

# The Impact of Effective Corporate Boards and Audit Committees on Attracting Foreign Ownership in Listed Companies in the Gulf Cooperation Council

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**Abstract**

This study empirically examines the impact of effectiveness of both corporate boards and audit committee on foreign ownership in selected non-financial listed companies of the stock markets in Gulf Cooperation Council (GCC) countries. The study was built on fixed effect model and conducted over the period of 2012-2015 for 143 non-financial listed companies on the GCC stock markets. Our results explain that foreign ownership is positively related to the effectiveness of both the boards of directors and the audit committees. The implication of this study may help beneficiaries in making better policy decisions and provide guidance for corporate managers on the needs of foreign investors.

**Keywords:** effectiveness of corporate boards, effectiveness of audit committee, foreign ownership, panel data analysis; fixed effect

*JEL classification:* G34, F21

## 1. Introduction

Foreign ownership is defined as the percentage of shareholding of non-resident foreign investors and foreign portfolio equity investors (Bokpin, Isshaq&Nyarko, 2015; Mangena&Tauringana, 2007;Waqas, Hashmi &Nazir, 2015).Participation of foreign investors in domestic financial markets has increased over the last few years in the developing countries (Ramaswamy&Li, 2001). Foreign capital inflow has become more significant in developing countries. Prior studies have stated that foreign investors play an important role in emerging markets. First, foreign investor participation promotes development of emerging markets by increasing the supply of capital (Bekaert, Harvey &Lundblad 2003; Mangena&Tauringana, 2007;Ramaswamy& Li, 2001), thus ensuring liquidity and efficiency of these emerging markets (Bekaert *et al.* 2003). Second, opening the market to foreign investors may increase the value of local companies, thereby reducing their cost of equity capital (Bekaert *et al.* 2003;Mangena&Tauringana, 2007). Third, foreign investors improve the inflow of foreign exchange, which is often greatly needed in developing countries to finance imports and other foreign payments (Mangena&Tauringana, 2007).

Miletkov, Poulsen and Wintoki (2014) andBushman and Smith (2003) pointed out that an effective corporate governance structure reduces foreign investors' risks and increases their confidence and willingness to invest in particular listed companies. Also, it helps to ensure that foreign investors receive reliable information about the performance of the company and that the value of their investment is not expropriated by managers and controlling shareholders. Ajinkya, Bhojrajand Sengupta (2005) indicated that effective corporate governance can constrain corporate managers and/or controlling shareholders from expropriating other investors by ensuring an environment of greater transparency through better monitoring; thus foreign investors will be likely to be more dependent on an effective corporate governance structure.

This study is motivated by the fact that most of the previous studies on foreign ownership have been conducted in developed countries with low ownership concentration (e.g.,Aggarwal, Klapper, &Wysocki, 2005; Bowman & Min, 2012; Dahlquist&Robertsson, 2001; Jiang & Kim, 2004; Kang, 1997; Miletkov et al., 2014; Min & Bowman, 2015). Their results indicate that foreign investors are more attracted to large firms with high book-to-market ratio, low leverage and high independence of the board of directors as well as the audit committee. However, the above results might notbe generalizable to developing countries, where the ownership structure is more concentrated. Therefore, our study focuseson developing countries, specifically theGulf Cooperation Council (GCC) countries,namely Saudi Arabia, Bahrain, Oman, the United Arab Emirates (UAE) and Qatar.

The GCC's developing countries have high concentrated ownership, where family owners control around 70% ofthe business (Gulf Family Business, McKinsey & Company, 2015). Other unique features in GCC countries are high level of government intervention, low legal protection, poor information, high insider trading, politically unstable markets, low financial reporting quality and high political connections (Kern, 2012). GCC countries have not

adequately attracted foreign portfolio investment. The foreign investors' investment activity in the GCC countries remains low, as investors' share in the stock market from outside the GCC is low. For example, in 2015 the average foreign ownership in Saudi Arabia is around 4.58% and in Dubai, it is around 6.75% (GulfBase, 2015).

