

العنوان:

مقارنة بين رسالتين دكتوراة وتحديد أوجه التشابه
والاختلاف بينهما

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دراسات نقدية 3



سوف نستعرض مقارنة علمية
لدراستين وتوضيح أوجه التشابه
والاختلاف بينهما.



Chapter 03

مقدمة:

تُعد مقارنة الدراسات من الأدوات المهمة في البحث العلمي، حيث تمكّن الباحث من فهم تطور المعرفة في مجال معين، وتحليل الفروقات المنهجية والتطبيقية بين الدراسات. وفي هذه المهمة .. سيتم مقارنة دراستين في مجال حوكمة الشركات في المملكة العربية السعودية، مع التركيز على الجوانب المنهجية والتطبيقية والنتائج.

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بيانات الدراسة الاولى:

العنوان: The Effect of Corporate Governance Mechanisms on Earnings Management Practices in Saudi Listed Companies

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مجال الدراسة: حوكمة الشركات وإدارة الأرباح

عينة الدراسة: 112 شركة مدرجة (994 مشاهدة خلال الفترة 2006–2017)

تتناول هذه الرسالة دراسة أثر آليات الحوكمة المؤسسية على ممارسات إدارة الأرباح في الشركات السعودية المدرجة في سوق المال، وذلك في ضوء لائحة حوكمة الشركات السعودية.

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03

بيانات الدراسة الثانية:

العنوان: Corporate Governance in Saudi Arabia: Overview and Empirical Investigation

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مجال الدراسة: حوكمة الشركات في السعودية

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تتناول هذه الرسالة دراسة واقع حوكمة الشركات في المملكة العربية السعودية، من خلال تقديم نظرة عامة على تطورها، وإجراء دراسة تجريبية لقياس مستوى تطبيق مبادئ الحوكمة وفعاليتها من وجهة نظر عدد من الأطراف ذات العلاقة مثل أعضاء مجالس الإدارة والمديرين والمراجعين والمساهمين

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- كلا الدراستين تركزان على حوكمة الشركات في المملكة العربية السعودية.
- الاطار النظري
- تعتمد الدراستان على نظرية الوكالة كإطار تفسيري رئيسي لفهم الحوكمة
- الهدف العام
- دراسة فعالية آليات حوكمة الشركات وتأثيرها على الأداء أو السلوك المؤسسي.
- محاور الحوكمة
- تركز الدراستان على عناصر مشتركة مثل:
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الثانية: الحوكمة في السعودية لا تزال في مرحلة تطوير وتحتاج إلى تحسين

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التحليل المقارن:

تُظهر المقارنة أن الدراسة الأولى تمثل نموذجاً متقدماً من الدراسات الكمية التي تعتمد على بيانات فعلية وتحليل إحصائي دقيق، بينما تمثل الدراسة الثانية توجهها استكشافياً يركز على فهم واقع الحوكمة من خلال آراء الممارسين. كما أن الاختلاف في نوع البيانات أدى إلى اختلاف في عمق النتائج ودقتها.

رأي كباحث:

من وجهة نظري، تُعد الدراسة الأولى أكثر قوة من الناحية المنهجية، نظراً لاعتمادها على بيانات كمية طويلة المدى ومعالجة المشكلات الإحصائية، مما يعزز من موثوقية نتائجها. في المقابل.. تتميز الدراسة الثانية بتقديم تصور شامل عن واقع الحوكمة في المملكة، إلا أن اعتمادها على الاستبيانات قد يجعل نتائجها أكثر عرضة للتحيز، كما أرى أن الدمج بين المنهجين (الكمي والميداني) قد يقدم نموذجاً بحثياً أكثر تكاملاً في دراسة حوكمة الشركات.

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الخاتمة:

خلصت هذه المهمة إلى وجود تشابه واضح بين الدراستين من حيث المجال والإطار النظري، مقابل اختلاف جوهري في المنهجية والتطبيق.

وتؤكد هذه المقارنة أهمية اختيار المنهج المناسب لطبيعة المشكلة البحثية، كما تبرز الحاجة إلى دراسات مستقبلية تجمع بين التحليل الكمي والميداني لتحقيق فهم أعمق لواقع حوكمة الشركات.

