

CORPORATE GOVERNANCE IN MIDDLE EAST FAMILY BUSINESSES

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Abstract

This study examines governance-related issues within Middle East family businesses. The absence of proper external monitoring mechanisms – governmental or other – to protect shareholder rights, and the absence of any pre-existing literature on the Middle East market provides the motivation to evaluate the corporate governance practices of Middle East family businesses. Using a sample of 124 family businesses, we construct a governance index and use a probit model to examine whether family-related variables can explain the level of corporate governance. It is found that the majority of boards had a prevalence of family members and a low proportion of independent directors. Family businesses, still being run by the first generation, have a limited number of independent members on their boards and tend to adopt poorer governance practices than other firms where the third or fourth generations are involved. Instituting a family council has a positive governance impact, however, much work is needed, especially that it seems to lack clear vision as it is rendering the involvement of new generations ineffective.

Keywords: Corporate Governance, Governance Score, Family Business, Middle East

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1 Introduction

Corporate governance has been a subject for academic research over the past decades (Adams, Hermalin, & Weisbach, 2010; Gillan, 2006). Using data pertaining to large, publicly traded firms, existing research primarily investigates governance practices and their implications on corporate policies, decision-making, and performance in the Americas, Europe, East Asia, and Latin America (Agrawal and Knoeber, 2012; Kaplan, 2012; Carney, 2010; Claessens, Djankov, & Lang, 2000). The existing literature, however, falls short from documenting corporate governance practices for family businesses operating in emerging markets having stark differences in economic environments, capital markets' depth and breadth, governance bodies and authorities, ownership structure, financial markets participants, in addition to cultural dissimilarities and differences in the ways of doing business (Center For International Private Enterprise (CIPE) 2011; PriceWaterhouseCoopers (PWC) 2013).

We attempt to fill the void in the literature by investigating the governance practices of privately-held enterprises operating in the Middle East and examining issues family businesses deal with in terms of governance structures. Is there a link between

increased generational participation in the corporate decision-making and corporate governance enhancements? Does the presence of independent directors on the Board of Directors (BOD) have an effect on the corporate governance? Does the governance of family businesses improve with the presence of a family council? What are the effects of the Chairman/CEO duality on the governance of the family business?

The focus on family businesses in the Middle East stems from various reasons. First, the Middle East region is striving to improve governance standards with significant achievements in a relatively short period of time (Koldertsova, 2010; Nadal, 2013). The past few years witnessed the establishment of at least four new institutes of corporate governance or institutes of directors that provide corporate governance information, training, and guidance for companies to improve their practices. Codes for national corporate governance rules have also been issued by most Middle Eastern countries (14 out of the 17 countries) over the past ten years. The Egyptian Institute of Directors also introduced a governance code targeted specifically at state-owned entities. The Jordanian, Palestinian and Emirati regulators introduced codes for banks, while the Lebanese, Yemeni and Egyptian Central Banks are currently

working on developing guidelines on corporate governance of banks. Moreover, the Lebanese Transparency Association introduced specialized guidelines for family-owned enterprises.

Second, family businesses play a key economic role in their local and regional markets (PWC 2013)². They play a critical role in their respective sectors and account for a large fraction of employment in various economic sectors including retail, automotive, construction, import/export, shipping, insurance, agriculture, financial services, real estate and manufacturing. Ninety percent of companies are family-owned businesses, contributing up to 80% to GDP as well as capturing 70% of the total employment market. A large percentage of firms start their operations as small trading entities that grow into large, diversified conglomerates over two or three generations by capitalizing on dominant positions within their own markets, robust trading networks within individual markets, and strong relationships with banks. Until the recent financial crisis, the latter has made access to finance far easier than it is for family businesses elsewhere in the world.

Third, a relatively large number of family businesses in the Middle East are first - or second-generation businesses that were originally established 50 or 60 years ago and that currently face a transition to the next generation in the next 5-10 years (PWC 2013; CIPE 2013). In Western countries, a large number of family businesses have moved to the ownership of the third and fourth generation. In the MENA region however, the majority of family firms are still under the second generation ownership with only around 20% starting to have involvement from members of the third generation. Succession planning can be a sensitive topic since the founder or the patriarch of the family may not feel completely secure about training a successor and ceding his/her own position to an heir. This process may also be intricate due to family members' hesitance to relinquish control to outside managers - even in the absence of qualified family members - especially that putting a succession plan in place would require a management team capable of growing the business independently of the shareholders as well as having highly qualified board members. Finally, succession planning, especially in the MENA region, may be further complicated by a strong cultural tradition of respect for older generations which affects the manner in which a change in management and control is handled.

