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Financial and Governance Transparency:

What Impact on Investments in the GCC Markets?

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Financial and Governance Transparency: What Impact on Investments in the GCC Markets?

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Preface & Content

The lack of transparency is often the norm rather than the exception among companies in emerging markets. Investors thus face paramount challenges in conducting investment analysis and valuation.

Does the lack of access to essential information lead sophisticated investors to forego investments in emerging markets?

This article reports the nature of financial and governance information to which institutional investors place the highest weight when assessing such investments.

In view of these expectations, how attractive are the GCC markets to international and sophisticated investors? Do they risk losing investments due to insufficient transparency?

The article pinpoints where the companies and the regulations in the Gulf Cooperation Council (GCC) markets, particularly Saudi Arabia, UAE, Qatar, and Kuwait, meet (or fail to meet) these investors' expectations.

Table of Contents

The Interplay between Transparency, Investments, and Valuations

When evaluating investments in emerging markets, sophisticated investors reflect poor investor protection at the country and company levels in deep valuation discounts and higher cost of capital.

The valuation discounts are clearly highlighted in our previous article reporting the responses of institutional investors. Interestingly, the investors also note how good governance at the level of the company can partially alleviate their risk concerns and is therefore associated with lower valuation discounts even for companies operating in weak legal frameworks for investor protection.

Within the corporate governance dimension, investors noted that they attribute the highest importance to transparency and disclosures. It is evident that access to reliable information is essential to any investment decision making. Investors seek to acquire sufficient information to assess the viability of the investment and evaluate the degree to which their rights will be protected.

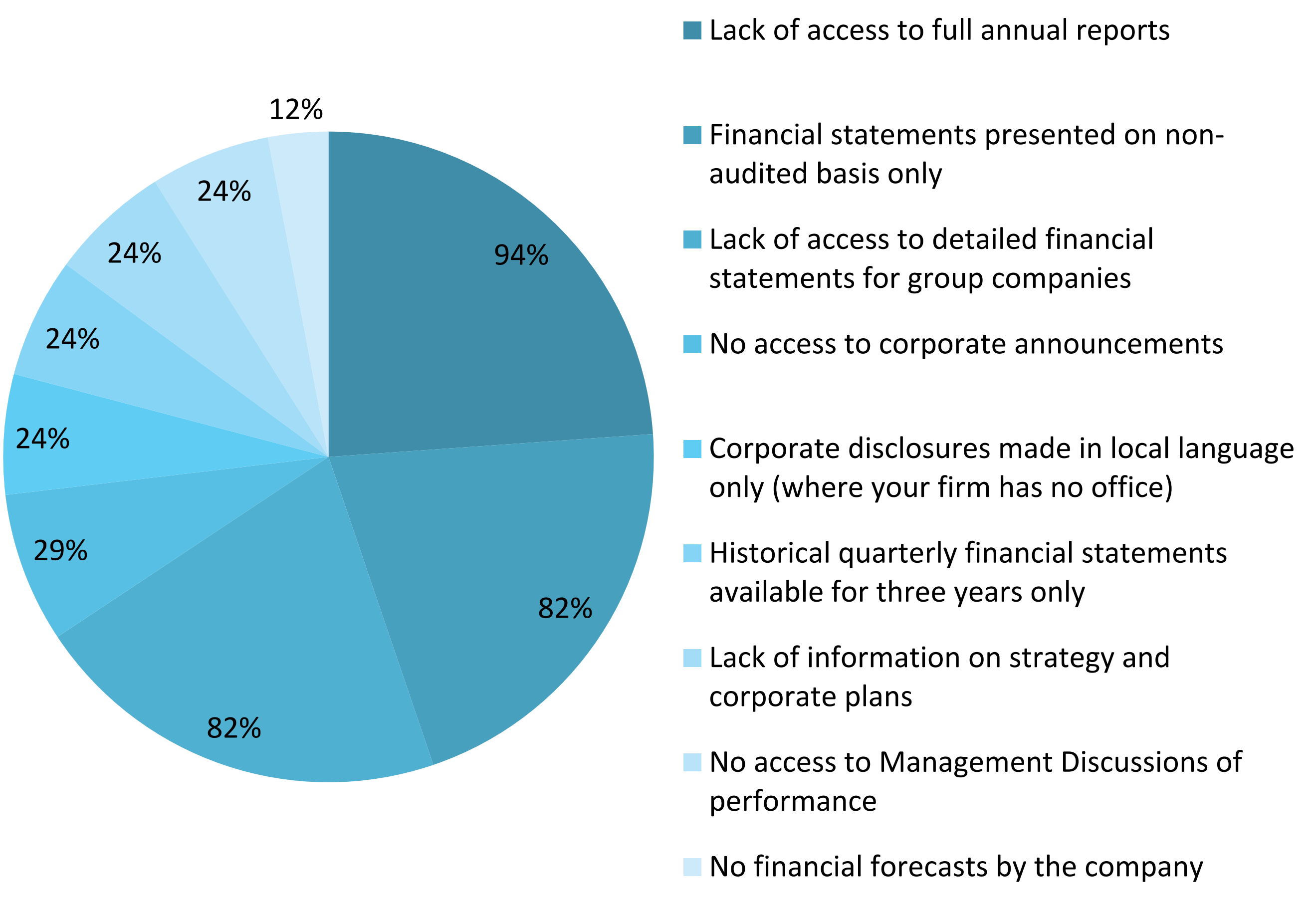
The case is even more compelling in emerging markets where the lack of information is often the norm rather than the exception. A previous article noted, for instance, several disclosure deficiencies of financial and governance information for companies listed in Turkey, Saudi Arabia, and Iran.

