The Role of Foreign Directors in Corporate Risk Disclosure: Empirical Evidence From Jordan

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Abstract

The current study examined the role of foreign directors in enhancing the level of risk disclosure in the annual reports of Jordanian listed companies. The content analysis method was used to measure the level of risk disclosure by computing the number of risk-related sentences in annual reports. To achieve the study's objective, random effect model has been applied on a sample of 376 firm-year observations of Jordanian non-financial companies for the period of 2014-2017. The findings are in line with the argument of agency theory and resource dependence theory, which posits that existence of foreign members on the board contributes in increasing the level of risk disclosure. The study aimed to fill the gap in the literature of risk disclosure regarding the relationship between foreign directors and risk disclosure. It is expected that the findings will be useful to researchers, authorities and investors alike in understanding the important role of foreign directors in improving practices of risk disclosure in Jordan.

Keywords: risk disclosure, foreign directors, content analysis, Jordan

1. Introduction

Global financial crises and major corporate collapses have rekindled the debate about the importance of including risk information in financial reports. This is attributed to the needs of stakeholders for valuable relevant information about companies' activities in order to accurately assess their financial position (Uddin & Hassan 2011; Zeghal & Aoun, 2016). As a response to those global events, regulatory institutions had to reassess the foundations of companies' regulations (ElKelish & Hassan, 2014; Beltratti & Stulz, 2012). Risk disclosure allows outside investors to analyze the company's current risks and judge future prospects to have a clear picture of the future risk that the company may face (Linsley & Shrives, 2006). Furthermore, risk disclosure contributes in improving investment efficiency by reducing agency problem and mitigating information asymmetry between investors and managers, and helps them to make sound investment decisions (Li, He, & Xiao, 2018).

Foreign members have a unique understanding and knowledge of outside markets' strategies that a firm wants. Thus, such knowledge may contribute additional value to the intended expansion of the company (Dewayanto, Kurniawanto, Suhardjanto, & Honggowati, 2017). Additionally, foreign directors have been evidenced to enhance the board's independence (Carter, Simkins, & Simpson, 2003). According to Miletkov, Poulsen and Wintoki (2017), foreign directors are expected to be related with firms having a limited number of qualified local directors, and these include firms in countries that are characterized by a smaller population, low level of education and lower capital market development. International boards are considered as an effective mechanism to transfer governance across countries. Companies are also introduced to corporate governance characteristics and board of director's practices of foreign companies through their foreign directors' experiences (Iliev & Roth, 2018).

Jordan is considered one of the most important Arab countries that attract foreign investment. Jordan undertook a number of reforms aimed to liberalize foreign investments in the 1970s. Additionally, due to Lebanon's civil war in the 1970s, Jordan replaced Lebanon as the financial center of the Middle East. Hence, many companies and businesses shifted their operations to Jordan (Al-Akra & Ali, 2012). Nevertheless, The United Nations Conference on Trade and Development (UNCTAD) indicated that hazards such as a high level of risk and uncertainties surrounding foreign investments in Jordan (Al-tamimi, 2017). Foreign members serving on board of directors can help in assuring foreign investors that a firm is managed effectively and with the investors' best interests as evidenced by the pressure placed on companies to reveal important information (including risk information)

(Dewayanto et al., 2017; Oxelheim & Randøy, 2003). Accordingly, the Jordanian situation is more attractive to study the effect of foreign director's role on the level of risk information disclosed by management. The potential effect of foreign directors on the level of risk disclosure has been neglected in prior studies. Therefore, the present study examined the role of foreign directors in improving risk disclosure practices in Jordanian non-financial firms.