شاكر لكم جهودكم .. والسلام عليكم ورحمة الله وبركاته



University
of Glasgow

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University
of Glasgow

**The Effect of Corporate Governance
Mechanisms on Earnings Management
Practices in Saudi Listed Companies**

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BSc, MAcc

**Submitted in Fulfilment of the Requirements
for the Degree of Doctor of Philosophy in
Accountancy**

**Adam Smith Business School
College of Social Sciences
University of Glasgow**

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ABSTRACT

The main objective of this thesis is to examine the impact of corporate governance mechanisms on earnings management practices in Saudi Arabia. To achieve this aim, the study first analyses the relationship between the level of compliance with the Saudi Corporate Governance Code (SCGC) and earnings management practices by employing a self-constructed corporate governance index (i.e., the compliance-index model), derived mainly from the 2017 Saudi Corporate Governance Code. Second, the study examines the association between a number of individual corporate governance mechanisms (i.e., the equilibrium-variable model) and earnings management practices in Saudi listed firms. Third, it examines the influence of family ownership on the association between corporate governance mechanisms (measured by a comprehensive governance index) and earnings management practices in Saudi listed firms. Through use of a sample of 112 Saudi listed firms between 2006 and 2017 (i.e., 994 firm-year observations) together with insights from agency theory, the compliance index model produces results showing a statistically significant and negative association between the Saudi Corporate Governance Index (SCGI) and the level of earnings management practices. However, this result does not hold for firms with high family ownership, since the results reveal that the effectiveness of corporate governance (measured by the SCGI) in constraining earnings management is reduced in Saudi firms with high family ownership. In a series of sensitivity analyses, this evidence is robust to (i) alternative earnings management models, (ii) endogeneity, and (iii) alternative proxy for family control.

Regarding the equilibrium-variable model, the results indicate that Saudi firms are likely to have lower levels of earnings management practices if they have a high percentage of strictly independent directors on the boards, a larger board size, and audit committees that meet more often. Additionally, the results show that Saudi firms with higher government ownership, institutional ownership and family ownership have lower levels of earnings management practices. In contrast, the current study did not find any evidence that the strict independence of audit committee index, percentage of directors with multiple directorships, percentage of family directors on the board and percentage of blockholders ownership have any significant relationship with the extent of earnings management practices in the Saudi firms. Also, the study found that non-strict board/audit independence is not effective in

reducing earnings management practices in Saudi firms. These results are moderately robust to (i) alternative earnings management models, (ii) endogeneity, and (iii) alternative proxies for strict board independence. Finally, the findings of this study indicate the effectiveness of the governance provisions provided in the 2017 Saudi Corporate Governance Code in improving governance practices in the Saudi context.

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AUTHOR'S DECLARATION

“I declare that, except where explicit reference is made to the contribution of others, that this dissertation is the result of my own work and has not been submitted for any other degree at the University of Glasgow or any other institution.”

Printed Name: **Bayan Almalki**

Signature: 

LIST OF ABBREVIATIONS

Abbreviation	Definition
CGQ	Corporate Governance Quotient
CLSA	Credit Lyonnais Security Asia
CMA	Capital Markets Authority
GA	General Assembly
GAAP	Generally Accepted Accounting Principles
GDP	Gross Domestic Product
GICS	Global Industry Classification Standard
GMI	Governance Metrics International
IFRS	International Financial Reporting Standards
IPO	Initial public offering
IRRC	Investors Responsibility Research Centre
ISS	Institutional Shareholder Services
M&A	Mergers and acquisitions
MENA	Middle East and North Africa
MSCI	Morgan Stanley Capital International
	Organization for Economic Cooperation and
OECD	Development
OLS	Ordinary least squares
	Organization of the Petroleum Exporting
OPEC	Countries
PCA	Principal component analysis
SAMA	Saudi Arabian Monetary Agency
SEC	Securities and Exchange Commission
	Saudi Organization for Certified Public
SOCPA	Accountants
SOX Act	Sarbanes-Oxley Act
Tadawul	Saudi Stock Exchange

CHAPTER ONE

Introduction

1 Introduction

Over the past two decades, a number of giant public corporations, such as Enron and WorldCom, have collapsed due to the involvement in fraudulent financial reporting (Ravisankar et al., 2011). Studies show that these aggressive accounting practices stem from earnings management practices (Rahman et al., 2016; Persons, 2005; Hasnan et al., 2013). However, the collapse of these companies has damaged their reputation and raised the shareholders' and stakeholders' concerns about the transparency and credibility of the financial information disclosed by the companies (Katmon & Farooque, 2017). Therefore, to restore the confidence of the stakeholders in capital markets and to minimise earnings management practices, regulatory bodies have imposed corporate governance rules after the occurrence of the corporate financial scandals.

For example, in the US, after the collapse of Enron and other high-profile American companies, the Sarbanes-Oxley Act of 2002 was introduced and applied to all listed companies in the US (Persons, 2005). Likewise, in the Saudi context, corporate governance reforms were established in the wake of the 2006 Saudi stock market crisis (Al-Faryan, 2020). Due to this crisis, the Saudi Capital Market Authority (CMA) in 2006 issued the first corporate governance code in Saudi Arabia to alleviate the negative implications of the Saudi stock market crash. The crisis resulted in the Saudi stock market losing about 50% of its market capitalisation at that time.(Gerged & Agwili, 2020). Therefore, the Saudi policymakers introduced the new governance regulations to restore investors' confidence in the Saudi capital market and address the issues that contributed to the Saudi market crash. These issues included the absence of solid governance regulations, weak legal framework, lack of accountability, weak investor protections, and lack of disclosure and transparency in the financial reporting of Saudi listed firms (Bahrawe et al., 2016; Al Nasser, 2020; Al Otaibi, 2019).

