustainable in the future (Agrawal & Chadha, 2005). Foreign share ownership as one of the most significant sources of investment is defined as the percentage of shares owned by foreign portfolio equity investors (Bokpin, Isshaq and Nyarko, 2015). Various benefits are associated with foreign share ownership, especially in the area of high economic growth and stable exchange rate such as the case of Gulf Cooperation Council (GCC) countries (Santos, 2015). GCC countries provide incentives to attract foreign investors, like tax-free initiatives and permitting foreigners to own 49% in listed companies (Santos, 2015). Despite these benefits and incentives, GCC countries have not been able to adequately attract foreign share ownership, whereby the level of foreign share ownership in the listed companies is still below the target (Al-Tuwaijri, 2010). For example, in 2015, the average foreign share ownership in Saudi Arabia is around 4.58% and in Dubai, it is about 6.75% (GulfBase, 2015). In more clarification, this is could be attributed to the following reasons: the GCC countries have unique features such as (i) insufficient corporate governance mechanism and low legal protection, as the investment industry is totally dominated by the royal families (Al-Matari, Al-Swidi & Fadzil, 2014; Claessens & Yurtoglu, 2013); (ii) high ownership concentration where the family owners controlled around 70% of business (Gulf Family Business et al., 2015), (iii) low institutional ownership, (iv) high government interventions and (v) low financial reporting quality (Kern, 2012).

Attracting foreign share ownership is an important for companies in the GCC countries due to many reasons. First, foreign investor participation promotes development of the GCC emerging markets by increasing the supply of capital, thus increase the liquidity and efficiency of these emerging markets, which in turn helps to improve local capital markets and develop their functions. Second, foreign share ownership may reduce the pressure of foreign exchange gap by supplying foreign currency to the relevant countries. Third, it helps to develop the region through technology, knowledge and skills that can improve the productivity of local firms. Therefore, it is important to understand firm characteristics that could attract foreign share ownership in the GCC countries.

Many studies on foreign share ownership have been conducted in developed countries (e.g., Bowman & Min, 2012; Miletkov, Poulsen, & Wintoki, 2014; Min & Bowman, 2015). The results indicate that foreign investors are more attracted to large firms with high

¹ The financial crises that occurred in Asia in 1997 and 1998 and the corporate scandals, namely Global Crossing 2002, WorldCom 2002, Enron 2001 and Tyco 2002

book-to-market ratio, low leverage and high independence of the board of directors. However, the results cannot be generalized to less developed and developing countries or emerging economies, in general, and GCC countries, in particular. To date, studies on the GCC countries in respect to foreign share ownership are scarce. We extend prior studies to examine the role of financial expertise of directors in corporate boards and the frequency of board meetings in attracting foreign share ownership in the non-financial listed companies of stock markets in the GCC countries, namely, Saudi Arabia, Bahrain, Oman, the United Arab Emirates (UAE) and Qatar. It is important to examine the effect of financial expertise on foreign share ownership as foreign investors are more attracted to companies with high financial reporting quality, and studies have shown that the financial expertise is associated with high financial reporting quality (Agrawal & Chadha, 2005; Jeanjean & Stolowy, 2009; Lanfranconi & Robertson, 2002; Minton, Taillard, & Williamson, 2014; Mustafa & Ben Youssef, 2010). Likewise, frequency of board meeting is equally important for high financial reporting (Hsu & Petchsakulwong, 2010; Vafeas, 1999). Specifically, the objectives of this study are:

- 1) To examine the relationship between financial expertise of directors in the corporate boards and foreign share ownership.
- 2) To examine the relationship between board size and foreign share ownership.
- 3) To examine the relationship between board independence and foreign share ownership.
- 4) To examine the relationship between frequency of board meetings and foreign share ownership.

The sample of this study is public companies listed on the stock markets of GCC countries. Our empirical analysis is conducted using a panel multiple regression model based on data set for 142 firms for the period of 2012 to 2015.

This study is organized as follows: Section two summarizes previous studies. Section three describes the data used and methodology. Section four displays the results and analysis, while the fifth section concludes the study.