2. Literature Review and Hypothesis Development

When the company appoints foreign members in its board, this conveys a good impression to foreign investors as a guarantee of good corporate governance practices (Abdullah, Chizema, & Chandren, 2016). In the same vein, Miletkov et al. (2017) also found a positive association between firm performances in countries having lower-quality legal environments and meanwhile they have directors hailed from a country having relatively greater quality legal environments than those of the host country. Added to the above studies, Tsang, Xie and Xin (2019) found that foreign institutional investors improve corporate disclosure more than local investors, particularly when foreign institutional investors come from nations having high disclosure requirements and investor protection. Ujunwa (2012) revealed that board nationality affects firm performance positively. Likewise, Oxelheim and Randøy (2003) indicated that firms' higher value was significantly related to the proportion of foreign board's members. In related studies, Du, Jian and Lai (2017), Jackson (2017) and Wu, Shen and Lu (2015) indicated that the existence of foreign directors on the board helps in mitigating earnings management practices and enhancing earnings quality. Furthermore, Ibrahim and Hanefah (2016) and Khan (2010) investigated the level of corporate social responsibility disclosure. They revealed that foreign directors had significant positive effect on CSR disclosure. Makhlouf, Al-Sufy and Almubaideen (2018) found foreign directors to be positively related with accounting conservatism in Jordan.

In contrast, some other studies in the topic did not support the assumption that foreign shareholders are better than their domestic counterparts in performing their duties effectively. To begin with, Barako and Brown (2008) revealed that the existence of foreign directors on the board had an insignificant effect on voluntary disclosure. They argued that foreign directors on the board probably support the interest of foreign owners and as such, their presence on the board may serve as a substitutive way to access wanted information rather than improved disclosure practices. Also, foreign director is more likely to have less effective monitoring role on management than local director, consequently reducing the effectiveness of the board in respect to its monitoring and disciplining functions (Masulis, Wang, & Xie, 2012).

In a nutshell, in light of the above-mentioned literature, it is clear that only few prior studies have investigated the association between foreign directors and disclosure, and their results are mixed and inconclusive. Hence, the link between the two variables still needs confirmation. Moreover, to the best of the author's knowledge of the available literature, corporate risk disclosure has yet to receive extensive focus and attention. Thus, more studies are required to identify the relationship between foreign directors and disclosure, especially in risk disclosure context. Therefore, the current study is among the first to fill this literature gap.

Based on the agency theory, foreign directors have a role in monitoring management effectively by exploiting their positions as representatives on behalf of foreign investors to militate against manager's interests. Foreign directors offer a mechanism to halt the negative impact of managers (Dewayanto et al., 2017). In addition, resource dependence theory views foreign members of a board as strategic resources, who facilitate the access to available external input. Hence, resource dependence theory favors skilled foreign directors to provide good connection with the external environments (Ujunwa, 2012). Furthermore, as foreign directors have a broad range of international connections with foreign stakeholders, they are expected to provide higher level of transparency and disclosure (Ibrahim & Hanefah, 2016).Therefore, based on agency theory, resource dependence theory and the discussion above, the expectation is that the presence of foreign directors is positively related to the level of risk disclosure. The following hypothesis is formulated:

H: There is a positive relationship between foreign directors and the level of risk disclosure.

3. Research Design

3.1 Sample and Data Collection

The sample of this study is Jordanian listed companies because they are considered the most important sources that contribute in an increase of GDP in Jordan (ASE, 2017; Moumen, Ben Othman, & Hussainey, 2016). Where, the total market value of them represented 83% of Jordan's GDP in 2017 (ASE, 2017). Eleven (11) firms were excluded given their data unavailability and other constraints. Moreover, firms in the financial sector were excluded as they have different codes of corporate governance and apply specific disclosure requirements (Al-Akra, Ali, & Marashdeh, 2009).

3.2 Method

The present study adopted content analysis as it aims to examine the level/nature of disclosure regardless of the quality of corporate risk disclosures (Amran, Bin & Hassan, 2009; Elzahar & Hussainey, 2012; Linsley & Shrives, 2006). Additionally, the current study used sentences as a coding unit because while a word is the smallest unit in a sentence, it cannot convey an idea or message clearly (Ivers, 1991; Linsley & Shrives, 2006). Moreover, using a sentence as coding units helps in avoiding the double-counting of the same sentence even if that sentence includes more than one word referring to risk disclosure (Elzahar & Hussainey, 2012).This study adopted the broad definition of Linsley and Shrives (2006) to identify the risk-related sentences which inform the reader if "any opportunity or prospect, or of any hazard, danger, harm, threat or exposure, has already impacted upon the company or may impact upon the company in the future or of the management of any such opportunity, prospect, hazard, harm, threat or exposure" (Linsley & Shrives, 2006, p.388).