Although the introduction of the 2006 Saudi corporate governance code has improved the governance and the disclosure practices of Saudi listed firms (e.g., Al-Janadi et al., 2016; Al-Bassam et al., 2015), the Saudi stock market has witnessed several corporate accounting scandals in recent years (e.g., Mobily)¹ (Zerban, 2018). These accounting scandals have raised public awareness regarding the need for more credible and transparent financial disclosure and the necessity of further improvements in the existing governance regulations in the Saudi market (Algoere & Ali, 2019). Therefore, CMA responded to these issues by introducing a new Saudi corporate governance code in 2017, which replaced the previous corporate governance code issued in 2006 (Algoere & Ali, 2019; Rizvi & Hussain, 2022).

Following the emergence of several accounting scandals worldwide, the topic of corporate governance and earnings management practices has attracted the attention of a significant number of authors and researchers, which manifested in the publication of numerous studies that examine the effectiveness of corporate governance mechanisms in constraining earnings management practices (Abdou et al., 2020; Feng & Huang, 2020; Al-Okaily et al., 2020; Saona et al., 2020; Wan Mohammad & Wasiuzzaman, 2019; Suyono & Farooque, 2018; Katmon & Farooque, 2017; Baatour et al., 2017; Sáenz González & García-Meca, 2014). This literature has been guided by agency theory, which suggests that the divergence of interests between shareholders (the principal) and the managers (the agent) in the public companies causes an agency problem (Jensen and Meckling, 1976). This agency problem stems from several inherent factors in the modern corporation, such as the separation between the management functions and ownership, expensive enforceable contracts, and the information asymmetry between insiders of the firms and shareholders (Hoque, 2006; Jensen and Meckling, 1976). These shortcomings in the agency relationship between managers and absentee owners might induce the managers to involve themselves in earnings management practices (Davidson et al., 2005). Managers might utilise the information asymmetry between insider and outside investors to hide the actual financial information of the firms (Healy & Wahlen, 1999), or they might exercise their discretion on the firms' earnings to meet their interests. For instance, managers might use earnings management practices to

¹ In 2014, Mobily, one of Saudi Arabia's largest telecommunication companies, was reported as a corrupt firm. The investigations conducted by CMA revealed that the company had recorded premature revenue from wholesale broadband leases and mobile promotional campaigns. Therefore, Mobily was required to restate 27 months of earnings, which reduced its profit by 1.76 billion riyals (\$469 million) (Zerban, 2018).

increase the firm's reported earnings to obtain higher compensation value (Healy, 1985; Healy & Wahlen, 1999).

However, such opportunistic behaviours by the managers obviously contradict the company's primary objective, which is maximising the shareholders' wealth. Therefore, to mitigate the agency problem in the modern firms and to prevent opportunistic managerial behaviours, firms should employ an effective monitoring system such as corporate governance mechanisms (Hoque, 2006; Fama and Jensen, 1983; Haniffa and Hudaib, 2006; Bonazzi and Islam, 2007; Peasnell et al., 2005; Abdul Rahman and Haneem Mohamed Ali, 2006). For instance, the presence of the board of directors in the firms as a form of governance mechanism is expected to provide effective monitoring of the managers' activities, the board of directors has oversight of the activities of the firm and is seen as the highest level of decision control systems in the company. Additionally, the board is responsible for monitoring the practices of the top management and overseeing the daily operation of the company (Fama and Jensen, 1983). In the same vein, the presence of the audit committee within the firm's governance system is expected to constrain earnings management practices (Be'dard et al., 2004; Saona et al., 2020; Sharma and Kuang, 2014), since the responsibilities of the audit committee include supervising the process of the financial reporting, evaluating the firm's internal control systems, and ensuring that the external auditor is capable of detecting any manipulation in the financial reporting (Felo et al., 2005; Klein, 2002). Hence, internal corporate governance mechanisms are expected to enhance the integrity and the reliability of the financial reporting process by establishing an effective control system that, in turn, will constrain the opportunistic behaviours of the managers (Katmon & Farooque, 2017; Feng & Huang, 2020; Lehmann, 2016).

Based on this theoretical view, a large and growing body of literature has investigated the effectiveness of corporate governance mechanisms on constraining earnings management practices (Abdou et al., 2020; Feng & Huang, 2020; Al-Okaily et al., 2020; Saona et al., 2020; Wan Mohammad & Wasiuzzaman, 2019; Suyono & Farooque, 2018; Katmon & Farooque, 2017; Baatour et al., 2017; Sáenz González & García-Meca, 2014; Qamhan et al., 2018; Alshetwi, 2016). Although prior studies reveal competing views concerning the effectiveness of corporate governance in constraining earnings management practices, they generally provide supporting evidence for the constraining role of corporate governance on earnings management practices in both developed and emerging markets.