In this article, we report the nature of financial and governance information to which institutional investors place the highest weight when assessing investments in emerging markets. We also attempt to assess whether companies in the Gulf Cooperation Council (GCC) markets, particularly Saudi Arabia, UAE, Qatar, and Kuwait, meet these investors' expectations and highlight the related regulatory requirements.

Can Insufficient Financial Disclosures Break an Investment Decision?

According to the vast majority of our surveyed institutional investors, a lack of access to full annual reports, audited financial statements, and detailed financial statements for group companies would lead them to rule out an investment in an emerging market, as reported in Figure 1.

Figure 1: Please indicate which of the below financial disclosure deficiencies would lead you to rule out an emerging market investment. Select all that apply.



Other disclosure deficiencies - such as the lack of announcements (shareholder meetings, strategic plans, or corporate events), the disclosures being in local language only, lack of access to historical quarterly financial statements beyond three years, and lack of access to management discussion of performance - constitute serious challenges to the screening process but are less likely to break the investment decision.

Can Insufficient Financial Disclosures Break an Investment Decision?

In view of these investor expectations, how attractive are the GCC markets to international and sophisticated investors? Do they risk losing investments due to insufficient transparency?

The Gulf financial markets are certainly eying growth and visibility. Over the recent past, they took various initiatives and revamped their regulations with the aim of upgrading the markets' competitiveness. In parallel to the listing of Qatar and the UAE on the MSCI Emerging Markets index and Saudi Arabia's plans to follow suit in 2018, publicly listed companies in these countries are expected to be seeking attractiveness to foreign and sophisticated investors.

In order to assess whether the listed companies in the GCC markets meet the investors' expectations, we researched the disclosure practices of the ten largest listed companies in each of Saudi Arabia, United Arab Emirates (Abu Dhabi and Dubai exchanges), Qatar, and Kuwait. We particularly looked into whether these companies made the most critical information to investors publicly available on their websites or the stock exchange portals, in annual reports, governance and board of directors' reports, or other governance documentations.

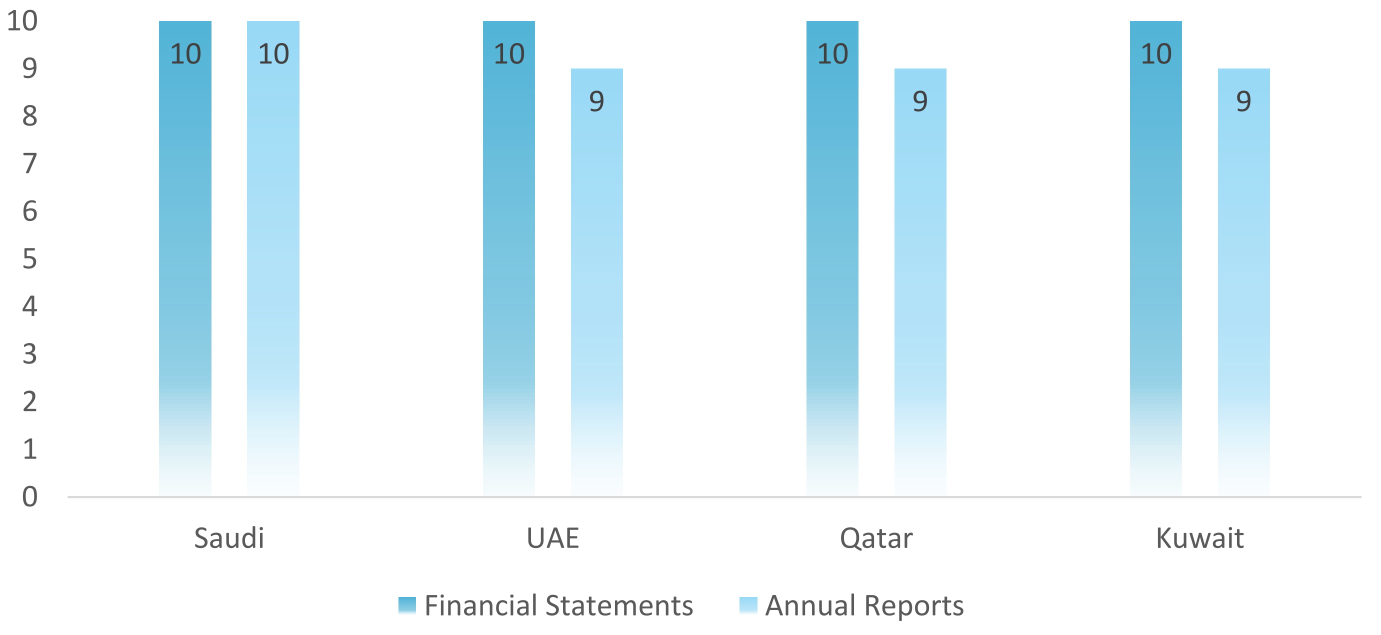
Can Insufficient Financial Disclosures Break an Investment Decision?

Annual Reports and Financial Statements

As shown in Figure 2, all the companies provide a record of their audited financial statements and the vast majority publishes annual reports or supports their audited financial statements with board reports and investor presentations.

The content of the annual reports varies across the sample. A number of companies include a discussion of the year’s performance, strategic plans, corporate governance, and /or environmental and sustainability information.