This current study adopted and replicated a set of decision rules which developed by Linsley and Shrives (2006) and Konishi and Ali (2007) (see Appendix B) to clarify the content analysis procedures and ensure the reliability of measurement and reduce variation of the results by distinguishing the risk information in the annual reports from other. Moreover, this study employed risk categories proposed by Linsley and Shrives's (2006) model comprising of financial risk, operation risk, empowerment risk, information processing and technology risk, integrity risk and strategic risk (see Appendix A). Finally, this study calculated a final risk disclosure score for each firm by gathering the number of risk-related sentences existing in the annual reports of Jordanian firms (Elzahar & Hussainey, 2012).

To ensure the validity and reliability of the adopted coding method, a single coder, who is an expert in the field and who is familiar with the content analysis method, reviewed and coded risk-related sentences that exist in the pilot study independently, which consisted of 40 firms, constituting 10.63% from the total 376 annual reports. Afterwards, the results of the two coders (the researcher and the coder) were compared to determine the level of consistency in applying rules, since the measurement is considered as reliable if other researchers replicate the same measurement and get the same results (Marston & Shrives, 1991). To verify the reliability of the measurement, Cronbach's Alpha was applied as a statistical test, and the obtained result is 83.2%, indicating high internal consistency between the outputs of both coders with no significant differences between them. Hence, content analysis method can be considered as a reliable measurement of risk information that are disclosed by Jordanian listed firms.

This study used multiple regression analysis model to investigate the influence of foreign directors on the level of corporate risk disclosure. Table 1 also contains some control variables used in this study.

$$CRD = \beta_0 + \beta_1\, FORD_{it+}\ \beta_2\, SIZE_{it} + \beta_3\, SECTR_{it} + \beta_4\, LEVER_{it} + \varepsilon_{\ it}$$

Table 1. Measurement of variables

Acronym	**Variables**	**Measurement**
CRD	Corporate Risk Disclosure	Measured by number of risk-related sentences existing in the annual reports of Jordanian companies.
FORD	Foreign Directors	Measured by dummy variable, 1 if the firm has at least one foreign director and 0 otherwise.
SIZE	Company Size	Measured by natural log of total assets.
SECTR	Type of Sector	Classified into industrial or services sector, measured by dummy variable, 1 if companies belong to an industrial sector, 0 otherwise.
LEVER	Leverage	Measured by total debt to total assets.

4. Results and Discussion

4.1 Descriptive Statistics of Variables

Table 2 shows the descriptive statistics for total risk-related sentences in 94 Jordanian firms' annual reports over the period from 2014-2017. All risk-related sentences were categorized through one of six risk categories and computed as shown in Table 2. The total number of risk disclosure sentences is 10,660 sentences in all the annual reports of

Jordanian firms. Total risk disclosure sentences for each firm ranged from a minimum value of 2 sentences to a maximum value of 61 sentences, with a mean value of 28 sentences.

Table 2. Descriptive statistics of risk disclosure

Risk Disclosure	**Sum**	**Mean**	**Min**	**Max**	**No. of Risk Sentences**	**Percentage**
Financial Risk	3090	8.218085	0	22	3090	29%
Operation Risk	2376	6.319149	0	14	2376	22%
Empowerment Risk	969	2.577128	0	10	969	9%
Information P & T Risk	836	2.223404	0	14	836	8%
Integrity Risk	1165	3.098404	0	11	1165	11%
Strategic Risk	2218	5.898936	0	20	2218	21%
Total Risk Disclosure	10660	28.35106	2	61	10660	100%

The descriptive statistics for independent and control variables are shown in Table 3. The average of foreign directors (FORD), who serving on the board of directors in Jordanian companies, is 32.45%. Regarding control variables, Table 3 shows that the average firm size (SIZE) is 7.479. As for type of sector, the the percentage of industrial sector (SECTR) is 52.13%, indicating that more than half of Jordanian firms are in industrial firms. The mean value of leverage (LEVER) is 32.273%.

