

# The Impact of Foreign Ownership on Corporate Risk Taking Behavior

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**Keywords:** Corporate Risk-taking, Foreign Ownership, Indonesia.

**Abstract:** This study aims to analyse the impact of foreign ownership on corporate risk taking behaviour at non-financial, non-trade, non-service and non-investing companies that are listed in the Indonesian Stock Exchange in 2014-2016. We use explanatory survey for this study. The sampling technique used is the purposive sampling method. We use secondary data obtained from the Indonesian Stock Exchange and annual reports. We then analyse the data using multiple linear regressions. The result of this study shows that foreign ownership has a positive but statistically non-significant impact on corporate risk taking behaviour.

## 1 INTRODUCTION

The participation of foreign investors in investing activities in the Indonesian stock market is increasing due to the local government's policy of opening business sectors that were previously restricted to foreign investors. This economic liberalization is one of the government's strategies to attract more foreign investors and expand several business sectors in Indonesia. (Suroyo & Nangoy, 2016).

The involvement of foreign investors in the stock market is often associated with increased risk. One reason for this is because foreign investors often focus on seeking high short-term earnings, so they encourage firm management to take higher risks, a move aimed at boosting profits (Vo, 2015). Some studies of foreign ownership conducted in the context of developing countries (An, Huang, Li, & Xiao, 2014; Zhao & Xiao, 2016), indicate that foreign investors often push local firms to conduct aggressive investment strategies, which could lead to an increase corporate risk taking activities. Given the government's policy to open more business sectors in Indonesia to foreign investors, it is interesting to examine the relationship between foreign ownership and corporate risk taking in the Indonesian context.

## 2 LITERATURE REVIEW

Research on the relationship between foreign ownership and corporate risk taking has been done before by, among others, Boubakri, Cosset, & Saffar (2013), Paligorova, (2010), and Vinh (2016). However, the available literature displays mixed results.

Several previous studies have found that foreign investors can influence corporate risk taking through improvements in the implementation of corporate governance in local companies. Foreign investors often show more initiative in improving corporate governance practices in local firms than local investors (Ferreira & Matos, 2008). These improvements are beneficial in reducing risk taking activities conducted by management (Nguyen, 2010). In contrast, a research done by An, Huang, Li, & Xiao (2014) states that the improvement of corporate governance practices due to foreign investors actually increases corporate risk taking. This is because better corporate governance increases the transparency and reliability of the company, resulting in increased investor confidence.

When companies operate in countries with poor corporate governance standards, they typically employ a more conservative investment policy. This is because countries with poor corporate governance practices typically have less developed stock markets and fewer diversification opportunities (Stulz, 2005).

In countries like these most shareholders, both foreign and local, often prefer to avoid risk (John, Litov, & Yeung, 2008).

Research conducted by Vo (2015) found that foreign ownership in Vietnamese companies is associated with lower levels of corporate risk taking activities because of a tendency for foreign investors investing in Vietnam to focus on long-term earnings. When foreign investors own a significant amount of stock in a particular company, they tend to limit the risk taking activities of the company's management to prevent large losses to their portfolio. (Cheng et al., 2011).

### 3 METHODS

The method used in this study is explanatory survey. Consistent with prior literature, the population of this research are non-financial, non-trading, non-services and non-investment companies that went public and are listed on the Indonesia Stock Exchange (BEI) for the period of 2014-2016. We use purposive sampling method to determine sample for this research. The criteria for selecting the sample under study are as follows: (a) Firms must be non-financial, non-trade, non-service and non-investment companies (b) Firms must be listed in the Indonesia Stock Exchange for the period of 2014- 2016, (c) Firms must issue financial statements continuously during the period of 2014-2016, (d) Firms have went public for at least 6 years (e) Firms must report financial statements with rupiah as a currency unit. Ownership data is obtained from the website of PT Kustodian Sentral Efek Indonesia (KSEI). Company data and financial statements are obtained from the Indonesia Stock Exchange website and each company's website. The analysis technique used is multiple linear regression analysis.

This study follows research conducted by Faccio, Marchica, & Mura (2011) in measuring corporate risk taking behaviour, by using the ratio of profitability to the volatility of profitability. The ratio is as follows:

$$CRT = \frac{ROA}{\sigma ROA} \quad (1)$$

Foreign ownership is measured by the following ratio:

$$FOROWN = \frac{\sum \text{foreign investors' shares}}{\sum \text{shares outstanding}} \times 100\% \quad (2)$$

This study uses two control variables, namely firm size and leverage.

$$SIZE = \ln \text{ total assets} \quad (3)$$

$$LEV = \frac{\text{total liabilities}}{\text{total assets}} \quad (4)$$

Company size was chosen because large firms are considered less risky and shows lower levels of risk (Vo, 2016). The leverage variable was chosen because leverage plays an important role in increasing the company's financial risk (Boubakri et al., 2013).