In order to further evaluate the 124 family businesses across the Middle East, we obtain results using a 20-factor governance score developed along the lines of Gompers, Ishii & Metrick (2003) and Brown and Caylor (2006). We document the following: First, corporate governance is still a topic that is significantly under-studied and misunderstood

given that one-third of the respondents reported that they were not well-enough informed about corporate governance. Second, having an effective and well-structured family council can enhance corporate governance since it represents a forum for communicating and voicing concerns and constitutes a venue for identifying the way of dealing with family and business issues.

Findings also show that, at the onset of family firms, chairman/CEO duality is prevalent across sample firms (close to 85 percent of the sample), and board structures significantly contest best governance practices. The majority of the firms in our sample had a prevalence of family members on board and a significantly low proportion of independent directors. Interestingly, sample firms still being run by the founding member or the first generation, have a limited number of independent members on their board and tend to adopt fewer governance practices than other firms where the third or fourth generations are involved.

Results further show that succession planning, one of the key challenges in family firms and one of the key pillars in sound governance practices, are substantially ignored within our sample, whereby few of the family businesses have any succession planning arrangements in place; even those businesses with established family councils report that family succession is not an area of focus on their agenda. While 51% of the firms in the sample with a family council are dealing with succession planning, 10% with no family council do have a succession plan. Finally, findings reveal that family firms adapting and abiding by corporate governance practices are less likely to have family members with higher compensation than the market salary.

The paper is structured as follows: following this introduction, we present in a second section the theoretical framework for the governance score and develop the hypotheses. The third section describes our sample and methodology, which includes a discussion of the data collection process as well as the calculation of the governance score, ME-Gov. A presentation of our results follows in the fourth section to conclude with a discussion of the findings and their practical and research implications.

2 Theoretical perspectives and hypothesis

There is scant empirical evidence that investigates corporate governance practices and their implications in the Middle East. For instance, Hussainey and Aljifri (2012) examine the degree to which internal and external corporate governance mechanisms affect UAE firms' capital structure. Chahine and Safieddine (2011) examine the effect of board size and its composition on banks' performance. Their findings document that bank performance is positively related to board size. Hussain and Mallin (2007) analyze the state of corporate governance in Bahrain and find that

² In the Gulf region, 80% of gross domestic product (GDP) outside the oil sector is generated by family businesses (PWC 2013)

companies have boards dominated by non-executive directors and that there is a separation of the Chair and CEO position. El Sayed (2007) examines the extent to which corporate leadership structure affects Egyptian publicly listed firms. Results indicate that CEO duality has no impact on corporate performance.

Family firms have a number of characteristics that distinguish them from typical listed firms. Amit and Villalonga (2004) find that family and non-family firms differ significantly in age, growth, performance, and corporate governance and control. Daily and Dollinger (1992) find that the principal common characteristic among the majority of family firms is that the main owner (family) is usually involved in the key-decision-making of the firm. Similarly, Ali, Chen, & Radhakrishnan (2007) report that in the U.S., families own 18% of their firms voting rights, hold top executive and board director positions in respectively 63% and 99% of their firms.

In order to examine the issues related to the BOD structure and role, family continuity and succession planning, we develop four hypotheses and base our findings on a sample of 124 firms. Anderson and Reeb (2003), using a sample of S&P 500 firms, find that boards in family firms contain significantly fewer independent directors, and more inside directors than boards in non-family firms. Lorsch and MacIver (1989) indicate that objective evaluation and monitoring of firm activity is one of the most critical functions of independent directors. Byrd and Hickman (1992) observe that independent directors are responsible for protection and promotion of minority shareholders' interests.

Hypothesis I: Presence of independent directors on the BOD has a significant influence on the firm's corporate governance.

Succession planning and family continuity is a critical concern for family members, practitioners, and family firm researchers. Prior studies have put forth that continuity of businesses from one generation to the next depends in significant part on succession planning. Gersick, Davis, Hampton and Landsberg (1997) indicate that proper succession planning is critical to take the business from one generation to the next. Beckard and Dyer (1983) find that only 30 percent of family businesses survive the transition to second generation and only 10 percent go on to a third generation. Statistics show that family businesses face continuity issues in the transition process from one generation to the next with 80% of firms not surviving the third generation. Morck, Strangeland, & Yeung (2000) report that heir-controlled firms exhibit lower levels of industry-adjusted performance and technical innovation, and conclude that inherited control is a strong impediment to organizational growth.