Many previous studies have examined the board of directors and audit committee characteristics individually on foreign ownership such as Bokpin, Isshaq & Nyarko, (2015); Bowman & Min, (2012); Mangena & Tauringana, (2007); Miletkov et al., (2014) and Min & Bowman, (2015) however, foreign investors take into consideration the effectiveness of corporate governance practices as a bundle in their investment decisions (Agrawal & Knoeber, 1996). Therefore, this study is motivated by Agrawal and Knoeber (1996) and Cai, Qian, and Liu (2009) who argued that using an individual measurement for governance mechanism might not reflect the effectiveness of the governance structure compared to using a composite measurement of the governance mechanism. Based on the fact that internal governance mechanisms complement each other, where the effectiveness of a particular mechanism may depend on the effectiveness of others (Rediker & Seth, 1995; Davis & Useem, 2002). Therefore this study contributes to the literature by examining the effectiveness of both the corporate boards and audit committee using a composite measurement as a bundle on attracting foreign ownership.

Thus, the aim of this study is to examine whether the effectiveness of both the board of directors and audit committee is associated with foreign ownership in listed companies in the GCC Stock Markets. More specifically, this study focuses on the four main internal monitoring characteristics of the board of directors as well as audit committee, namely, independence, size, frequency of meetings and financial expertise, which effectively capture the board of directors and audit committee as monitoring devices. The components of these characteristics are constructed as a score to reflect the effectiveness of the board of directors and the audit committee. These characteristics complement each other, for example, independent directors without financial expertise might not understand accounting numbers (Agrawal & Chadha, 2005; and Mustafa & Ben Youssef, 2010), and less frequent meetings and inappropriate size of the board may make it difficult to monitor management and enhance the quality of financial reporting. In other words, the absence or failure of one of the board's monitoring characteristics can lead to the weakness or failure of others, which in turn, can weaken and hinder the performance of the board of directors as an internal monitoring device. Thus, this study intends to achieve the following objective: To examine the impact of the effectiveness of both the board of directors and audit committee on attracting foreign ownership.

This paper is organised as follows: Section two summaries previous studies. Section three describes the data used and methodology. Section four presents the results and analysis, while the fifth section concludes the study.

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

Since foreign investors take into consideration the quality of financial reporting in their investment decision. This study focus on investigate the effectiveness of the board of

directors and audit committees that have a significant role in financial reporting quality (Mangena & Tauringana, 2007; Nawafly & Al-arussi, 2016). Several studies have examined the effectiveness of the board of directors and audit committee (Kalbers & Fogarty, 1993; Garcia-Sanchez, 2010; McMullen & Raghunandan, 1996).

Alzoubi (2012) and Juhl, Satirenjit, Subramaniam and Cooper (2013) contended that the board of directors is the main factor that affects financial reporting quality. It has been contended that effective corporate governance may increase the confidence of foreign investors through the quality of financial reporting as the information sources to the foreign investors.

Goh (2009) contended that board size, board independence and frequency of board meetings are the main factors that reflect the effectiveness of the board. In addition, Chobpichien, Haron and Ibrahim (2008) and Juhl et al. (2013) claimed that board size, independence, financial expertise and frequency of board meetings are the key elements that reflect board quality and that encourage managers to report more information to external stakeholders.

Other studies, such as Zaman, Hudaib and Haniffa (2011) who investigated the relationship between audit committee effectiveness and earnings quality, have argued that the effectiveness of the audit committee enhances financial reporting quality and provides high quality financial accounting information to investors and other users through annual reporting. According to Salleh and Haat (2014), the primary objective of the audit committee is to achieve the board's legal responsibilities in light of the credibility and objectivity of the financial report. The effectiveness of the audit committee refers to the number of members of the committee who have the qualifications, power and resources to safeguard the interests of foreign investors by ensuring correct financial reporting, internal controls and risk management via effective overseeing of activities (Salleh & Haat, 2014).

In the context of a previous study on foreign ownership, Bokpin and Isshaq (2009) and Bokpin et al. (2015) studied the effect of transparency and corporate governance on foreign share ownership, and found that decisions of foreign investors are based on corporate governance and disclosure norms of listed firms. It has also been revealed that foreign investors steer clear of investment in companies that lack a corporate governance structure and which have ineffective disclosure practices since disclosure and transparency are important for foreign investors (Mangena & Tauringana, 2007; Al-arussi, Selamat & Hanefah, 2009).

Additionally, Kim, Eppler-Kim, Kim, and Byun (2010) examined the influence of weak corporate governance on equity invested by foreign investors and found that foreign equity ownership has a negative effect on a firm's ownership concentration. However, it impacts positively on the efforts taken by the company to improve corporate governance.