Table 3. Descriptive statistics for all variables

Variable	**Obs**	**Mean**	**Std.Dev.**	**Min**	**Max**
FORD	376	.324	.469	0	1
SIZE	376	7.479	.639	5.861	9.255
SECTR	376	.521	.5	0	1
LEVER	376	32.273	23.024	0	104

4.2 Diagnostic Tests

Several tests must be conducted to verify the quality of the data panel. In this study, multicollinearity was tested by the correlations matrix test as shown in Table 4. All variables have correlation of less than 0.477, which means there is no multicollinearity, because none of the variables correlated above 0.9.

Table 4. Correlations matrix of study variables

Variables	CRD	FORD	SIZE	SECTR	LEVER
(1) CRD	1.000				
(2) FORD	0.2476***	1.000			
(3) SIZE	0.300***	0.1388***	1.000		
(4) SECTR	0.202***	0.0728	-0.120**	1.000	
(5) LEVER	0.258***	-0.0584	0.390***	0.026	1.000

This study used Breusch Pagan test to examine the presence of heteroscedasticity problem. In addition, the Wooldridge test was conducted to detect whether the autocorrelation problem existed or not. The Breusch Pagan test showed an insignificant p-value (0.1895 > 0.05). Consequently, the heteroscedasticity problem was confirmed to be non-existent in the study data. Additionally, the result of Wooldridge test also showed insignificant p-value (0.0707> 0.05). This indicates that the autocorrelation problem did not exist in the study data. In order to determine the appropriate model to the study, some tests were conducted. Lagrange Multiplier test (LM) assisted in selecting between random effect model and pooled OLS model. The result of LM test was significant (0.000 < 0.05). Thereby, using random effects was deemed to be suitable for the study (Gujarati & Porter, 2012). The Hausman specification test was used to select between fixed model and random model. Hausman test obtained an insignificant result (0.0664 > 0.05). Hence, it could be concluded that RE model is opted to analyze the data.

4.3 Regression Analysis Results

The model was estimated by using random effect method. Table 5 shows the findings of the relationship between dependent variable (corporate risk disclosure), independent variable (foreign directors) and control variables (firm size, leverage and sector type). The model is statistically significant and fit at the 1% level with the p-value = 0.000. R^2 = 0.344.

As shown in Table 5, there is a significant positive relationship between foreign directors (FORD) and risk disclosure (CRD) (t = 1.80, P = 0.071). This result indicates that foreign directors, who serve on the board of directors, have significant positive effect on the level of risk disclosure and enhanced quality of financial reports. This result is consistent with the findings of the previous studies and with the view of resource dependence theory that proposes foreign members of a board as outside strategic resources, who facilitate the access to available external input and provide connections with a firm’s external environment (Ujunwa, 2012). The result is in line with Dewayanto et al. (2017) and Tsang et al. (2019) who found that foreign investors help in the improvement of corporate disclosure. Likewise, Jackson (2017), Oxelheim and Randøy (2003) and Wu et al. (2015) indicated that the presence of more foreign investors enhanced firm value and earnings quality and mitigated earnings management. Khan (2010) found foreign directors to have a positive effect on the level of corporate social responsibility disclosure. In addition, Ibrahim and Hanefah (2016) and Makhlouf et al. (2018) found foreign directors to be positively related with the CSR disclosure and accounting conservatism, respectively in Jordan.

Table 5. Multiple regression results

CRD	**Coef.**	**Predict sign**	**t-value**	**p-value**	**Sig**
FORD	2.837	+	1.80	0.071	*
SIZE	1.640	+/-	1.22	0.222	
SECTR	4.057	+/-	2.36	0.018	**
LEVER	0.018	+/-	0.67	0.501	
Number of Obs	376				
R- Squared	0.344				
Prob>Chi2	0.000				

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

The relationship between firm size (SIZE) and corporate risk disclosure (CRD) is insignificantly positive (t= 1.22, p = 0.222). These findings suggest that firm size does not affect the level of risk disclosure in Jordanian companies. This result is in line with Hassan (2009), who revealed an insignificant association between the two variables. Table 5 shows a significant positive relationship between type of sector (SECTR) and corporate risk disclosure (CRD) (t = 2.36, p = 0.018), suggesting that firms in the industrial sector disclose risk information more than those in the service sector. This result is consistent with Rajab and Handley-Schachler (2009), who revealed that industry type was significantly and positively related to the risk information that companies disclose. Moreover, leverage of firms (LEVER) has an insignificant association with corporate risk disclosure (CRD) (t = 0.67, p = 0.501). This result indicates that leverage does not affect the level of risk disclosure. This result is similar to previous studies of Linsley and Shrives (2006), Abraham and Cox (2007) and Elzahar and Hussainey (2012), who found an insignificant relationship between leverage and risk disclosure.