The majority of prior studies in the literature examine the influence of corporate governance mechanisms on earnings management practices by using either the individual corporate governance mechanisms such as board independence, board size, audit independence, and board meetings (Sáenz González & García-Meca, 2014; Rahman & Ali, 2006; Jamaludin et al., 2015; Peasnell et al., 2005; Saona et al., 2020) or by using corporate governance indices to proxy for the corporate governance mechanisms in the companies (Larcker et al., 2007; Bowen et al., 2008; Lehmann, 2016). However, limited studies combine the two approaches (e.g., Elghuweel et al., 2016; Feng & Huang, 2020). Prior studies have used different approaches to proxy for corporate governance mechanisms due to the absence of a unifying theory in the corporate governance literature that guides researchers in constructing corporate governance measures (Al-Najjar & Al-Najjar, 2017; Baker & Anderson, 2010b; Scholtz & Smit, 2015; Brown et al., 2011). Nevertheless, there is no one approach that is superior to the other since both approaches have deficiencies and strengths (Brown et al., 2011; Schnyder, 2012; Baker & Anderson, 2010; Daines et al., 2010). For instance, individual corporate governance measures have limited ability to capture the multidimensional aspects of a corporate governance system (which might correlate with each other), and they cannot reflect on their own the overall quality of corporate governance in the companies (Bekiris and Doukakis, 2011; Brown et al., 2011; Larcker et al., 2007). Consequently, using individual corporate governance measures in the empirical analysis to proxy for a complex concept like corporate governance might induce the risk of correlated omitted variables bias (Larcker et al., 2007; Schnyder, 2012). Unlike individual corporate governance mechanisms, corporate governance indices are broader in the scope as they incorporate several individual corporate governance measures into one index (Elghuweel et al., 2016; Agrawal and Knoeber, 1996; Pergola and Joseph, 2011). This, in turn, might make the governance index capture better the quality of the firms' governance mechanism than individual corporate governance characteristics do. However, despite this advantage of the governance index, computing the governance index might induce higher measurements error than computing individual corporate governance characteristics (Baker & Anderson, 2010; Daines et al., 2010). For instance, measuring a single governance characteristic such as a board's stock ownership involves recording one value leading to lower measurement error (Baker & Anderson, 2010). In contrast, the governance index has numerous provisions covering different governance aspects. Therefore, the probability of making mistakes in recording these values when computing the governance index score is higher than in a single governance characteristic (Baker & Anderson, 2010). Consequently, using such a governance proxy (i.e., governance index) that involves considerable governance measures might lead the statistical analysis to misspecify the relationship between corporate

governance and any economic outcome (Baker & Anderson, 2010). Hence, based on the discussion above, the inherent limitations in constructing corporate governance measures (i.e., single governance mechanisms or governance index) produce governance measures that suffer from low reliability and construct validity (Larcker et al., 2007; Black et al., 2017). Larcker et al. (2007) argue that such governance measures might explain the inconsistency of the results of studies that examine the association between corporate governance and various accounting and economic outcomes.

To overcome the inherent limitations of corporate governance measures, the current study seeks to extend and contribute to the existing literature by first investigating how corporate governance mechanisms influence earnings management practices, using both the compliance-index model (composite governance index is the main independent variable in the model) and the equilibrium-variable model (individual corporate governance characteristics are the main independent variables in the model). Employing both approaches in this study will help capture more precisely the quality of corporate governance in Saudi firms since each approach will offset the limitations of the other². Therefore, the study's findings regarding the effect of corporate governance on earnings management practices will be more conclusive than the findings of prior studies that measure corporate governance by using either the individual corporate governance characteristics or governance index.

Second, the current study contributes to the literature that examine the association between board independence and earnings management practices by developing a comprehensive measure to proxy for strict board independence. The measure contains 11 formal independence criteria extracted from the 2017 Saudi Corporate Governance Code to evaluate the independence of each declared independent director on the board and audit committee of Saudi firms. By using this measure for board and audit independence, this study addresses the limitations of previous studies that used the percentage of independent directors on the board as a proxy for board independence (e.g., Park and Shin, 2004; Peasnell et al., 2005; Saona et al., 2020; Suyono and Farooque, 2018). These studies could be criticised for not considering the quality of the directors' independence when computing the ratio of the independent directors on the board (Crespí-Cladera and Pascual-Fuster, 2014; García-Meca and Sánchez-Ballesta, 2009). Accordingly, their findings regarding the effectiveness of the independent directors in constraining earnings management practices might be questionable.

² Please see section 2.2.1 in the literature review chapter and section 1.5 in this chapter for further discussion on this issue.

However, the developed measure in this study is expected to provide an accurate evaluation of the board independence in the Saudi firms. Therefore, by using this measure, this study is expected to provide accurate and reliable results regarding the effectiveness of board independence in constraining earnings management practices.