In addition to succession planning, the presence, or lack thereof, of a family charter and council may serve as a good indicator of the strength of a family business's governance structure.

Hypothesis II: The presence of an effective family council or assembly, taking into account family continuity and succession planning, results in a better governance at the business level.

Bartholomeusz and Tanewski (2006) find that it is substantially more common for the Chairman of the Board and CEO to hold the same position in family firms compared to non-family ones.

Hillier and McColgan (2004) sample UK firms and note that stock prices react favorably when companies announce the departure of a family CEO, but only when these directors are replaced by a non-family successor. Shleifer and Vishny (1997), show that CEO duality is linked with ineffective governance.

Family firms are more likely to have CEO duality since such structure provides the family with the opportunity of getting benefits that are not shared with the minority shareholders. However, According to Lam and Lee (2007), CEO duality has a negative impact on family-owned businesses. Thus, segregation of CEO and chairman duties is more appropriate for family firms.

Hypothesis III: Having the Chairman of the Board act as the CEO of the firm results in weaker governance for the business.

Gompers et al. (2003) constructed a governance index to proxy for the level of shareholder rights. GIM classify 24 governance factors into five groups: tactics for delaying hostile takeover, voting rights, director/officer protection, other takeover defenses, and state laws. They found that firms with stronger shareholder rights had higher firm value, higher profits, higher sales growth, lower capital expenditures, and made fewer corporate acquisitions.

Brown and Caylor (2006) also created a measure of corporate governance, Gov-Score, which constitutes a measure of 51 factors encompassing eight corporate governance categories: audit, BOD, charter/bylaws, director evaluation, executive and director compensation,

ownership, progressive practices, and state of incorporation. They note that better-governed firms are relatively more profitable, more valuable, and pay out more cash to their shareholders.

Hypothesis IV: The higher the ME-GOV, the more likely family members are to be compensated in line with the market.

2.1. Estimating corporate governance quantitatively: the governance score

We derive the ME-GOV using the following twenty parameters.

2.1.1 Presence of well-defined written strategy

Firms having a well-defined and written strategy are scored 1, otherwise 0. A well-defined strategy helps in shaping the corporation performance and the way the strategy is being implemented.

2.1.2 BOD written and documented charter

Firms having a written and documented charter specifying the BOD's composition and responsibilities are assigned a score of 1, otherwise 0.

2.1.3 Financial expertise of board members

Firms having at least one board member with expertise in financial matters are scored 1, otherwise 0. Ismail and Kamarudin (2012) examine whether the presence of financial experts reduces the perceived inherent risk of auditors. Results show that financial experts on the audit committee reduce the auditors' perception of the risk inherent in family firms.

2.1.4 Audit and accounting expertise of board members

Firms with an audit and accounting expert sitting on their board are assigned a score of 1, otherwise 0. Felo, Krishnamurthy, and Solieri (2003) found that the percentage of audit committee members having expertise in accounting is positively related to financial reporting quality.

2.1.5 Human resources expertise of board members

A score of 1 is allocated for firms with at least one Human Resources expert sitting on the board, otherwise 0. Huselid, Jackson & Schuler (1997) found positive relationships between HR management effectiveness and productivity, cash flow, and market value.

2.1.6 Industry expertise of board members

Firms with at least one board member being an industry expert are assigned a score of 1, otherwise 0. Faleye, Hoitash and Hoitash (2013) that board industry expertise is robustly associated with an increase in firm value since their presence has a positive effect on innovation.

2.1.7 Strategy expertise of board members

Firms having at least one member with expertise in strategy are given a score of 1, otherwise 0. The presence of a strategy expert on the board is very important in enhancing the ability of the latter in overseeing corporate strategy development and implementation which is considered to be one of the most important duties of the board.

2.1.8 Representation of non-family minority shareholders on the board

Firms having at least one non-family minority shareholder on the board are scored 1, otherwise 0. Many studies show a positive relationship between the fraction of minorities on the board and firm value.

2.1.9 Establishment of Audit Committee

Firms having an Audit Committee are scored 1, otherwise 0. In his findings, Swamy (2012) shows a positive relationship between audit committee and performance.

2.1.10 Establishment of Nomination committee

Firms with an established Nomination Committee are scored 1, otherwise 0. Vafeas (1999) examines the association between the employment and composition of nominating committees with board and ownership characteristics. The results of the study are consistent with nominating committees substituting inside ownership in controlling management, mostly improving board quality, and being staffed with independent, experienced, and knowledgeable members.