Meanwhile, Haldar and Nageswara (2012) investigated the association between foreign portfolio investment and corporate governance in India. The study used 500 industrial firms as a sample. The findings reveal that foreign ownership in the country is greatly influenced by the financial characteristics and factors of corporate governance.

Similarly, Aggarwal *et al.* (2005) revealed that foreign investors have a greater tendency to opt for firms having a robust corporate governance mechanism as their money requires protection from mismanaged companies. In this case, shareholders are able to control the confiscation of assets. Also, block shareholders influence the company's value and the personal benefits obtained from it. This type of companies face high costs in raising external funds.

Furthermore, Klapper and Love (2004) revealed that ineffective corporate governance changes the choice of foreign investors to foreign direct investment (FDI) as opposed to indirect portfolio investment as FDI has better protection. Along a similar line of contention, Dahlquist *et al.* (2003) studied foreign ownership and the characteristics of the company in the context of Sweden's protected market. They showed the significant presence of foreign investors in major firms having good corporate governance and having large cash assets. They also noted that the size of the company is determined by its liquidity size.

Ammer, Holland, Smith, and Warnock (2012), Leuz, Lins, and Warnock (2010) and Miletkov *et al.* (2014) revealed that the investment of the US in a foreign company multiplies when the companies are cross-listed on the USExchange, although following the correction of selection bias related to the size of companies, financially transparent companies and liquidity of companies attract foreign investment as they are expected to be cross-listed more.

Previous studies on foreign ownership such as Bowman & Min, (2012), Mangena & Taurigana (2007), Miletkov *et al.* (2014) and Min & Bowman (2015) examined the relationship of foreign ownership and corporate governance mechanisms, the results indicate that foreign investors are more attracted to high independence of the board of directors as well as the audit committee.

Based on the above discussion, the following hypotheses formulated as follow:

*H1: There is a significantly positive relationship between the board of directors' effectiveness and foreign ownership.*

*H2: There is a significantly positive relationship between audit committee' effectiveness and foreign ownership.*

### **3. Data and Methodology**

#### *3.1 Data Description*

The study utilizes secondary data collected from the annual reports of non-financial listed companies in the GCC Stock Markets. The sample comprises only non-financial listed companies that have foreign ownership for the period of 2012 to 2015. The total number of selected companies is 143 which presented 572 observations (Table 1 shows the sample size of the study).

Table 1. Sample size of selected non-financial companies with foreign ownership

Country			Saudi Arabia	Oman	Qatar	Bahrain	UAE	Total
Selected companies ownership.	Non- with	financial foreign	40	56	20	12	15	143

The data of the board of directors' effectiveness, audit committee' effectiveness, foreign ownership, firm size and leverage are collected from the annual reports. While the data of the economic variables collected from World Bank database. Political risk variable data is obtained from the Political Risk Services (PRS) group's database. STATA software package is used.

### 3.2 Model Specification

This study uses panel data analysis (fixed effect) to examine the effect of both the board of directors and audit committee on the foreign ownership.

This study includes firm size and leverage, exchange rate risks, inflation risks, economic growth which measured by GDP and political risks as control variables.

The regression model is as follow:

$$\text{FOROWNERS}_{it} = \alpha_0 + \beta_1 \text{BDSCORE}_{it} + \beta_2 \text{ACSCORE}_{it} + \beta_3 \text{FMSIZE}_{it} + \beta_4 \text{LEV}_{it} + \beta_5 \text{PR}_{it} + \beta_6 \text{ERR}_{it} + \beta_7 \text{IR}_{it} + \beta_8 \text{GDP}_{it} + \varepsilon_{it}$$

Where,

Following the literature, the former variables are defined and measured as follow:

**FOROWNERS** Foreign ownership, measured by the percentage of shares held by foreign investors in the listed non-financial company at the end of financial year.

**BDSCORE** Board of Directors' effectiveness (Score), and measured by the sum of four components (financial expertise, size, independence and frequency of meetings) ranges between 0 and 4 with 0 indicating lowest effectiveness and 4 highest effectiveness. Where,

Board Financial expertise = a value of "1" is given if at least one of the board members is a financial expertise. Or alternatively a value of "1" is given if the percentage of financial experts more than the median value and "0" otherwise.