Figure 2: Disclosure of Financial Statements*



***Out of the largest 10 companies in each market**
Source: B.e.e. Analysis

It is worth mentioning that the market regulators in the four countries instruct listed companies to publish corporate governance or board of directors’ reports on top of their audited financial statements.

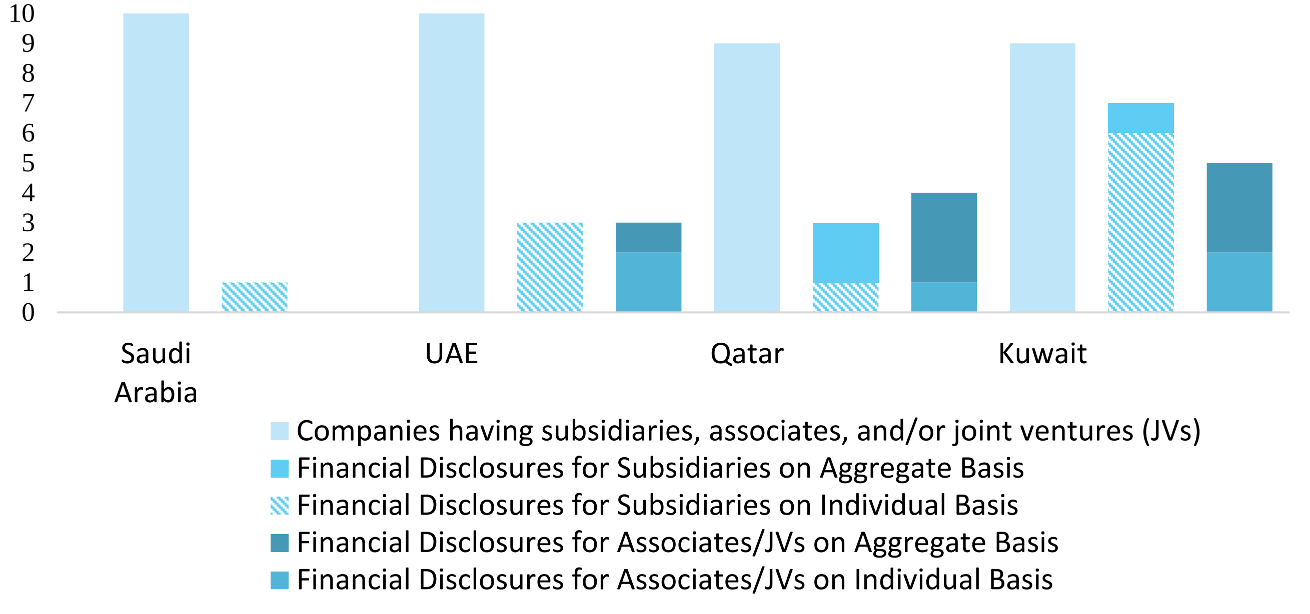
Can Insufficient Financial Disclosures Break an Investment Decision?

Group Companies

In light of the complex and conglomerate structures widely adopted by the large regional companies, information on group companies is of particular relevance to investors.

As a matter of fact, almost all the companies in the sample report having subsidiaries, associates, and /or investment companies and provide at least some basic overview of these companies, including the group's ownership percentages.

Figure 3: Disclosures of Group Companies' Financials*



***out of the largest 10 companies in each market**
Source: B.e.e. analysis

As such, access to group financial information is essential for potential investors to more reliably assess the performance of the group's components and their impact on the overall performance and therefore better pinpoint potential risks.

Can Insufficient Financial Disclosures Break an Investment Decision?

Group Companies

Nevertheless, as shown in Figure 3, less than half of the Qatari and UAE companies, and only one Saudi company, disclose extracts of the individual companies' financial statements. Kuwaiti firms show the best performance, where 7 (5) out of the 9 companies having subsidiaries and/or associates disclose extracts from financial statements of their subsidiaries (associates/ joint ventures). Also, a number of companies disclose the financial extracts on an aggregate, rather than individual, basis.

It is worth noting here the minimal regulatory requirements imposed by the market authorities in the listing rules, corporate governance codes, or disclosure rules.

Saudi Arabia's listing rules include a continuing obligation for the issuing company to report such information as the name of every subsidiary, its share capital, the ownership percentage, and its main business. Kuwait's regulations include a brief requirement to disclose material information related to subsidiaries and/or associates that have a "significant effect on [their] financial position". Qatar and the UAE provide no guidelines in that respect.