2.1.11 Establishment of Remuneration Committee

Firms having Remuneration Committee are scored 1, otherwise 0. Câmara (2012) found that the presence of a remuneration committee promotes the rigor and transparency of the remuneration setting process.

2.1.12 Establishment of Risk Committee

Firms with an established Risk Committee are scored 1, otherwise 0. Tonello (2012) suggests that risk committee of the board is not a one-size fits-all solution, and it may be a better fit for companies with special circumstances. Organizations with complex market, credit, liquidity, commodity pricing, regulatory and other risks that require special attention may find a risk committee useful.

2.1.13 Establishment of Human Resources Committee

Firms having a Human Resources Committee are scored 1, otherwise 0. Huselid (1995) indicates that Human Resource management practices have an economically and statistically significant impact on a firm's turnover and productivity as well as on short and long term measures of corporate financial performance.

2.1.14 Establishment of Governance Committee

Firms having an established Governance Committee are scored 1, otherwise 0.

2.1.15 Presence of CEO/Chairman Duality

Firms with CEO duality are scored 0, otherwise 1. Klai and Omri (2011) emphasize the need of separating the positions of CEO and Board chairman in order to guarantee the board independence and improve the firm transparency, thus avoiding conflict of interest.

2.1.16 Appointment of Big 4 external auditor

Firms assigning big 4 external auditors are scored 1 otherwise 0. Allocating well-experienced and professional auditors helps in improving accountability and transparency in corporate governance.

2.1.17 Establishment of internal audit department

Companies having an internal audit department are scored 1, otherwise 0. Lasher (2010) examines the role of the internal audit function. Results show that an internal audit function of high-quality can provide greater monitoring and therefore greater transparency to any potential bias in management's decision making focused upon the proportion of nonfamily management in the firm.

2.1.18 Presence of corporate governance code

Firms documenting and adopting a corporate governance code are scored 1, otherwise 0. Becht, Bolton and Röell (2002) show that corporate governance's main concern is the resolution of collective action problems among dispersed investors and the reconciliation of conflicts of interest between various corporate claimholders.

2.1.19 Qualified audit opinion

Firms having a qualified audit opinion are scored 0 otherwise 1. A qualified audit opinion indicates that the information provided is limited in scope and that the company is not following the appropriate accounting principles. Yeganeh, Dadashi and Akbari (2010) indicate that there is a significant relationship between businesses with a moderate or weak governance rate and the representation of qualified auditors' opinion.

2.1.20 Presence of independent board members

Firms having at least one independent board member are assigned a score of 1, otherwise 0. Klai and Omri (2011) found that independent directors in the board allow disclosing information of good quality and helps improve earnings quality.

3 Sample and methodology

3.1 Sample

In order to examine the governance structures of Middle East companies, data is collected through a survey sent to 500 firms. The sampled companies were selected based on two criteria. The first criterion is related to the country of incorporation. We restrict the sample to businesses incorporated in the Gulf Cooperation Council (GCC) countries, as they tend to have similar business laws, family structures and cultural values. The second criterion on which companies were selected relates to size. We sent the questionnaire to the top 500 family companies in terms of employees (or revenues when available).

Appendix 1 presents the questionnaire sent to the 500 companies. The questionnaire is made up of 80 questions, divided into the following categories: general information, shareholding, the family business, corporate governance, family governance, and the nature of the relation between the family and the business. Several measures were used to analyze the data, including ownership, generational state, and other corporate governance characteristics. Appendix 2 provides detailed explanations on each section of the questionnaire. The final sample comprises 124 companies with dully completed questionnaires from different countries and operating within different industries and service lines.

Table 1 provides descriptive statistics on the industries to which the sample firms belong. The different industries and service lines are consistent with the type and structure of family businesses, which tend to be diverse and unfocused in the Middle East.

Table 1. Breakdown of Sample by Industry

	# of firms	Percentage (%)
Retail	32	26%
Engineering & Construction	21	17%
Real Estate	16	13%
Manufacturing	20	16%
Services	17	14%
FMCG	10	8%
Healthcare	8	6%
Total	124	100%

The 124 family businesses in the sample are from 7 different industries, with the majority of companies from the retail industry (32 companies), construction/engineering (21 companies), manufacturing (20 companies), services (17

companies) and real estate (16 companies). A financial analysis of the sample is consistent with our earlier observations of scale and complexity of operations, as average annual sales for the 124 sampled companies are USD 2 billion. Table 2 shows

details of financial data for the sample studied. With respect to employees, the average number is 1,450,

offering further evidence of the complexity and scale of operations for these family businesses.