Literature Review and Hypothesis Development

Several studies have been undertaken on the relationship between the foreign share ownership and factors that may affect in attracting foreign ownership (Bokpin & Isshaq, 2009; Bokpin et al. 2015; Mangena & Taurigana, 2007; Miletkov, et al., 2014; Min & Bowman, 2015). This part summarizes shortly the relationship between the foreign share ownership and the variables of interest, namely; financial expertise of board of directors, board size, board independence and frequency of board meetings.

In respect to the financial expertise, Lanfranconi and Robertson (2002) explained that the business scandals of Enron and WorldCom were due to the lack of financial expertise of board members. Specifically, in the case of Enron, the board members did not possess the right knowledge to discern the complex financial planning arrangements employed for special purpose entities. In the case of WorldCom, the members were not equipped with basic accounting expertise and knowledge and were

unaware of the expenditure being capitalized rather than being expensed. In both cases, the directors' role in carrying out their duties is questionable. Based on empirical studies (Burak Guner, Malmendier & Tate, 2008; Hashim & Devi, 2007; Volpe & Woodlock, 2008), financial expertise is a crucial determinant of the financial statements quality. Agrawal and Chadha's (2005) findings, from their study involving US firms, shed light on the importance of accounting knowledge among external directors. At first, they did not find independent director to be determinant of the probability of the firm's requirement for restatement of accounts. However, upon testing the independent director with financial expertise, they found the result to be significant. This finding indicates that independent directors are only useful in reducing the likelihood of financial restatements if they have financial expertise. Boards' members should have financial expertise to review the quality of the financial information released by the company to investors (Johl, Satirejit, Subramaniam & Cooper, 2013; Jeanjean & Stolowy, 2009). In relation to this, Minton, et al. (2014) and Dionne and Triki (2005) revealed that financial expertise of directors may positively affect the behaviour of the firm concerning hedging policies for safeguarding investors' wealth by forecasting crises. In terms of board size, most of the previous studies found no significant association with foreign share ownership (Bokpin & Isshaq, 2009; Mangena & Taurigana, 2007; Miletkov et al. 2014). While, Epps and Ismail (2009) stated that a larger board is a better monitoring mechanism of management because the directors' experience and expertise will significantly enhance board performance and increase the investors' confidence. In relation to this, the agency theory posits that a larger board would be more competent and result in better performance owing to the integration of different expertise, skills and knowledge brought into the meeting discussion of board. Some previous studies found a negative link between foreign share ownership and board size. Mangena and Taurigana (2007) and Miletkov et al. (2014) found no significant link between board size and foreign share ownership, while the coefficients are positive. This results point to the assumption that board size should not be taken into consideration in the foreign investor's decision process which is contrary to what is suggested in the literature (e.g. Karamanou & Vafeas, 2005; Mangena & Pike, 2005).

Regarding to board independency, Miletkov et al. (2014) studied the effect of board independence on foreign share ownership in non-financial companies in the U.S. The result shows a positive relationship between board independence and foreign ownership. In Korea, Min and Bowman (2015), who examined the impact of board independence on foreign share ownership, found that the positive effect of an independent directors on foreign ownership is greater. Mangena and Taurigana (2007) found a positive association between foreign share ownership and both the independence of audit committee and the percentage of non-executive directors on the firm's board on the Zimbabwe Stock Exchange. In Ghana, Bokpin and Isshaq (2009) investigated the impact of transparency and corporate governance on foreign share ownership for a sample of firms listed on the Ghana Stock Exchange. They found that board independency is associated with foreign share ownership. While, Suwaidan, Abed and Al-Khoury (2013) indicated there is no relationship between board independence with foreign share ownership. In respect to the frequency of board meetings, Ebrahim (2007) suggested that the board meetings frequency may be utilized to gauge the activities of the board that improves their effectiveness. The frequently

meeting board can develop the performance of the companies as frequent meetings could be a reflection of increasing monitoring and review of management performance to satisfy and meet the interests of investors (Hsu & Petchsakulwong, 2010). On the whole, the frequency of meetings of the board members is expected to enhance the monitoring function of the board specifically in issues that concern the financial reporting process and this is expected to lead to annual report transparency that is invaluable for the foreign investors. In relation to this, Chobpichien (2008) stated that foreign investors are concerned with board operations, primarily when it comes to the activity of the board that is gauged through the frequency of board meetings held in year. It is believed that board meetings which measure the board effectiveness can lead to enhanced company performance as frequent of board meetings could reflect increased monitoring and oversight of the performance of management that brings about the satisfaction of the investor's interests (Hsu & Petchsakulwong, 2010; Vafeas, 1999). Overall, the frequency of meetings held by the board members can contribute to enhancing the board's role in monitoring the financial reporting process, and in turn, result in the transparency of the information contained in the annual report that foreign investors use to help them to a much better investment decision.