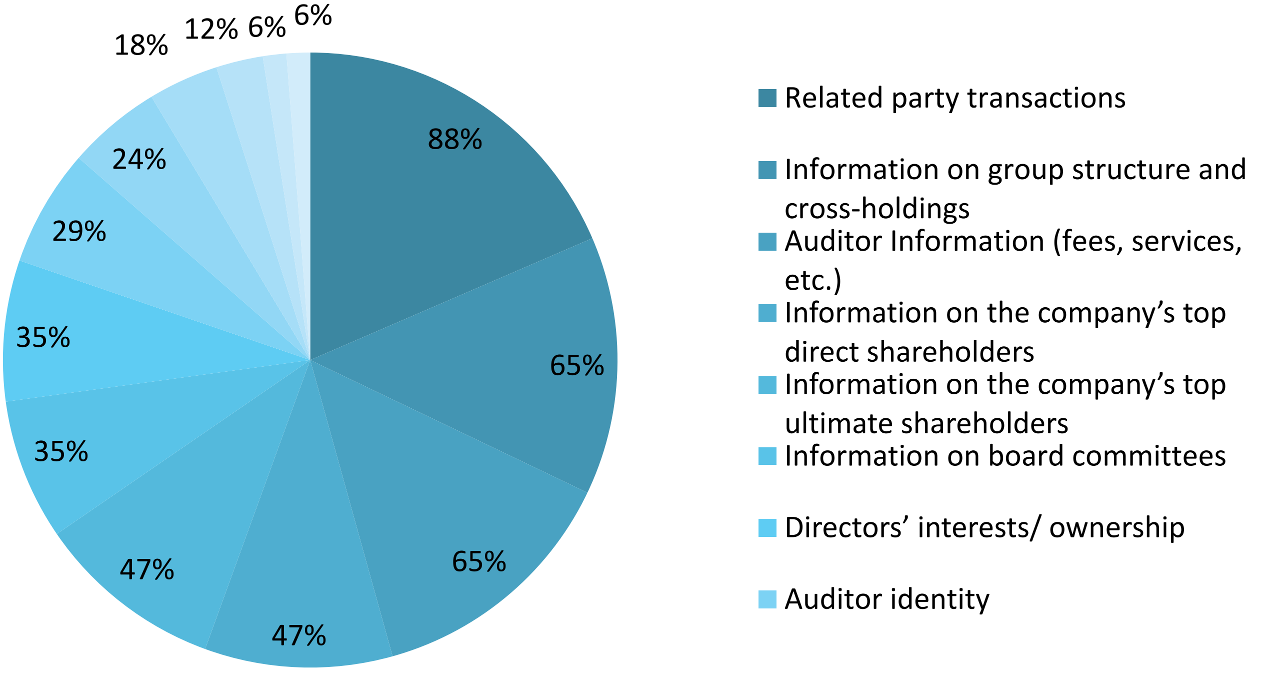
It is worth noting that the International Financial Reporting Standards (IFRS) 12 mandates the disclosure of the individual summarized financial information including amounts of current and non-current assets and liabilities, profits or losses, and total comprehensive income for each subsidiary having non-controlling interests that are material to the reporting entity and for joint ventures and associates that is material to the reporting entity.

Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

In order to assess the control systems within an organization and their effectiveness in protecting their rights, investors often look into the company's governance structures and practices.

The surveyed investment professionals reveal that they are likely to rule out companies that do not disclose information about related party transactions as this raises major concerns about the exercise and protection of minority shareholders' rights, as reported in Figure 4.

Figure 4: Please indicate the lack of which of the below governance disclosures would lead you to rule out an emerging market investment. Select all that apply.



The disclosure of auditor information (such as auditor's fees and services) and information about the group structure and cross-holdings are also critical to the investment decision according to 65% of the institutional investors participating in the survey.

The failure to disclose the company's top direct and ultimate shareholders, the information about board committees, directors' ownership information, and auditor identity were said to be important but are less likely to rule out an investment.

Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

Related Party Transactions

Relationships with related parties are a normal part of business operations and may be established between the company and its subsidiaries, associates, shareholders, directors, or management. This is reflected in our sample where all 40 companies report having related party transactions.

Nevertheless, the complex and opaque ownership structures of emerging market companies coupled with deficient disclosures of related party transactions often create concerns when investors cannot assess how the company's resources are channeled.

The related party transactions naturally underlie a conflict of interest risk as they may be motivated by unfair benefit expropriation by the related party. For instance, involved parties may agree to transactions at non-arm's length basis, giving themselves unfair advantages at the expense of the company's ultimate value and shareholders' interests. As such, investor concerns over insufficient transparency can be driven by the inability to assess the influence of the transactions on the financial performance of the company.

Appropriate disclosure of the company's conflict of interest and related party transaction policy as well as the details of such transactions may provide investors with relative assurance.

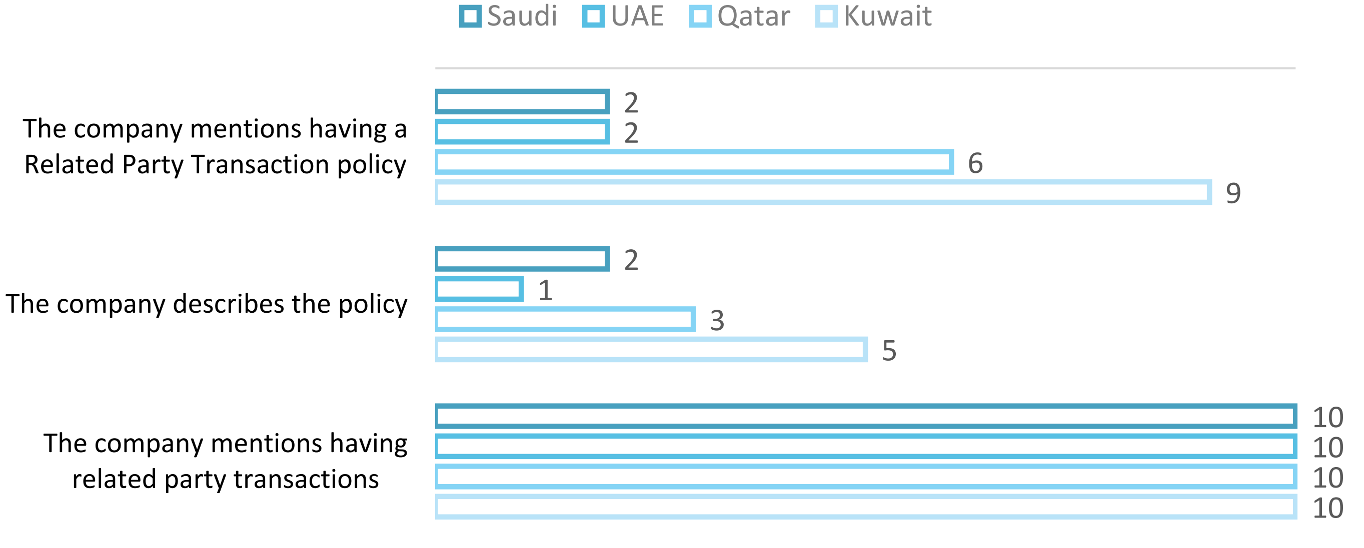
Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