Table 2. Descriptive Statistics on Financial Data (Mean & Median values in Millions USD)

	Mean	Median
Total Assets	408	300
Current Assets	101	20
Current Liabilities	51	20
Receivables	34	30
Sales (annual)	331	200

3.2. Methodology

The empirical models employed try to capture the hypothesis on how family variables can influence the corporate governance quality and stage of development in family firms.

3.2.1 Empirical model 1

$$y = \beta_1 + \beta_2 F1 + \beta_3 F2 + \beta_4 FCA + \beta_5 \text{Age} + \beta_6 \text{Log TA} + \beta_7 \text{Gen1}$$

3.2.2 Empirical Model 2

$$y = \beta_1 + \beta_2 F1 + \beta_3 F2 + \beta_4 FCA + \beta_5 \text{Age} + \beta_6 \text{Log TA} + \beta_7 \text{Gen1} + \beta_8 \text{Gen2}$$

3.2.3 Empirical Model 3

$$y = \beta_1 + \beta_2 F1 + \beta_3 F2 + \beta_4 FCA + \beta_5 \text{Age} + \beta_6 \text{Log TA} + \beta_7 \text{Gen1} + \beta_8 \text{Gen3}$$

Where Y: corporate governance score being the dependent variable, a quality variable: the higher the score the better the governance at the business level

F1: Family members' compensation relative to the market.

F2: Family members' compensation relative to non-family members.

FCA: Presence of family council or assembly.

Age: Firm Age.

Log TA: Logarithm of the firm's total assets (reflecting the firm' size).

Gen1: involvement of family's first generation in the business.

Gen2: involvement of family's second generation in the business.

Gen3: involvement of family's third generation in the business.

The three regression models are performed over the same sample consisting of 124 family firms from different countries in the Middle East, operating in various industries. These models were used to capture the effect of the involvement of the family's first, second and third generations in the business on the firm's corporate governance practices and quality. The first model accounts for the participation of the first generation in the business, the second model considers

the participation of both first and second generations while the third model accounts for the involvement of the first and third generations.

4 Results

Our first hypothesis concerning the presence of independent directors is strongly supported. Our results show a high correlation between independent board members and other significant variables. For example, 80% of firms with independent directors had non-family minority shareholders on BOD, 79% had corporate governance code, 69% had financial experts on the BOD as well as an internal audit department, 61% showed non-CEO duality, and 59% had industry expert on BOD.

As for the second hypothesis concerning family council, empirical results do not seem to support it. While 51% of the firms in the sample with a family council are dealing with succession planning, 10% with no family council do have a succession plan. 57% of firms with above median Gov-Score have established a family council, yet do not seem more likely to have independent directors or corporate governance codes.

Regarding the third hypothesis, our results highly support it. Family firms where the Chairman of the Board is not the CEO, seem to have better governance than the ones with CEO duality. 85% of the firms with non-CEO duality had audit experts on the BOD, 76% followed a good corporate governance code, 64% of the firms had a strategy expert on the BOD as well as a non-family minority shareholder, and 56% had a financial expert.

Regarding the fourth hypothesis related to the ME-GOV score, it is seen that whenever the governance score for the family firm is high, chances for the family member to have a greater pay than non-family member is low.

4.1 Correlation matrix

We built a correlation matrix among the 20 governance variables that were used to derive the firm's corporate governance quality score, in order to identify the components having the strongest direct influence on the corporate governance structure in family firms. Based on the correlation matrix in Table 3, the following relationships were identified.