Accordingly, due to a significant role of above factors in enhancing the whole environment of investment at the relevant markets, this study illustrates the key hypotheses of attention as following:

H1: There is a positive relationship between the board's financial expertise and foreign share ownership.

H2: There is a positive relationship between board size and foreign share ownership.

H3: There is a positive relationship between board independence and foreign share ownership.

H4: There is a positive relationship between the frequency of board meetings and foreign share ownership.

Data and Methodology

Sample Selection

The sample comprises non-financial listed companies that have foreign ownership for the period of 2012 to 2015. The total number of selected companies is 142 which presented 568 observations (Table 1 shows the sample size of the study).

Table 1

Sample of Companies

Country	Saudi Arabia	Oman	Qatar	Bahrain	UAE	Total
-Non- financial companies with foreign ownership (final sample)	40	55	20	12	15	142

Model Specification

This study uses panel data analysis (fixed-effects) to examine the effect of the independent variables which are the financial expertise of the board of directors, board size, board independence and frequency of board meetings on foreign share ownership. We include firm size, leverage, exchange rate risks, inflation risks, economic growth which measured by GDP and political risks as control variables.

The regression model is as follows:

$$\text{FORESHARE}_{it} = \alpha_0 + \beta_1 \text{BDEXPERT}_{it} + \beta_2 \text{BDSIZE}_{it} + \beta_3 \text{BDIND}_{it} + \beta_4 \text{BDMEET}_{it} + \beta_5 \text{FMSIZE}_{it} + \beta_6 \text{LEV}_{it} + \beta_7 \text{PR}_{it} + \beta_8 \text{ERR}_{it} + \beta_9 \text{IR}_{it} + \beta_{10} \text{GDP}_{it} + \epsilon_{it}$$

Where;

α_0	Constant.
FORESHARE	Foreign share ownership measured by the percentage of shares held by foreign investors at the end of financial year.
BDEXPERT	Board financial expertise measured as a dummy variable, coded 1 if at least one board member has educational qualification in accounting or financial experience and career history; 0, otherwise.
BDSIZE	Board size measured by the total number of directors on the corporate board.
BDIND	Board independence measured by total number of independent directors on the board divided by the total Board meetings number of board members.
BDMEET	Board meetings measured by the number of meetings held by the board of directors during the year.
FMSIZE	Firm size measured by using the natural logarithm of the total assets.
LEV	Firm leverage Measured by dividing total liabilities by the total assets.
PR	Political risks Measured by international countries risks guide (ICRG). The measurement of political risk is by assigning risk points to a pre-set group of factors, the following risk components, Government Stability 12, Socioeconomic Conditions 12, Investment Profile 12, Internal Conflict 12, External Conflict 12, Corruption 6, Military in Politics 6, Religious Tensions 6, Law and Order 6, Ethnic Tensions 6, Democratic Accountability 6, and Bureaucracy Quality 4 Total 100. Risk ratings range from a high of 100 (least risk) to a low of 0 (highest risk)
ERR	Measured by using the yearly exchange rate risk percentage of change of nominal exchange rate of currencies of GCC countries to the US dollar.
IR	Inflation risk measured by using yearly percentage of change in the customer price index (CPI) per each GCC country.

GDP	Economic growth Gross Domestic Product Measured by using yearly GDP growth rate of each GCC country.
ε	Random Error.

Empirical Findings of the Study

Descriptive Statistics

A summary of descriptive statistics of foreign share ownership in the stock markets of GCC countries is presented in Table 3. The result on foreign share ownership during the four years (2012, 2013, 2014 and 2015) in Table 3 indicates that the mean proportion of shares held by the foreign investors is 11%, with a minimum holding of 0.02% and a maximum holding of 59%. The 0.02% minimum value for the foreign share ownership indicates that there are companies that have low shares held by foreign investors.

