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Corporate governance practices in emerging markets: The case of GCC countries

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ABSTRACT

This paper examines the corporate governance (CG) practices in emerging markets with special reference to the listed firms in the Gulf Cooperation Council's (GCC) oil rich countries. It develops an un-weighted Corporate Governance Index (*CGI*) model for non-financial firms using recent data. The usefulness of the model is demonstrated with a specific country example. The index identifies thirty internal governance attributes which are abridged in three categories of all the selected firms to form the best CG practices in the region. The results demonstrate that GCC companies adhere to 69% of the attributes addressed in the *CGI*. The results also show that the firms listed in the United Arab Emirates stock markets exhibit the best adherence to the CG attributes examined in the study followed by Oman, Saudi Arabia, Qatar and Kuwait, respectively. The current paper offers valuable recommendations to policy makers to gradually embed strong and specific governance practices. Special emphasis is placed to board effectiveness and structural and organizational frameworks in order to ensure a sustainable quality of CG practices in the region.

1. Introduction

Corporate governance (CG) plays a significant role in firms' dedication and adoption of ethical practices within the entire organizational structure and in relationships with employees, customers, creditors, shareholders and regulators. It facilitates and monitors effective management and legal compliance and prevents unlawful and improper behavior. The focus on CG has increased due to the chain of financial scandals including Enron, Satyam and Andersons and then the fall of the Lehman Brothers which led to a global financial crisis (GFC) at the end of 2007. To safeguard various stakeholders' interests a good CG is required.

Bhagat et al. (2007) document that this intensified interest in CG has accelerated the creation of governance indices by firms that have institutional investors as their primary focus as these investors will rate a company's governance quality on the basis of these indices. They also suggest that constructing a corporate governance index (*CGI* hereafter) is beneficial as it combines the various elements of a firm's governance system into one number which will be used to judge the quality of governance. However, Hyden and Court (2002) argue that the ambiguity and complications in the governance concept lead to the nonexistence of any standardized or systematic technique in the data collection effort necessary for preparing such an index.

The report issued by Standard and Poor's in 2002 defines *CGI* as a composite assessment of various CG practices followed by a company. The main aim of preparing this index is to assess the extent to which corporate governance influence is embedded in a company's structural framework and to compare the respective companies' governance score regarding the accepted standards set by the regulatory bodies. This will enable a company to assess the shortcomings encountered in specific areas of governance and thus adopt corrective measures to overcome these shortcomings and exhibit better governance. Black et al. (2010) note that there is a preconceived assumption that "one size fits all", meaning that fair governance practices are universal and must be applied to all countries as well as firms within a specific country. They reiterate that the OECD principles of CG are an example formulated under this approach. Bhatti and Bhatti (2010) propose an Islamic CG model which fits well within OECD principles and discuss issues of Sharia compliancy. The extant research, including Black et al. (2010) asserts that there are no specific models of CG that can be universally employed but there are different codes of "best practice" that take into account specific legislation, board structures and business practices in individual countries and/or jurisdiction.

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The main objective of this paper is to construct a uniform *CGI* which can be commonly applied to a group of six GCC countries [Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and the United Arab Emirates (UAE)]. The GCC, founded on May 25th, 1981, is a regional organization of states which share common geo-political and socio-economic objectives. The countries follow common civil law which has attributes such as low investor protection, weak capital markets and high insider shareholdings. The member countries have a one tier board structure and a high percentage of family shareholdings. A lenient dividend policy is adopted under such legal conditions in order to compensate investors. Sharia courts also co-exist along with civil courts but are basically restricted to family matters and countries adopting civil law often opt for internal mechanisms of CG. However, in the GCC context, there has been no comprehensive index constructed to date. Therefore, to the best of the our knowledge, this study will be the first of its kind to explore the feasibility and extent of adherence to some of the most important internal governance mechanisms by the non-financial firms in the GCC countries as of 30th June 2012. The paper will contribute to governance literature by providing an original and up-to-date insight on the current governance practices by developing CGI model for GCC region. To demonstrate the usefulness of the CGI model, a specific country example is also presented.

The remainder of the paper is structured as follows. Section 2 discusses the prior studies which have emerged with respect to *CGI* and Section 3 presents the methodology used in the construction of the *CGI* and the data collection techniques. The results and discussions are detailed in Sections 4 and 5 which provide some recommendations to policy makers. The final section contains concluding remarks.