Table 3. Correlation matrix

	Financial Expert on BOD	Strategy Expert on BOD	Audit Expert On BOD	Industry Expert on BOD	Non-Family Minority Shareholders on BOD	Audit Committee	Governance Committee	Nomination Committee	Remuneration Committee	Risk Committee	Corporate Governance Code	Non-CEO Duality	Big 4 External Auditors	Internal Audit Department	Unqualified Audit Opinion	Independent Board Members	Family Council/ Assembly	Well-Defined and Written Strategy	Documented charter laying down the BOD composition and responsibilities
Financial Expert on BOD	1.00																		
Strategy Expert on BOD	0.29	1.00																	
Audit Expert on BOD	0.52	0.49	1.00																
Industry Expert on BOD	0.64	0.43	0.52	1.00															
Non-Family Minority Shareholders on BOD	0.68	0.45	0.41	0.68	1.00														
Audit Committee	0.30	-0.23	-0.16	0.38	0.56	1.00													
Governance Committee	0.45	-0.32	-0.16	0.35	0.52	0.89	1.00												
Nomination Committee	0.06	0.11	0.09	0.05	0.07	0.07	0.13	1.00											
Remuneration Committee	0.41	-0.41	0.01	0.38	0.38	0.82	0.89	-0.07	1.00										
Risk Committee	0.06	-0.08	0.29	0.15	0.09	0.08	0.11	-0.03	0.40	1.00									
Corporate Governance Code	0.73	0.41	0.57	0.57	0.84	0.32	0.44	0.08	0.32	-0.04	1.00								
Non-CEO Duality	0.56	0.64	0.85	0.44	0.64	-0.04	0.06	0.10	-0.04	0.04	0.76	1.00							
Big 4 External Auditors	0.50	0.52	0.49	0.24	0.41	-0.06	0.06	0.07	-0.06	-0.07	0.54	0.70	1.00						
Internal Audit Department	0.64	0.52	0.70	0.50	0.73	0.14	0.25	0.09	0.14	0.00	0.81	0.87	0.67	1.00					
Unqualified Audit Opinion	-0.62	-0.09	-0.54	-0.64	-0.52	-0.23	-0.40	-0.05	-0.43	-0.17	-0.61	-0.45	-0.15	-0.53	1.00				
Independent Board Members	0.69	0.31	0.43	0.59	0.80	0.38	0.49	0.06	0.34	-0.11	0.79	0.61	0.46	0.69	-0.61	1.00			
Family Council/Assembly	-0.15	0.38	0.27	-0.10	0.05	-0.36	-0.44	0.09	-0.36	0.19	0.04	0.26	0.09	0.17	0.23	-0.11	1.00		
Well-Defined and Written Strategy	0.46	0.39	0.55	0.31	0.51	0.05	0.17	0.08	0.05	-0.04	0.64	0.71	0.56	0.65	-0.36	0.53	0.22	1.00	
Documented charter laying down the BOD composition and responsibilities	0.55	0.46	0.63	0.48	0.58	0.11	0.22	0.09	0.11	-0.01	0.70	0.74	0.59	0.70	-0.43	0.58	0.07	0.68	1.00

Firms having a corporate governance code are more likely to have non-family minority shareholders as well as financial, audit and industry experts sitting on their boards. Big 4 external auditors are more likely employed by firms with a corporate governance code, that employ financial and strategy experts on their boards of directors and that show a segregation of CEO/Chairman duties. Family firms with financial, audit and strategy experts on their BOD and a corporate governance code tend to segregate the duties and responsibilities of the CEO and the Chairman. Firms with established risk committees, and financial, industry and strategy experts as well as non-family minority shareholders on their boards and non-CEO duality are more likely to have an internal audit department. Firms with independent board members on their BOD have a tendency to have an internal audit department, a corporate governance code, segregation in the CEO/Chairman Duties and experts sitting on their boards. Firms having a documented charter laying down the BOD composition and

responsibilities and a well-defined and written strategy tend to have independent board members, experts (financial, audit, industry and strategy) sitting on the BOD, segregation of CEO/Chairman responsibilities, an internal audit department, in addition to Big 4 external auditors.

4.2 Governance score

The maximum governance score in the sample is 80 over 100, while the minimum score is 0 over 100. The average and the median are 42 and 50 respectively. A higher governance score reflects better corporate governance practices. Based on the Frequency Table reported in table 4, results show that 100% of family firms that have a corporate governance score equal to or above the mean enjoy the following: presence of financial expert and industry expert on the BOD, presence of non-family minority shareholders and independent board members, and existence of a corporate governance code.