In terms of board expertise, Table 3 shows the mean of the firms have members with financial expertise on their boards of directors is 0.489, with a minimum of zero and a maximum of 1. The zero value indicates that some companies do not have member with financial expertise in their board of directors.

The mean board size is eight. The board size of the sample companies is not very different from the studies done in the stock markets of GCC countries such as Aljifri and Moustafa (2007) in the UAE had eight; and Al-Abbas (2009) and Ghabayen (2012) in Saudi Arabia also had eight. In terms of board independence, the mean of independent directors in GCC non-financial listed companies is 0.54, with a minimum of zero and a maximum of 1 (100%). This average is similar to the studies done by Fallatah and Dickins (2012). With respect to frequency of board meetings, the statistics indicate that the average number of board meetings of the board of directors is 5.8, with a minimum of zero and a maximum of 16 meetings.

Table 3
Descriptive Statistics for Continuous Variables

Variables	Observations	Mean	Std. Dev.	Min	Max
FORESHARE	568	0.1121081	0.1401384	0.0002	0.5935
BDEXPERT	568	0.4894366	0.500329	0	1
BDSIZE	568	8.105634	1.855286	5	18
BDIND	568	0.5402407	0.2422207	0	1
BDMEE	568	5.850352	1.794701	0	16
LOGFIRMSIZE	568	12.86787	2.726536	7.116394	18.39986
LEV	568	23.00343	20.02098	0	86.9
PR	568	79.43009	6.342608	62.95833	89
ERR	568	0.0000187	0.0000793	-0.0001453	0.0002085

IR	568	-13.70409	55.82844	-168.6511	114.3759
GDP	568	4.615293	1.884813	2.542739	9.332676

FORESHAREit = Foreign Share Ownership; BDSIZEit = Board Size; BDIND = Board Independence; BDMEE = Board Meeting; BDEXPERT = Board Financial Expertise; FMSIZE = Firm Size; LEV= Leverage; PR = Political risks; EER= Exchange Rate Risks; IR= Inflation risks; GDP = Gross Domestic Product.

Correlation Matrix and Multicollinearity

In Table 4, we provide the Pearson correlations among the variables. The results reveal several significant relationships between the dependent variable and independent variables, as well as among the independent variables. With regards to the independent variables, although the correlation coefficients are significant, they are all below 0.70 for the four years.

Table 4
Correlations Matrix of Study Variables

	1	2	3	4	5	6	7	8	9	10	11
1 FORESHARE	1										
2 BDEXPERT	.638**	1									
3 BDSIZE	.084*	.123**	1								
4 BDINDR	.714**	.660**	-.007	1							
5 BDMEE	.111**	.196**	.114**	.117**	1						
6 FIRMSIZE	-.012	.085*	.314**	.003	.237**	1					
7 LEV	.175**	.227**	.086*	.258**	.079	.161**	1				
8 PR	.217**	.231**	-.136**	.203**	.091*	-.100*	.164**	1			
9 ERR	-.062	-.029	.040	.013	.038	.125**	-.044	-.271**	1		
10 IR	-.107*	-.060	.133**	-.143**	.061	.347**	-.001	.009	.025	1	
11 GDP	.091*	.044	-.082*	.056	-.100*	-.285**	.056	.216**	-.529**	-.204**	1

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

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

Regression Results and Discussion:

Table 5 shows the relationship of foreign share ownership with the financial expertise of board members, board size, proportion of independent directors and frequency meeting of the board of directors. The estimations are for the period from 2012 until 2015. The regression model shows significant variations in foreign share ownership relationships. It can be seen from the results in Table 5 that the R-Square is 0. 3633.