5. Conclusion and Limitation

5.1 Conclusion

The main purpose of the paper is to examine the effect of foreign directors on level of risk disclosure of non-financial Jordanian listed firms. The current research provides a contribution to the literature of risk disclosure by documenting that the foreign directors can improve the transparency of financial reporting by exploiting their experience to control the financial reporting processes. The study examined a sample of 94 Jordanian listed firms' annual reports in the four-year period from 2014 to 2017. Content analysis method has been used to compute the number of risk-related sentences. Total of risk disclosure sentences to each firm ranges from a minimum value of 2 sentences to a maximum value of 61 sentences and the mean of RD is 28 sentences. Also, random effect method is employed for the empirical analysis. The findings show that the existence of foreign directors on the board is positively related with the level of risk disclosure. The results refer to the practical implication of the foreign directors in increasing the level of risk disclosure in Jordanian listed firms. Thereby, policymakers should consider such characteristic of the board of directors to benefit from the capabilities of foreign directors in improving their monitoring role and enhance the amount of risk information.

5.2 Limitations and Suggestions

This study has added more understanding to the nature of the relationship between foreign directors and corporate risk disclosure practices. However, the study has several limitations. Therefore, this study can be extended in future research in several ways to overcome its limitations as follows.

This study focuses on the effect of foreign directors on corporate risk disclosure. Therefore, future empirical researches are advised to consider other board diversity variables namely, age, gender, ethnic, etc. This study focused on the factors that probably influence the level of risk disclosure and ignored the outcomes of risk disclosure practices. Further research could be conducted to investigate the consequences of risk disclosure (e.g., cost of capital, analysts' forecast, firm value and share prices). Further, the period of study restricted to cover only four years (from 2014 to 2017), which may not be generalized for other before-and-after periods.

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Appendix

Appendix A: Risk disclosure categories adopted from Linsley and Shrives (2006)

Financial risk

- Interest rate
- Exchange rate
- Commodity
- Liquidity
- Credit

Operations Risk

- Customer Satisfaction
- Product Development
- Efficiency and Performance
- Sourcing
- Stock Obsolescence and Shrinkage
- Product and Service Failure
- Environmental
- Health and Safety
- Brand Name Erosion

Empowerment Risk

- Leadership And Management
- Outsourcing
- Performance Incentives
- Change Readiness
- Communications

Information Processing and Technology Risk

- Integrity
- Access
- Availability

- Infrastructure

Integrity Risk

- Management and Employee Fraud
- Illegal Acts
- Reputation

Strategic Risk

- Environmental Scan
- Industry
- Business Portfolio
- Competitors
- Pricing
- Valuation
- Planning
- Life Cycle
- Performance Measurement
- Regulatory
- Sovereign and Political

Appendix B: Decision rules for risk disclosures

- To identify risk disclosures a broad definition of risk is to be adopted as explained below.
- Sentences are to be coded as risk disclosures if the reader is informed of any opportunity or prospect, or of any hazard, danger, harm, threat or exposure, that has already impacted upon the company or may impact upon the company in the future or of the management of any such opportunity, prospect, hazard, harm, threat or exposure.
- Although the definition of risk is broad, disclosures must be specifically stated; they cannot be implied.
- The risk disclosures shall be classified into the categories in the Appendix A.
- If a sentence has more than one possible classification, the information will be classified into the category that is most emphasised within the sentence.
- Any disclosure that is repeated shall be recorded as a risk disclosure sentence each time it is discussed. If a disclosure is too vague in its reference to risk, then it shall not be recorded as a risk disclosure.