Board Size = a value of "1" is given if the number of members in the

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	board is larger than the median value and “0” otherwise
	Board Independence = a value of “1” is given if all board member are independent. Or alternatively a value of “1” is given if the percentage of independent members in the board is larger than the median value and “0” otherwise
	frequency of meetings of board = a value of “1” is given if the number of board meetings is larger than the median value and “0” otherwise
ACSCORE	Audit Committee` effectiveness (Score), and measured by the sum of four components (financial expertise, size, independence and frequency of meetings) ranges between 0 and 4 with 0 indicating lowest effectiveness and 4 highest effectiveness. Where,  Financial expertise of Audit Committee = a value of “1” is given if at least one of the Audit Committee members is a financial expertise. Or alternatively a value of “1” is given if the percentage of financial experts more than the median value and “0” otherwise.  Audit Committee size = a value of “1” is given if the number of members in the Audit Committee is larger than the median value and “0” otherwise  Audit Committee Independence = a value of “1” is given if all Audit Committee members are independent. Or alternatively a value of “1” is given if the percentage of independent members in the Audit Committee is larger than the median value and “0” otherwise  frequency of meetings of Audit Committee = a value of “1” is given if the number of Audit Committee meetings is larger than the median value and “0” otherwise
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). It is scored by assigning risk points to a pre-set group of factors. Political risks rating range from a high of 100 (least risk) to a low of 0 (highest risk) guide (ICRG) rate for each GCC countries.
ERR	Exchange rate risk, measured by using the yearly 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 consumer price index (CPI) per each GCC countries.
GDP	Economic growth, measured by using yearly Gross Domestic Product (GDP) growth rate of each GCC countries.

## 4. Results and Discussion

### 4.1 Descriptive Statistics

A summary of descriptive statistics of foreign ownership in GCC countries is presented in Table 2. The descriptive statistics of foreign ownership model involves all the main independent variables. The results of the foreign ownership during the study period. Table 2 indicates that the mean proportion of shares held by the foreign investors is 0.11 percent with a minimum holding of zero and a maximum holding of 0.59 percent. The zero minimum value for the foreign ownership indicates that there are companies that did not have shares held by foreign investors in 2012, while in 2013, 2014 and 2015, they had shares owned by foreign investors.

Table 2. Descriptive Statistics for Continuous Variables

Variables	Observations	Mean	Std. Dev.	Min	Max
FOREOWNERSHIP	572	0.11	0.14	0	0.59
BDSCORE	572	1.76	1.23	0	4
ACSCORE	572	1.58	1.23	0	4
LOGFIRMSIZE	572	12.83	2.76	6.95	18.40
LEV	572	23.39	20.49	0	86.9
PR	572	81.94	4.30	72	89
ERR	572	0.0000186	0.0000793	-0.0001453	0.0002085
IR	572	-13.91	56.02	-168.65	114.38
GDP	572	4.62	1.89	2.54	9.33

Table 2 summarises the effectiveness of the board (board score) with an average of 1.76 with a minimum score of 0 and maximum score of 4, which indicates that some boards are more effective than others. Table 2 also shows that the average score for the effectiveness of the audit committee is 1.58 with a minimum score of 0 and maximum score of 4, which indicates that the audit committee score is more effective some companies than others.

### 4.2. Correlations matrix and multicollinearity

In Table 3, the Pearson correlation results reveal several significant relationships between independent and control variables, Results in Table 3 show low coefficient correlation, where all values of correlation are below than 0.70. Tabachnick and Fidell (1983) emphasis the

existence of multicollinearity problem if the correlation between variables is more than 0.9 percent. Since the highest values are less than 0.9 percent, indicating un-existence of multicollinearity.

Table 3. Correlations Matrix of Study Variables

	1	2	3	4	5	6	7	8	9
1 FORESHARE	1								
2 BDSCORE	.590**	1							
3 ACSCORE	.520**	.653**	1						
4 LOGFIRMSIZE	-0.01	.246**	.154**	1					
5 LEV	.175**	.233**	.204**	.161**	1				
6 PR	.217**	.192**	.164**	-.100*	.164**	1			
7 ERR	-0.06	-0.01	0.017	.125**	-0.044	-.271**	1		
8 IR	-.107*	0.015	-0.034	.347**	-0.001	0.009	0.025	1	
9 GDP	.091*	-0.03	0.03	-.285**	0.056	.216**	-.529**	-.204**	1

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

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

Myers (1990) suggested that even when the correlations between the independent variables are not very high, some degree of multicollinearity can still exist. This study examines the extent to which multicollinearity presents a problem in the estimation of the relationship between our dependent and independent variables by computing the variance inflation factor (VIF) for each independent variable. The VIFs should not exceed the critical value of 10 figure level (Myers, 1990). Table 4 shows the mean VIFs in our model do not exceed 1.43.