2. Corporate governance indices: a literature review

Various CG indices have been developed in the literature, mostly based on developed countries. However, very little work has been done on the developing and emerging markets. This paper attempts to build an understanding of the emerging markets of Asia, in particularly oil based, liquidity rich GCC countries. Some interesting work has been done by two professional bodies; Institutional Shareholder Service (ISS) and Investors Responsibility Research Center (IRRC). Both, ISS and IRRC provide a large CG database which offers a composite measure to calculate the overall quality of a firm's CG. Important research in this area has been done by La Porta et al. (1998), Klapper and Love (2002), Gompers et al. (2003), De Toledo and Pillicer (2006), Brown and Caylor (2006), Leal and Carvalhal-da-Silva (2005), Ananchotikul (2007), Garay and Gonzalez (2008), Daines et al., 2010; Ibrahimpasic (2012) and Hassan (2012), are among others.

A pioneering work to measure the extent of CG was conducted by La Porta et al. (1998) that develops an “anti-director rights” index to measure the degree of shareholder protection, a major factor in CG in 49 countries around the world. The index is calculated by finding the sum of six dummies that assume the value of 1 if a given form of shareholder protection is present and 0 otherwise. The results indicate that common law countries provide stronger investor protection than civil law countries and that stronger investor protection is related to greater ownership dispersion.

Following the same lines, Klapper and Love (2002) constructed a weighted average *CGI* for 374 firms in 14 emerging countries on a scale of 0–100. They employed a firm level survey completed by Credit Lyonnais Securities Asia (CLSA) but with only six governance components out of the seven studied by CLSA to build the index. The components studied are management discipline, transparency, independence, accountability, responsibility and fairness. The paper observed that countries having weak legal systems, scored higher index in terms of CG and companies intending to expand in the market with the help of external credit have more incentive to adhere to better governance. Moreover, Klapper and Love noted that the countries listed in US stock markets exhibit better governance ratings.

Table 1
Cronbach's alpha reliability test.

Number of sub-indices in the scale	3
Scale reliability coefficient	0.78
Cronbach's alpha coefficient if an item is deleted	
If disclosure is deleted	0.71
If board effectiveness is deleted	0.66
If shareholders rights is deleted	0.73

Another well-known and commonly used *CG* index; the ‘G-Index’ was constructed by Gompers et al. (2003) for 1500 large firms between 1990 and 1998. They used un-weighted index to compute *CGI* retrieving IRRC data as an equally weighted sum of 24 shareholders rights practices across five characteristics; delay, protection, voting, state and others. The index assigns a value of 1 for every attribute that denies shareholder rights and 0 otherwise. Results reveal that good governance has a significant relationship with stock returns. In the same vein, De Toledo and Pillicer (2006) developed a governance index for 97 non-financial public companies in Spain by maintaining a binary scale. A total of 25 questions based on the questionnaire developed by Brown and Caylor (2006); Gompers et al. (2003) and Klapper and Love (2004) are considered to arrive at the *CGI* and companies scoring 25 are assumed to portray high governance standards.[1]

A study by Leal and Carvalhal-da-Silva (2005) on Brazil proved to be another milestone in index construction related to emerging countries. They prepared an un-weighted *CGI* for 131 firms listed in the Sao Paulo stock exchange from 1998 to 2002. A set of 15 questions having binary codes of 1 and 0 classified under four governance categories, namely disclosure, board composition, ownership and control structure and shareholder rights, were formulated to arrive at the final index. Information for formulating the index was retrieved from publicly available information and the maximum index value was 15. The study reveals that the disclosure content is high in the country but only 4% of the firms exhibit a high score in terms of governance.

For Thailand, Ananchotikul (2007) examined 87 attributes that are classified under five major governance elements, namely board structure, board responsibility, conflict of interest, shareholder rights, disclosure and transparency. The values for Ananchotikul's (2007) index range from 0 to 100 with 100 being the perfect CG score and 0, the worst. A weighted average method of the sub-indices is used to arrive at the overall index. Similar studies have been undertaken by Garay and Gonzalez (2008) who used a binary scale to code the governance attributes studied for 46 publicly listed firms in Venezuela.

In the GCC context, Hassan (2012) developed a CG disclosure index for 95 listed companies in the UAE basing it on OECD guidelines and the governance code in the UAE. The study employs a weighted and un-weighted approach to construction of the index which consists of 42 attributes classified under four major governance categories, namely ownership structure, board structure external auditing and transparency. Weights are

[1] See, Brown and Caylor (2006), Aggarwal et al. (2009) and Heidrick and Struggles (2009) for other indices constructed on developed markets.