Related Party Transactions' Policy

The disclosure of the related party transactions policy allows investors to assess whether the company's procedures are sufficient to tackle any conflicts of interest underlying such transactions.

However, the practices adopted by the surveyed GCC countries are not encouraging. As shown in Figure 5, less than half of the surveyed companies report having a policy and only eleven companies describe it in their annual reports or on their websites. Again, the Kuwaiti companies displayed the best practices where almost all of them mentioned having an official policy and half of them provided a brief. The weakest disclosures are noted for the Saudi and Emirati companies.

Figure 5: Disclosures of Related Party Transactions*



***out of the largest 10 companies in each market**
Source: B.e.e. analysis

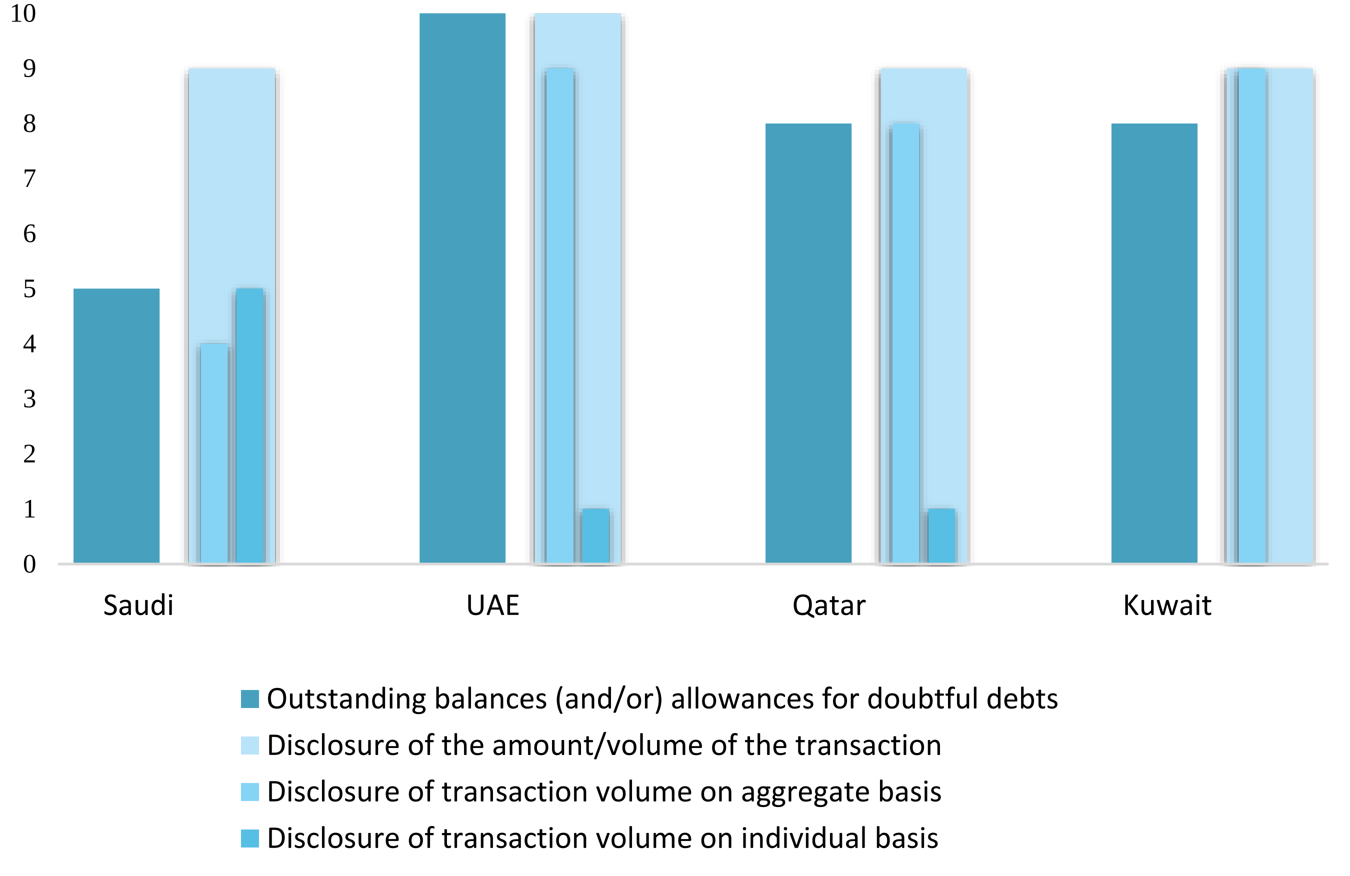
Differences in the regulatory requirements are also noted across the markets. While the market regulators in Saudi Arabia and the UAE do require listed companies to develop and implement policies for conflict of interest and related party transactions, Qatar's market regulators are the only ones to mandate that the rules and procedures be made public. The Kuwait market regulations on the other hand do not tackle the conflict of interest policy.

Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

Disclosure of Transaction Details

All the sample companies have sections dedicated to related party transactions in their annual reports but very few provide sufficient descriptions on a transaction by transaction basis. Figure 6 displays that almost all of the companies in the sample disclosed information about the volumes of the related party transactions on an aggregate basis or by category, but only seven companies reported the amounts of each individual transaction. Disclosures of outstanding transaction balances are relatively available, except for Saudi companies.

Figure 6: Disclosure of Transaction Volume*



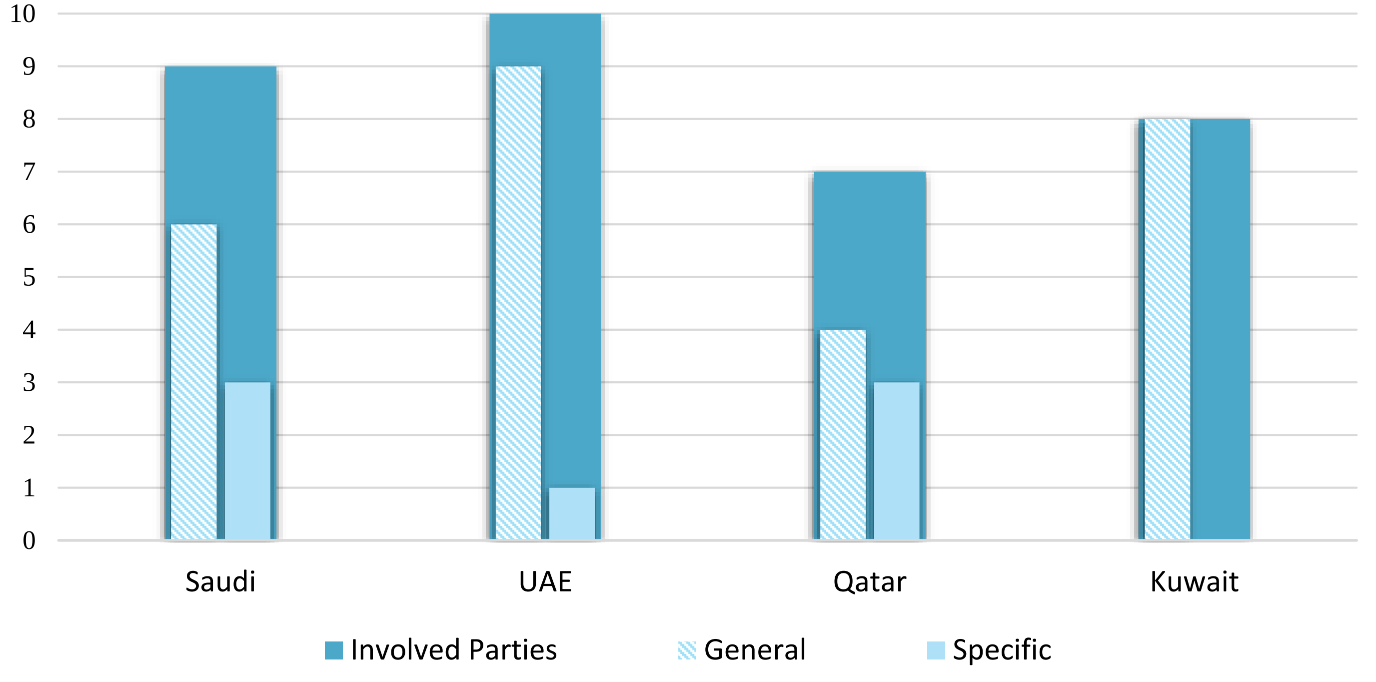
***out of the largest 10 companies in each market**
Source: B.e.e. analysis

Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

Disclosure of Transaction Details

Similarly, Figure 7 shows that only seven companies across all markets report the names of the parties involved while the majority report their broad categories (for example shareholders, directors of the board, management, etc.). Also, only one Saudi company out of the total sample provides a description of how the parties were involved in the transaction.