Table 5
Results of Model Using Fixed-Effects

Variables	Coefficients	T-Statistics	P-Values
Constant	-0.427***	-3.99	0.000
BDEXPERT	0.0261***	5.59	0.000
BDSIZE	0.00315***	2.38	0.018
BDIND	0.101***	9.11	0.000
BDMEE	-0.000157	-0.02	0.985
LOGFMSIZE	0.0222***	3.59	0.000
LEV	-0.000794***	-5.34	0.000
PR	0.00222**	2.55	0.011
ERR	-19.689	-1.43	0.153
IR	-0.0000303	-1.41	0.160
GDP	0.000719	1.29	0.198
Observations		568	
R-squared		0.3633	
Prob > F		0.0000	
Significant at *** p<0.01, ** p<0.05, * p<0.1, levels			

Table 5 shows that foreign share ownership is positively associated with financial expertise of board members, board size and proportion of independent directors. We interpret these results as an indication that foreign investors invest in companies in which their interests are more likely to be protected. The positive association of foreign share ownership and financial expertise of board of directors indicates that financial expertise is a significant determinant of financial reporting quality and can increase the confidence of foreign investors. This result supports the agency theory which suggests that corporate with more financial expertise members is important to enhance board monitoring as it leads to high financial reporting quality (Pfeffer & Salancik 2003). This result indicates that board members' financial expertise can prevent fraud and protect foreign investors from losing their capital. The result of this study is consistent with Lanfranconi and Robertson (2002). The positive relationship between board size and foreign share ownership indicates that firms with large boards would be more competent owing to the integration of different expertise, skills and knowledge into the discussion during meetings of the board, which significantly result in a better monitoring mechanism of management, better performance and increased investors' confidence. This result is consistent to previous studies by Akhtaruddin, Hossain, Hossain & Yao (2009) and Hsu & Petchsakulwong (2010).

In the case of board independence, the positive relationship of foreign share ownership and board independence indicates that foreign investors perceive non-executive directors as effective in monitoring and controlling the opportunistic behaviour of managers, thus protecting the interests of foreign investors. A similar finding was reported by Mangena and Taurigana (2007), Miletkov et al. (2014) and Min and Bowman (2015) who also found board independence is positively related to foreign ownership. As for frequency of the meetings of the board of directors, we find no significant relationship with foreign share ownership. These results suggest that the frequency of meetings of the board of directors is not an important consideration in the decision process of the foreign investors. This is inconsistent with the literature, which

suggests that the frequency of board meetings is one of the determinants of the effectiveness of the board of directors (Ebrahim, 2007; Hsu & Petchsakulwong, 2010). The first reasonable justification of insignificant relationship between board meeting and foreign share ownership is that the frequency of board meetings increases when problems arise (Jensen, 1993). Therefore, foreign investors avoid companies that has problems in their financial performance. In this context, Jackling and Johl (2009) contended that increased board meeting is a reaction to poor performance, which is in turn linked to enhanced operating performance in the future. The outcomes of this analysis are in the parallel with the agency theory, which argues that the board of directors as a monitoring device of management to protect foreign investors. Where a larger board with financial expertise and more independency would be more competent and result in a better performance owing to the integration of foreign share ownership structure of the stock markets in the GCC countries and enhance the protection of the shareholders, which may provide a better environment investment.

Concluding Remarks

The aim of this study is to examine the role of financial expertise of the board of directors associated with board size, board independence and frequency of board meetings on foreign share ownership, for firms in GCC countries. Our empirical study uses a multiple regression analysis covering a four-year period from 2012 to 2015 for 142 non-financial listed companies. We find that foreign share ownership is positively related to the financial expertise of the board of directors, board size and board independence. This result suggest that foreign ownership is higher in firms with an effective corporate board. Therefore, the findings of this study show that the large board of directors with more financial expertise and independency is an effective mechanism for attracting foreign investors.

It has important implications for corporate decision-makers, especially for those countries with lower levels of investor protection. Given this, it is suggested that foreign investors avoid investing in companies in developing countries due to weak corporate boards. The results of this study suggest that foreign investors have a preference for companies which have an effective corporate board and companies in which their investments are more likely to be protected. In view of the efforts to improve corporate governance in developing countries, our results are likely to have policy implications. For developing countries, such as GCC countries, fostering an environment with a more effective governance mechanism could have positive effects on foreign investors' participation in listed companies. Thus, policy makers should introduce policies that can motivate more investors to the region. Policy makers have to reformulate the regulations that can protect and enhance the confidence of foreign investors. We believe that investigating the determinants of foreign share ownership, particularly the effect of corporate boards, is still a fundamental research problem. Future researchers could extend this study to other countries in the Middle East region and indeed to other countries where data on foreign ownership is available.

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