Third, this study contributes to the body of literature by examining the influence of family ownership on the association between corporate governance mechanisms (measured by using a comprehensive governance index) and earnings management practices in Saudi listed firms. According to the researcher's knowledge, no single study exists in the literature that examines the effectiveness of corporate governance in reducing earnings management practices in family firms by constructing a comprehensive governance index. Hence, this study is distinct from prior studies that only examined the effectiveness of individual corporate governance mechanisms (e.g., board independence and audit independence) in constraining earnings management practices in family firms (e.g., Prencipe and Bar-Yosef, 2011; Jaggi and Leung, 2007; Jaggi et al., 2009; Wan Mohammad and Wasiuzzaman, 2019). Therefore, the findings of this study are expected to be more convincing since the corporate governance index will be better able to capture the quality of the governance mechanism in the firms than the individual corporate governance characteristics. Therefore, the conclusion of the current study regarding the effectiveness of corporate governance in family firms will not be limited to specific components of corporate governance, such as audit committee characteristics or board composition (Bekiris and Doukakis, 2011).

In the Saudi context, this study makes a number of distinctive contributions. (i) unlike prior Saudi studies that examine the effect of the limited number of individual corporate governance characteristics on earnings management practices (e.g., Alshetwi, 2018; Baatour et al., 2017; Al Nasser, 2021; Habbash, 2012), this study extends these studies by examining the effect of seven individual corporate governance mechanisms (i.e., strict board independent, strict audit committee independent, board size, board meeting, audit meeting, multiple directorships and family members on the board) and four ownership types (i.e., government, institutional, family, and blockholders' ownership) on constraining earnings management practices in Saudi listed companies. Hence, this study can be considered broader in scope than previous Saudi studies. Additionally, it will help expand the current understanding regarding the effectiveness of these governance mechanisms in the Saudi context, which has institutional environments remarkably different from the US or UK.

(ii) Previous Saudi studies (e.g., Alshetwi, 2018; Baatour et al., 2017; Al Nasser, 2021; Althuneibat, 2016; Habbash, 2012) suffer from methodological deficiencies such as ignoring the endogeneity problem and employing a smaller sample size and shorter time scale. Therefore, this study overcomes these limitations by using the instrumental variable approach to address the possible endogeneity which may exist between internal governance mechanisms and earnings management. In addition, this study uses a larger sample size and longer time scale than prior Saudi studies. This, in turn, will allow the researcher to capture more precisely the effects of both cross-sectional and time-series changes in governance mechanisms on earnings management and improve the generalisation of the results (Omar & Simon, 2011; Ntim et al., 2012).

(iii) This study can be considered innovative in the Saudi context since it employs the largest self-constructed SCGI that contains 142 governance provisions. Additionally, this study will provide evidence for the first time on the level of compliance with the 2017 Saudi Corporate Governance Code achieved by Saudi firms.

In a sample of 112 Saudi listed firms from 2006-2017, first, the results of the compliance index model show a statistically significant and negative association between the SCGI and the level of earnings management practices. This implies that Saudi listed firms with better corporate governance standards tend to have lower earnings management practices. However, this result does not hold for firms with high family ownership since the results reveal that the effectiveness of corporate governance (measured by SCGI) in constraining earnings management is reduced in Saudi firms with high family ownership. In a series of sensitivity analyses, the evidence of the study is robust to (i) alternative earnings management models, (ii) endogeneity, and (iii) alternative proxy for the family control.

Second, regarding the equilibrium-variable model, the results indicate that Saudi firms are likely to have lower levels of earnings management if they have a large proportion of strict independent directors on the boards, larger board size, and their audit committees meet more often. Additionally, the results show that Saudi firms with higher government ownership, institutional ownership and family ownership have lower levels of earnings management practices. These results are moderately robust to (i) alternative earnings management models; (ii) endogeneity; and (iii) alternative proxy for strict board independence.

1.1 Research problem

During the past couple of decades, several giant public firms in the western world, such as Enron and WorldCom, have collapsed due to their involvement in fraudulent financial reporting (Ravisankar et al., 2011). Prior studies (Rahman et al., 2016; Persons, 2005; Hasnan et al., 2013) show that these aggressive accounting practices stem from earnings management practices. Similar to western firms, accounting scandals have made their way to the Saudi market in which several Saudi companies have engaged in aggressive accounting practices, resulting in CMA reporting them as corrupt firms (e.g., Mobily and Al-Mojil Group). In addition to these scandals, the Saudi market witnessed a serious market crisis in 2006, which resulted in the Saudi stock market losing about 50% of its market capitalisation at that time (Gerged & Agwili, 2020). These incidents have shaken investor's confidence in the Saudi capital market and raised the shareholders' and stakeholders' concerns regarding the quality of firms' governance mechanisms and the credibility of the financial information disclosed by the companies (Algoere & Ali, 2019). Thus, to restore the confidence of the stakeholders in the Saudi capital markets, Saudi regulatory bodies have reformed corporate governance rules by introducing the Saudi corporate governance code for the first time in 2006 and updating it comprehensively in 2017. The main aim of this reform was to address the factors that led to the Saudi market crash and the occurrence of accounting scandals in Saudi firms. These factors included the absence of solid governance regulations, weak legal framework, lack of accountability, weak investor protections, and lack of disclosure and transparency in the financial reporting of Saudi-listed firms (Bahrawe et al., 2016; Al Nasser, 2020; Al Otaibi, 2019).