Table 4. Frequency table

	Total		Group 1 Score < Median		Group 2 Score >=Median	
	Frequency of 0	Frequency of 1	Frequency of 0	Frequency of 1	Frequency of 0	Frequency of 1
FAMILY COUNCIL/ ASSEMBLY	51%	49%	59%	41%	43%	57%
WELL-DEFINED AND WRITTEN STRATEGY	43%	57%	82%	18%	5%	95%
DOCUMENTED CHARTER LAYING DOWN THE BOD COMPOSITION AND RESPONSIBILITIES	48%	52%	90%	10%	6%	94%
FINANCIAL EXPERT ON BOD	29%	71%	59%	41%	0%	100%
STRATEGY EXPERT ON BOD	56%	44%	84%	16%	30%	70%
AUDIT AND ACCOUNTING EXPERT ON BOD	48%	52%	84%	16%	13%	87%
INDUSTRY EXPERT ON BOD	20%	80%	41%	59%	0%	100%
NON-FAMILY MINORITY SHAREHOLDERS ON BOD	35%	65%	70%	30%	0%	100%
AUDIT COMMITTEE	65%	35%	70%	30%	59%	41%
GOVERNANCE COMMITTEE	68%	32%	79%	21%	57%	43%
NOMINATION COMMITTEE	99%	1%	100%	0%	98%	2%
REMUNERATION COMMITTEE	65%	35%	70%	30%	59%	41%
RISK COMMITTEE	92%	8%	92%	8%	92%	8%
HUMAN RESOURCES COMMITTEE	100%	0%	100%	0%	100%	0%
CORPORATE GOVERNANCE CODE	43%	57%	87%	13%	0%	100%
NON CEO DUALITY	56%	44%	100%	0%	13%	87%
BIG 4 EXTERNAL AUDITORS	38%	62%	70%	30%	6%	94%
INTERNAL AUDIT DEPARTMENT	49%	51%	93%	7%	6%	94%
UNQUALIFIED AUDIT OPINION	76%	24%	52%	48%	98%	2%
INDEPENDENT BOARD MEMBERS	32%	68%	66%	34%	0%	100%

On the other hand, 100% of family firms with a governance score below the mean have CEO duality and do not have a nomination nor a Human Resources committee.

It is also important to mention that all firms included in the sample do not have a Human Resources committee, while only 2% of the latter firms do have nomination committees and 8% of both firms with low

and high corporate governance scores have a risk committee.

Moreover, 94% of family firms with good corporate governance score have an internal audit department as well as a documented charter compared to 7% and 10% respectively for firms with below the mean corporate governance score. In addition, 95% of firms with high scores have a well-defined written strategy versus 18% for the firms with poor corporate governance.

As for family governance criteria, results show that 88% of firms having a corporate governance score above or equal to the median have family members compensation that is in line with the market and non-family members. On the other hand, 72% and 67% of family firms with poor governance scores exhibit family members' compensation exceeding that of the market and that of non-family members respectively.

Also, results indicate that 70% and 63% of family firms with a low governance score have involvement of the first and second generations respectively, while only 16% have a third generation intervention in the business. However, the percentage of family firms with good governance score having

third generation involvement is also considered low, at only 20%.

In addition, 37% of family firms with above the mean governance scores have involvement of the first and second generations, while 67% and 70% of firms with weak governance have the first and second generations respectively participating in the business. On the other hand, the third generation involvement in the business is still low for both family firms with good and weak governance scores representing only 20% and 16% respectively.

Finally, the table shows that 49% of total firms in the sample have a family council or assembly which reflects a significant improvement from 2009.

4.3 Regression

Based on our sample, the regressions show a negative relationship between the ME-GOV and the compensation of family members relative to non-family members. In other words, the better the governance score for the family firm, the less likely the firm would pay a family member higher than a non-family member.

Table 5. Probits

PARAMETERS	MODEL 1		MODEL 2		MODEL 3	
	Coefficient	z-Statistic	Coefficient	z-Statistic	Coefficient	z-Statistic
INTERCEPT	-5.647	-1.931	-7.041	-2.450	-6.524	-2.505
		(0.0535)		(0.0143)		(0.0122)
FAMILY MEMBERS COMPENSATION RELATIVE TO THE MARKET	-0.381	-0.801	-0.633	-1.313	-0.168	-0.394
		(0.4229)		(0.1893)		(0.6939)
FAMILY MEMBERS COMPENSATION RELATIVE TO NON- FAMILY MEMBERS	-0.867	-1.981	-1.163	-2.320	-0.733	-1.775
		(0.0476)		(0.0203)		(0.0759)
FAMILY COUNCIL / ASSEMBLY	1.303	2.091	1.419	1.872	0.606	1.425
		(0.0365)		(0.0612)		(0.1542)
AGE	0.161	3.650	0.181	3.991	0.170	4.367
		(0.0003)		(0.0001)		(0.00)
LOG OF TOTAL ASSETS	-0.062	-0.618	-0.032	-0.291	-0.053	-0.552
		(0.5366)		(0.7714)		(0.581)
# OF 1ST GENERATION	-0.652	-2.538	0.499	1.035		
		(0.0111)		(0.3005)		
# OF 2ND GENERATION			-0.314	-2.478		
				(0.0132)		
# OF 3RD GENERATION					0.004	0.122
						(0.903)
MCFADDEN R-SQUARED	0.681		0.717		0.625	
S.D. DEPENDENT VAR	0.501		0.501		0.501	
AKAIKE INFO CRITERION	0.559		0.525		0.635	
SCHWARZ CRITERION	0.721		0.710		0.798	
HANNAN-QUINN CRITER.	0.625		0.600		0.701	
RESTR. DEVIANCE	166.055		166.055		166.055	
LR STATISTIC	113.017		119.115		103.823	
PROB(LR STATISTIC)	0.000		0.000		0.000	
OBS WITH DEP=0	63		63		63	
OBS WITH DEP=1	57		57		57	

The first regression model reveals a negative link between the first generation and governance score. However the more the second generation takes the lead and get involved, the lower the governance score. The participation of the third generation seems to be a mute issue as its coefficient is insignificant.