### 4 RESULTS AND DISCUSSION

Table 1 shows the results of the regression tests that examined the effect of foreign ownership along with firm size and leverage as control variables on corporate risk taking.

The regression coefficients of the study showed varying signs, positive and negative. A positive coefficient indicates the unidirectional effect of the independent variable to the dependent variable, whereas a negative coefficient indicates the opposite effect of the independent variable to the dependent variable. Based on table 1, foreign ownership has a positive but non-significant effect on corporate risk taking. The size of the firm has a negative, significant effect on corporate risk taking. Leverage has a positive, significant effect on corporate risk taking.

A coefficient of determination test was done to determine the proportion of the variance in the dependent variable that is predictable from the independent variable. Based on table 1, a coefficient of determination (R Square) value of 0,550 or 55% was obtained for the model. Regression results show that foreign ownership along with the control variables firm size and leverage were able to explain 55% of the variance in volatility of profitability as a proxy for corporate risk taking and the remaining 45% is influenced by other variables not examined by this research.

According to the results of the study, foreign ownership has a positive but non-significant impact on corporate risk taking. These results do not support the studies done by Vinh, (2016) and Cheng et al., (2011) which show that foreign ownership actually reduces corporate risk taking behaviour. However, these results support the studies conducted by An et al., (2014) and Zhao & Xiao, (2016), which state that

foreign ownership has a positive influence on corporate risk taking.

Foreign ownership can increase corporate risk taking behaviour for several reasons. One possibility is that the involvement of foreign investors leads to an improvement in corporate governance, which leads to an increase in corporate risk taking (An, Huang, Li, & Xiao, 2014). This is because commitments and monitoring by foreign institutional investors increase the transparency and reliability of the company, resulting in increased investor confidence. The implication is that managers in companies with foreign investors are more trusted by investors and are more likely to take risky projects. Another possible explanation is that the increase of foreign investment provides local firms with larger capital and enables them to take advantage of risk-sharing effect, meaning managers often feel they can afford to take more risk because they have a stronger buffer against risk. This supports the view of Umutlu, Akdeniz & Altay-Salih, (2010).

The results show that leverage has a significant positive relationship to corporate risk taking. This is in accordance with the results of research conducted by Bhagat, (2015) and Vinh, (2016). Leverage is one of the strategies company management do when they are seeking to increase company value, and aggressive leveraging practices often lead to an increase in the level of corporate risk (Moreno-Bromberg & Roger, 2016).

The results show that firm size has a significant negative relationship with corporate risk taking. These results are consistent with research conducted by Nguyen, (2010) and Boubakri et al., (2013). Companies with greater asset levels are judged to have a smaller risk level. In contrast, firms with smaller amounts of assets are often in their growth stage, so investors will usually encourage these companies to take on riskier projects or engage in more aggressive investment strategies (Lu, 2011).

Table 1: Results of regression tests

Dependent Variables	Independent Variables	Coefficient	t Test			F Test		
			t value	Sig	Results	F value	Sig	Results
CRT	Constant	,265	4,31	,000		43,51	,000 <sup>b</sup>	sig
	SIZE	-,010	-4,32	,000	sig			
	LEV	,058	10,88	,000	sig			
	FOROWN	,030	2,12	,036	not sig			
significance at (α): 0,05 R : ,741 <sup>a</sup> R <sup>2</sup> : ,550								

## 5 CONCLUSIONS

This study examines the relationship between foreign ownership and corporate risk taking in non-financial, non-trade, non-service and non-investment firms listed on the Indonesia Stock Exchange in the period 2014-2016. Based on the results of our analysis we find that foreign ownership tends to increase corporate risk taking behaviour, although not on a significant level. The results of this study are in accordance with research conducted by An et al., (2014) and Zhao & Xiao, (2016), which state that foreign ownership tends to increase corporate risk taking behaviour. The results of this study are also in accordance with the research conducted by Umutlu, Akdeniz & Altay-Salih, (2010) which states that the

influence of foreign ownership on corporate risk taking is non-significant.

The implications of our study are important for a variety of stakeholders. It is relevant to company shareholders, firm management, and policymakers in emerging markets. For example, policymakers and regulators are interested in the possible adverse or beneficial volatility effects on stock market that foreign investment brings, and might adjust their economic policies accordingly. In emerging markets, especially, strict regulations on foreign investments tend to lead to poor economic growth, and so governments might be interested in easing back the restrictions on foreign investments to benefit from the larger and more diverse capital foreign investors bring.

In this study, we measure corporate risk taking using only a single proxy and two control variables. Future studies might want to employ more proxies to measure risk taking and use more control variables. Furthermore, future studies might analyze other factors of ownership on corporate risk taking, such as local investor ownership, ownership structure, and state ownership.

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