Due to the importance of the new governance code to the Saudi market, this study is conducted to investigate whether the new governance code that put forward by CMA is effective in limiting the practices of earnings management, which was the leading cause of the accounting scandals in the Saudi firms (e.g., Mobily and Al-Mojil Group). Furthermore, the current study fills the gap and provides unique contribution to the Saudi governance literature by investigating the effectiveness of this new governance regulation in Saudi Arabia since, according to the researcher's knowledge, no single study provides evidence regarding the efficiency of the new governance regulations in constraining earnings management practices in the Saudi firms. Therefore, this study examines the efficiency of the new governance regulation by first analysing the relationship between the level of compliance of Saudi firms with the Saudi Corporate Governance Code (SCGC) and earnings

management practices by using a self-constructed corporate governance index (i.e., the compliance-index model), that derived mainly from the 2017 Saudi Corporate Governance Code. Second, this study examines the association between several individual corporate governance mechanisms (i.e., the equilibrium-variable model) and earnings management practices in Saudi-listed firms. Third, this study examines the influence of family ownership on the association between corporate governance mechanisms (measured by a comprehensive governance index) and earnings management practices in Saudi-listed firms. Finally, the findings of this study are expected to enhance the current understanding of investors, policymakers and regulatory bodies in Saudi Arabia, such as CMA, the Ministry of Commerce and Tadawul regarding the efficiency of the new governance regulations since this study provides an empirical assessment of the effectiveness of the 2017 Saudi Corporate Governance Code in constraining earnings management practices in Saudi firms.

1.2 Motivation of the Study

First, the researcher is motivated to examine the governance practices in the Saudi context due to raised concern by shareholders regarding the quality of corporate governance practices in the Saudi firms after the collapse of the Al-Mojil Group in 2012 and the occurrence of the accounting scandal of Mobily in 2014 (Algoere & Ali, 2019). Regulatory bodies in Saudi Arabia have responded to this concern by reforming corporate governance regulations to strengthen corporate governance practices and increase the credibility and transparency of financial disclosure in Saudi firms (Al-Faryan, 2020). Specifically, CMA introduced a new Saudi corporate governance code in 2017, which replaced the previous corporate governance code issued in 2006 (Algoere & Ali, 2019; Rizvi & Hussain, 2022). According to the researcher's knowledge, there is no single study in the Saudi governance literature that investigate the effectiveness of this new governance regulation in Saudi Arabia. Thus, this study is motivated to fill this gap by examining the relationship between the level of compliance of Saudi firms with the Saudi Corporate Governance Code (SCGC) and earnings management practices using a self-constructed corporate governance index (i.e., the compliance-index model), that derived mainly from the 2017 Saudi Corporate Governance Code. In addition, this study provides evidence for the first time regarding the efficiency of the new independence criteria provided by the 2017 Saudi Corporate Governance Code to assess the quality of the independence of independent directors on the board of Saudi firms. It is worth mentioning that earnings management practices are selected

in this study to be the benchmark that demonstrates the strength and the quality of the corporate governance practices in Saudi firms because these practices were the leading cause of the collapse of the Al-Mojil Group (Zerban, 2018). Also, they were used by Mobily firm to manipulate its reported earnings (Zerban, 2018). Thus, strong corporate governance mechanisms are expected to focus on constraining earnings management practices in the firms due to their negative consequences on the firms and their stakeholders (Abdou et al., 2020; Feng & Huang, 2020; Al-Okaily et al., 2020; Saona et al., 2020). Hence, this study examines the quality of governance practices in Saudi Arabia from an earnings management perspective.