Regression results further show a positive rapport between corporate governance and the presence of a family council or assembly in the sample. However, the positive correlation between family council and the corporate governance score does not seem to work its way to the involvement of the new generations in the business. This indicates that for family firms to have enhanced corporate governance, they not only need to establish a family council or assembly but also to focus on its mission, role and effectiveness. The main role of the family council is defining the family's shared vision and values, acting as the family's voice to the business and the point of contact with the BOD, discussing and dealing with family matters, providing frameworks for educating and developing the skills of family members, dealing with family employment policies and most importantly dealing with succession planning. In our sample, a significant number of family firms having an ineffective family council. On the other hand, 59% of the companies having an above-the-median governance score, have their family council dealing with succession planning and acting as the family's voice to the business and point of contact with the BOD. Thus the role of family council is extremely important and valuable since it enables the management concentrate on achieving growth and profitability goals, and assists in unifying the voice of the family, giving a well-determined direction for both the board and the management.

In addition, our sample shows that more than half the firms prefer to appoint a family member as CEO, especially that selecting a non-family member is filled with emotional, business and governance challenges. Further, around 40% of firms with a good governance score conduct an objective and fair performance assessment for the appointed CEO. Finally, around one third of family firms in the sample have a shared vision for the business which clearly articulates the situation going forward as well as the objectives that family members need to achieve in order for their businesses to be successful.

5 Conclusion

The purpose of this study is to examine the quality of corporate governance in Middle Eastern family businesses.

The modern Middle Eastern family business is employing second and third generation family members to run the business, which is all the more evidence for the need of proper corporate governance mechanisms to ensure the sustainability of the firms, especially those who have plans of entering capital

markets. The main findings of our research on the governance structures of Middle Eastern family businesses reveal expected results inadequate governance structures, evidenced by a majority of firms having Chairman/CEO duality, substantial family involvement in managerial decisions, and a significantly low ratio of independent directors to total directors.

The family-run business is not an anachronism, but a viable and prevalent model for competing effectively in the global economy, achieving impressive long-term growth, attracting top talent, and increasing family wealth over generations. However, in order to take a place in the worldwide roster of highly successful family-run firms, these businesses must eliminate or curb the restless entrepreneur syndrome, let go of emotional attachments to core but less profitable businesses, and institute guidelines that provide clear lines of separation between family and business activities. A challenging global economy and internal transition to new generations of family management make these changes all the more critical and timely, but they can be successfully implemented through careful planning and commitment to the sustainability of the business.

The involvement of the third generation in the business plays an insignificant role in enhancing the firm's performance in terms of corporate governance, and a negative relationship is identified between the governance score and the second generation by the time the first generation is still involved in the business.

Families need to focus on drawing clear distinctions between family and company activities. This can be accomplished by creating a formal governance structure to govern the family and business. The presence of an effective family council or assembly has a positive influence on the governance within family firms, especially if the council is committed to fulfilling its well-defined role and objectives. A sizable portion (33%) of our sample is still uncertain as to the benefits of governance to the family. This is a clear indicator of the need to educate businesses within the Middle East on the importance of governance for ensuring the successful continuity of the family business.

The study comes with some limitations. Family businesses were compared at a particular point in time, the year 2013, and as such, the questionnaire did not capture at what particular point the business is within the development of each generational phase.

Designing an effective governance structure is straight forward; however, implementation should be managed carefully and introduced gradually, over a long period of time. Families should use the governance structure to include and involve various family members who might not otherwise be actively engaged with the business.

Corporate governance has become a major factor affecting the success of emerging market businesses.

At a time when the increasingly global economy creates opportunities, but also competitive threats, instituting good corporate governance practices is an important part of any strategy to prosper. For small, medium-sized and family owned companies, which comprise the majority of companies in the Middle East and North Africa (MENA) region, corporate governance procedures can help facilitate a smooth intergeneration and transfer of wealth and reduce conflicts within families. Good governance is an essential component for ensuring the integrity of financial reporting and effective business management.

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