Figure 7: Disclosure of Involved Parties*



***out of the largest 10 companies in each market**

Source: B.e.e. analysis

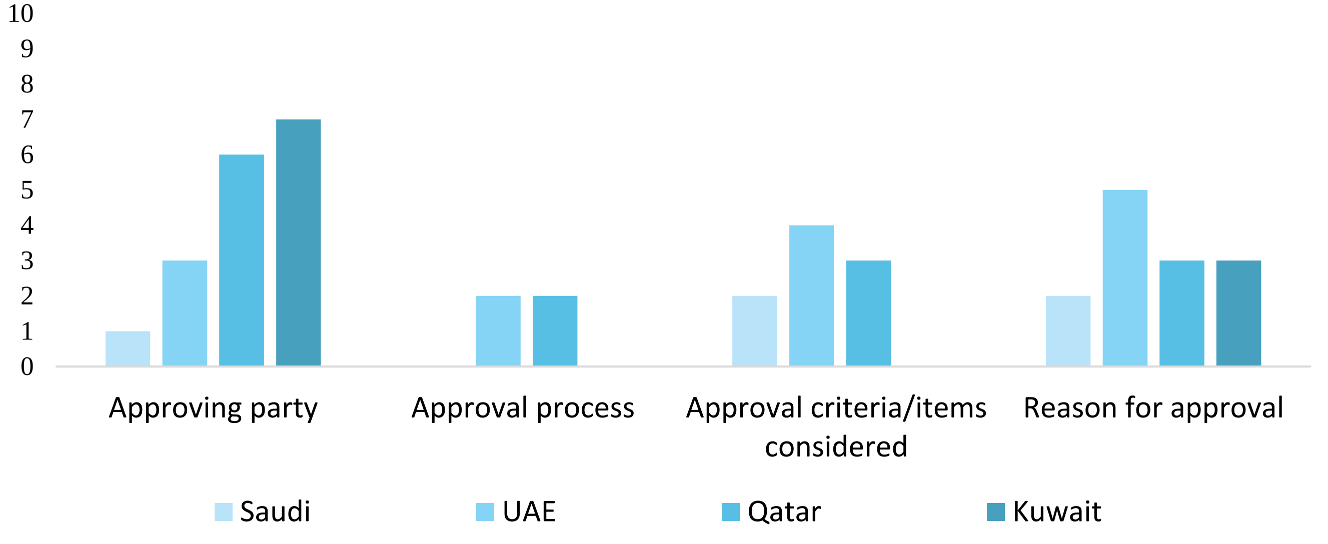
Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

Approval Process

The most alarming disclosure deficiency relates to the approval process and criteria for related party transactions. As shown in Figure 8, while seven Kuwaiti and six Qatari companies specify the approving party, very few UAE and Saudi companies do so. Most often, the general management is referred to as the approving party.

Also, very few companies disclose the process and criteria for approving the transaction. Five UAE companies, the largest count across the surveyed markets, report that the transactions were approved for meeting the criteria or being made on arm's length basis.

Figure 8: Disclosure of Transaction Approval Process*



***out of the largest 10 companies in each market**

Source: B.e.e. analysis

Notwithstanding the noted deficiency in the disclosure practices for related party transactions, it is worth highlighting some exemplary practices in the region. Savola, for instance, the Saudi food and retail company (not included in our sample), furnishes its shareholders, investors, and stakeholders at large with relevant governance information. The company mentions in its annual report having a strict conflict of interest policy duly covering related party transactions which are also detailed with great diligence in the report. For instance, Savola provides a detailed description of each related party transaction stating the name of the counterparty and those of all involved persons along with their relationship with the company, the transaction volume in individual and aggregate basis, and the nature and purpose of each transaction.

Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

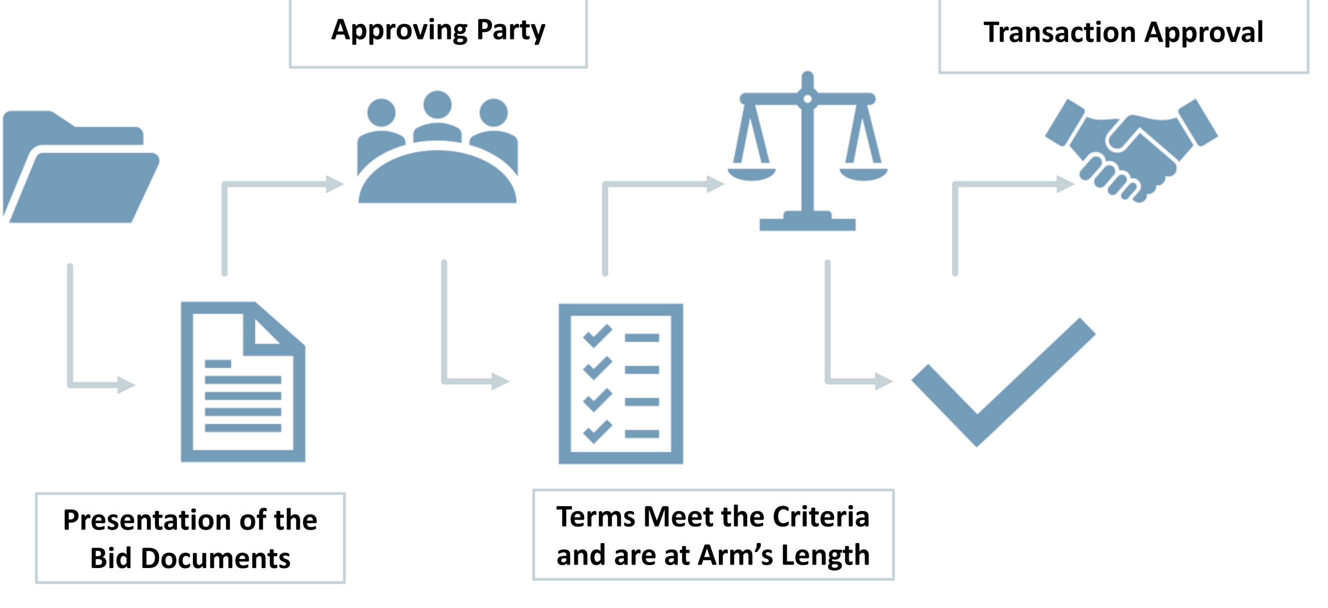
Approval Process

Furthermore, Savola specifies the approval process involving a vote at the general assembly in absence of the related party.

On the regulatory front, Qatar and Kuwait only provide a broad requirement to disclose the transactions without specifying the information to be disclosed. Saudi Arabia's regulations instruct that the transactions be listed and described in the board of directors' report along with such details as the names of persons in relation, the nature, conditions, durations and the amount of the contract. Furthermore, transactions equaling or exceeding 1% of the company's total revenues shall be disclosed to the public without delay.