Second, the agency theory framework provides the theoretical motivation for the researcher to examine the effect of corporate governance mechanisms in limiting earnings management practices. Agency theory suggests divergence of interests and asymmetric information problems between shareholders (the principal) and the managers (the agent) in public companies, which causes an agency problem (Jensen and Meckling, 1976). Managers might utilise the information asymmetry between insiders and outsider investors to hide the actual financial information of the firms (Healy & Wahlen, 1999) or use earnings management to increase the firm's reported earnings to obtain higher compensation value (Healy, 1985; Healy & Wahlen, 1999). In order to mitigate the agency problem in public firms and to prevent opportunistic managerial behaviours, agency theory suggests employing an effective monitoring system such as corporate governance mechanisms in the firms (Hoque, 2006; Fama and Jensen, 1983; Haniffa and Hudaib, 2006; Bonazzi and Islam, 2007; Peasnell et al., 2005; Abdul Rahman and Haneem Mohamed Ali, 2006). For instance, the presence of the board of directors in the firms as a form of governance mechanism is expected to monitor the managers' activities effectively. Since one of the primary responsibilities of the board is to monitor the practices of the top management and overseeing the company's daily operations (Fama and Jensen, 1983). In addition, Fama and Jensen (1983) suggest that the board of directors should include outside independent directors, which can increase the board of directors' effectiveness and decrease agency problems. Since independent directors do not have personal interests in the firms, thus, they are more willing to act in favour of shareholders' interests and provide effective monitoring (Agrawal & Chadra, 2005; Razali & Arshad, 2014; Shan et al., 2013). In the same vein, the presence of the audit committee within the firm's governance system is expected to constrain earnings management practices (Be'dard et al., 2004; Saona et al., 2020; Sharma and Kuang, 2014) since the main responsibilities of the audit committee are to supervise the process of the financial reporting, evaluate the firm's internal control systems, and ensure that the external auditor is capable

of detecting any manipulation in the financial reporting (Felo et al., 2005; Klein, 2002). Hence, internal corporate governance mechanisms are expected to enhance the integrity and the reliability of the financial reporting process by establishing an effective control system that, in turn, will constrain the opportunistic behaviours of the managers (Katmon & Farooque, 2017; Feng & Huang, 2020; Lehmann, 2016). Based on the above discussion, the current study examined the effect of corporate governance mechanisms on earnings management practices based on the agency theory perspective.

Third, this study investigates the effectiveness of the governance practices in constraining earnings management practises in the Saudi context for the following five reasons.

1. Saudi Arabia is an Islamic state where Islam is the country's official religion (Al-Faryan, 2020). The constitution of Saudi Arabia is the Holy Quran (a religious book that contains the words of God) and the Sunnah (the traditions, practices and sayings of the Prophet Muhammad; peace be upon him) (Al-Faryan, 2020). In Saudi Arabia, Islam extensively influences all aspects of Saudis' life (Al-Faryan, 2020). As a comprehensive religion, Islam has established sets of rules and regulations that should be adhered to by its followers (Sulphey, 2015). Islamic regulations come from the Shariah (Islamic law) that derives from the teaching of the Holy Quran and the Sunnah (Sulphey, 2015). The Shariah of Islam provides a comprehensive guideline for Muslims in all aspects of their lives, including politics, economics, religion, law, environment, business, banking and society (Sulphey, 2015; Abu-Tapanjeh, 2009). Accordingly, Shariah guidelines are not limited to religious rituals (Sulphey, 2015). Shariah recognises that Muslims certainly will involve themselves in secular material transactions in their life. However, Shariah emphasises that such dealings should be directed by the values of accountability, trustworthiness, equity, fairness, morality, responsibility, and social justice that are embedded in the Islamic principles (Albassam & Ntim, 2017). For example, Islam encourages Muslims to conduct their business in line with the Shariah rules that business practices should be ethical, fair, honest and just (Abu-Tapanjeh, 2009; Lewis, 2005). Therefore, Shariah rules prohibit all forms of manipulations and exploitation in business and prohibit business people from deceiving and exploiting others (Sulphey, 2015; Abu-Tapanjeh, 2009; Lewis, 2005). Additionally, Shariah rules prohibit practices like price-fixing, interest and monopolies to prevent the powerful group in the market from exploiting the others (Lewis, 2005). Furthermore, Islam is concerned about the social commitments of the business activities. Therefore, trading and investing should only be done in the

course of legitimate business operations. For example, activities like gambling are prohibited in Islam because they are detrimental to society (Lewis, 2005). Additionally, there are distinctive values in Islam such as accountability and trustworthiness (emanating mainly from the Shariah rules) that might positively impact the operations of the firms in Islamic countries. These Islamic values will be explained in detail as follows: Accountability is one of the fundamental ethical values in Islam that derive from the Quran and the Sunnah of Prophet Muhammad; peace be upon him. Islamic accountability means that humans are made accountable to God for all their deeds and words (Sulphey, 2015; Abu-Tapanjeh, 2009). In addition to the accountability to God Almighty, the accountability in Islam entails that humans are accountable to all parties that they might form contractual relationships with or have responsibilities toward, such as managers, employees, companies, local community, shareholders and environment (Sulphey, 2015; Lewis, 2005; Abu-Tapanjeh, 2009). The accountability in Islam was highlighted by Prophet Muhammad; peace be upon him, as he said, “Each one of you is a guardian, and each guardian is accountable to everything under his care” (Sahih al-Bukhari). Ahmed et al. (2013) and Abu-Tapanjeh (2009) argue that the concept of accountability in Islam is broader than its counterpart in the West, since the accountability in the Western corporate governance model might be limited to the board of directors, management, firms, stakeholders or the society, however, in Islam, accountability is not only limited to these certain groups, but the person is accountable first to God Almighty, the ultimate authority. Additionally, unlike the Western concept of accountability that holds the person accountable for their written and defined obligations only, accountability in Islam makes the individual accountable for all their oral pledges as well as all written, defined obligations (Ahmed et al., 2013). Accordingly, the concept of Islamic accountability might strengthen the effectiveness of the board of directors in performing their duties, as the directors of the board are holding themselves accountable to God Almighty in the first place, who monitors them in all times and places, in addition to their accountability to the shareholders and other firms’ stakeholders. Furthermore, Abu-Tapanjeh (2009) and Sulphey (2015) state that firms guided by Islamic accountability are expected to produce accurate, fair, transparent and timely disclosure to all their stakeholders and provide accurate and correct information regarding their financial performance. Trustworthiness in Islam means that every person is a trustee of all the worldly wealth that belongs to God Almighty regardless of their position, so managers, shareholders, directors or any other stakeholders are entrusted with all the company's wealth (Sulphey, 2015;