Table 4. Standard Tests on VIF Results

Variables	Collinearity Statistics	
	VIF	1/VIF
BDSCORE	1.87	0.534446
ACSCORE	1.78	0.563239
LOGFSIZE	1.34	0.746162
GDP	1.55	0.646073
ERR	1.46	0.684420
PR	1.18	0.850589
IR	1.18	0.846486
LEV	1.11	0.904524
<b>Mean VIF</b>	<b>1.43</b>	

#### 4.3 Discussion of Results

The analysis of the fixed effect model is conducted based on the Hausman test statistics, where the probability of the test statistics (0.066) is statistically significant at 10% level, which implies that the fixed effect model is an appropriate to conduct the regression analysis. Table 5 shows that the foreign ownership (dependent variable) of the underlying model is fit and statically significant at the 5% level, where the calculated F-value = 16.80 is higher than its critical value of 1.95. The adjusted R<sup>2</sup> indicates that the total variation of the foreign ownership over the study period is explained within its explanatory variables by about 41%.

Table 5. Results of the Model

Variables	Coefficient	T-Statistics	P-Values
_cons	-0.339***	-2.99	0.003
BDSCORE	0.00970***	5.49	0.000
ACSCORE	0.00703***	4.44	0.000
LOGFMSIZE	0.0230***	3.39	0.001
LEV	-0.00104***	-6.61	0.000
PR	0.00184**	2.17	0.031
ERR	-22.36	-1.46	0.145
IR	-0.000029	-1.35	0.176
GDP	0.0000263	-0.04	0.966
Observations		572	
R-squared		0.242	
Adjusted R squared		0.41	
Number of id		143	
Prob> F		0.0000	
Hausmantest (Prob>chi2)		0.0661	

\*\*\* p<0.01, \*\* p<0.05, \* p<0.1

Table 5 shows that the coefficient of board of directors' effectiveness is strong and positively related to foreign ownership at the 1% significance level. Therefore, foreign investors are attracted to companies with a strong board of directors. This result supports the argument of the agency theory which considers the board as a significant monitoring mechanism of the management and for protecting foreign investors from managers (Jensen & Meckling, 1976). Also, this result supports the argument of Fama and Jensen (1983) that boards assist in enhancing financial reporting via overseeing management, to ensure foreign investors to be protected from exploitation by management. This finding is consistent with previous studies, such as Johl *et al.* (2013), Chobpichien *et al.* (2008) and Ward, Brown and Rodriguez (2009) which state that the board effectiveness can optimally mitigate agency cost and safeguard the interests of investors.

As for audit committee effectiveness, Table 5 shows that audit committee effectiveness is positively related to foreign ownership, with the coefficient at the 1% significance level. This

result indicates that a strong audit committee attracts more foreign investors to the company. This result supports the agency theory on audit committee effectiveness in protecting investors. This result is consistent with SallehandHaat (2014) who described the effectiveness of the audit committee as the power and resources that qualified members have to safeguard the interests of investors by ensuring correct financial reporting, establishing smooth information flow among them and ensuring transparent and authentic reporting for foreign investors. Other studies, like Rouf (2011) and Kyereboah-Coleman (2008) have described the audit committee as the most dependable mechanism used to protect the interests of the foreign investors.

## 5. Concluding Remarks

The aim of this study is to examine the relationship between foreign ownership and effectiveness of board of directors and effectiveness of audit committee in GCC countries, as in term of the firm level. Our empirical study uses a panel data set of 143 non-financial listed firms in GCC countries during the period from 2012 to 2015. We find a positive relationship between effectiveness of the corporate board and audit committee with foreign ownership in GCC countries with high ownership concentration and low legal protection. These results indicate that the effectiveness of the board and audit committee is important determinants of foreign ownership level in the GCC countries. It suggests that foreign ownership is higher in firms with an effective corporate board as well as audit committee. Our findings show that increasing the effectiveness of the board of directors and audit committee 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 governance structures. The results of this study suggest that foreign investors have a preference for companies which have an effective corporate board as well as audit committee 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. The results provide an important indication that foreign ownership needs to be more investigated for a deep future study with different factors. 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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