The UAE companies, showing the best performance on most of the measures, are also subject to detailed regulations. The Abu Dhabi corporate governance rules require, for instance, that listed companies share on the company's and exchange's websites the information pertaining to the nature and conditions of the deal, the parties involved and their interests, and a confirmation of the fairness of the terms.

These observations point to the importance of providing companies with clear guidelines on the disclosure requirements. Nevertheless, they also highlight the challenges to implementing the regulations in place where lack of compliance is noted by a large number of companies.

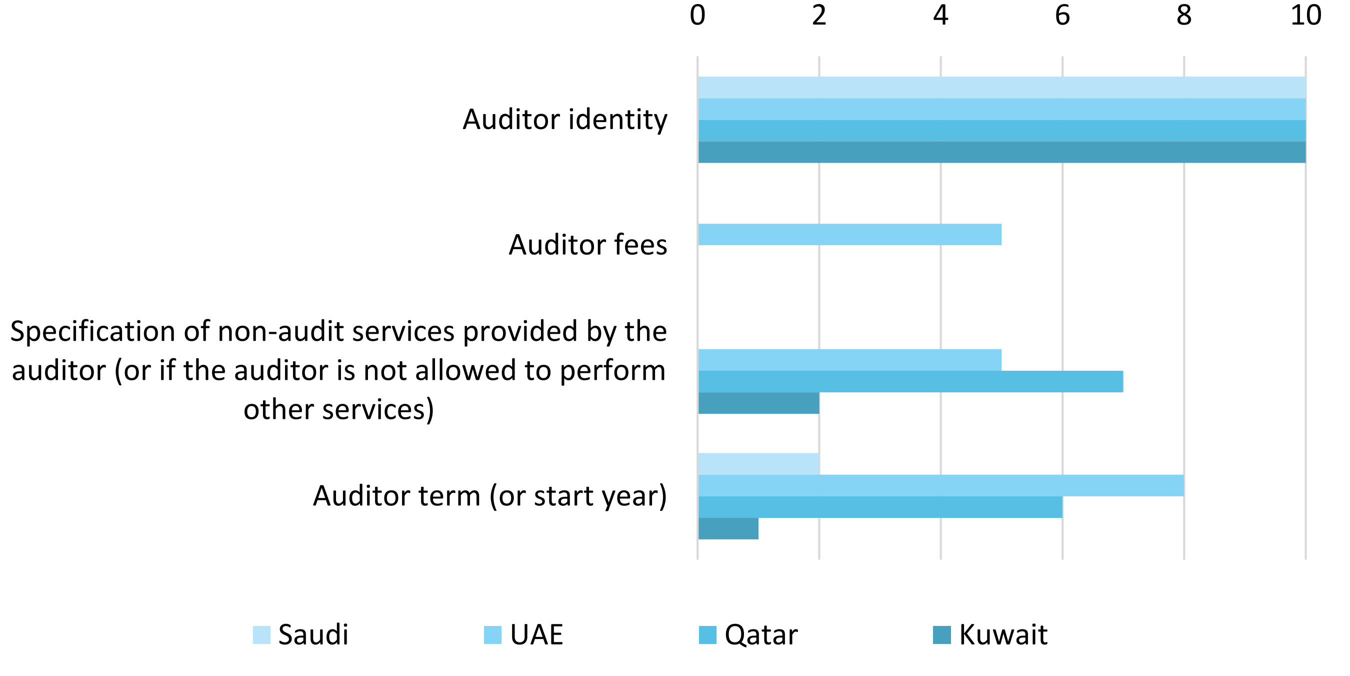


Can Insufficient Governance and Audit Disclosures Break an Investment Decision?

Auditor Information

As reported in Figure 9, all the sample companies identify their external auditors in their annual reports or on the stock exchange portal. Nevertheless, less than half the companies provide further details such as the auditors' term or start year and the other non-audit services they provide, if any. The best performance is noted for the Qatari and UAE companies. As to auditor fees, only five UAE companies state such information.

Figure 9: Disclosure of External Auditor Information*



***out of the largest 10 companies in each market**
Source: B.e.e. analysis

It is worth noting here the parallel traits between the regulations and company practices. While the four markets require measures and guidelines for audit independence and specify the maximum term of the auditor, none of them mandate disclosure of such information as the service fees or the term.

Conclusion

The observations cast doubt on the ability of sophisticated investors to get access to the information they deem critical to the investment decision process in the four GCC markets. While most of the surveyed companies provide basic information on their group structures, subsidiaries, and other group companies, related party transactions, and auditor identity, few of them make the effort to disclose further relevant details.

A similar observation is noted at the regulatory front where the disclosure principles are generally broad. Generally speaking, when the regulations do provide clear guidelines with a higher level of details, we note better transparency practices by companies– though not full compliance. While this draws our attention to the importance of improving the regulatory guidelines, it also stresses the need for regulators to reinforce the implementation of the policies in place.

It is worth noting here that the sample, being focused on the ten largest companies in each market, is not necessarily representative of the overall market. In view of the argument that larger companies often seek more visibility and have more resources allocated to transparency and compliance, it could be expected that the smaller firms in the market exhibit even weaker transparency practices.

It is therefore evident that the insufficient levels of disclosure could lead several Gulf companies to be perceived with significant uncertainties would certainly be translated into lack of attractiveness and lower investment and valuation levels. The case for policymakers and companies to take the extra step in transparency cannot be more compelling.

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