Lewis, 2005). Hence, Muslims are expected to be honest, fair, truthful and responsible in fulfilling their obligations of being trustees of God's wealth (Lewis, 2005). In this regard, Quranic verses and Sunnah texts have exhorted Muslims to be trustworthy. For example, God says in the Holy Quran in Sura al-Anfal (8:27), "O you who believe! Betray not the trust of Allah and the Messenger, nor betray knowingly things entrusted to you.". Additionally, regarding the importance of trustworthiness in Islam, Prophet Muhammad, peace be upon him, said, "An honest and trustworthy merchant will be with the Prophets, the honest men and the martyrs on the Day of Judgment" (Sunan al-Tirmidhi). Therefore, by applying the concept of Islamic trustworthiness to the corporate context, it is expected that firms that follow Shariah rules and adopt the Islamic values in their operations might avoid earnings management practices because it is considered a form of manipulation and dishonesty that is prohibited in Islam, since Islam commands individuals to conduct business activities in a just, fair and honest manner and prohibits exploiting and deceiving people (Lewis, 2005; Abu-Tapanjeh, 2009). Therefore, Islamic firms entrusted with shareholders' wealth are expected to avoid engaging in earnings management practices as these practices might lead to exploiting shareholders' wealth. However, it is worth mentioning that there are significant similarities between the Islamic principles such as accountability, transparency, trustworthiness, equal distribution of wealth and commitment to the whole society and the governance standards. Abu-Tapanjeh (2009) argues that applying corporate governance practices might be equivalent to meeting several Islamic principles due to the similarities between the two concepts. Therefore, firms in Islamic countries are expected to adhere to governance practices because they correspond to the Islamic principles that Muslims are enthusiastic to meet because they are a part of their religious obligations (Abu-Tapanjeh, 2009). Albassam and Ntim (2017) empirically found that Saudi listed firms that incorporate Islamic values into their business operations produce higher corporate governance disclosure than firms that do not incorporate any Islamic values into their business operations. This finding indicated that Saudi firms that are guided by Islamic values in their operations have good governance quality, since these Islamic values have influenced the Saudi firms to increase their disclosure and transparency regarding their governance practices (Albassam & Ntim, 2017). Hence, it can be argued from the above discussions that Islamic regulations and values might influence the application of corporate governance mechanisms and earnings management practices in the firms. Therefore, the corporate governance mechanisms and the earnings management might be uniquely different in Saudi firms

from those in firms operating in developed/non-Islamic countries. Therefore, the effectiveness of corporate governance mechanisms in constraining earnings management practices in Saudi firms that are influenced by Islamic principles and values is a highly interesting topic of investigation, since Saudi firms might adopt several Islamic values that may work hand in hand with the governance mechanisms in reducing earnings management practices. Additionally, the motivations for applying good governance practices or avoiding earnings management in Saudi firms might be driven by religious factors, such as accountability to God Almighty and following Shariah rules in conducting honest, fair and just business, instead of being driven by secular factors such as legal liability, adherence to the regulations, or accountability to shareholders and other stakeholders. Therefore, the findings of this study are expected to shed light on the effectiveness of the corporate governance mechanisms on constraining earnings management practices in firms operating in solidly Islamic countries like Saudi Arabia.

2. Similar to the majority of Arab countries but distinct from most developed countries, Saudi Arabia is characterised by having a solid hierarchical social structure (Al-Twajjry et al., 2002; Haniffa & Hudaib, 2006), whereby the social ties between families and tribes are also solid in the society (Al-Bassam et al., 2015; Hussainey & Al-Nodel, 2008; Al Nasser, 2020). Since the family is a central pillar in Saudi society, this in turn impacts the ownership structure of the Saudi firms, in which the majority of Saudi listed companies have concentrated ownership mainly in the hands of families (Alhebbri and Al-Duais, 2020). Therefore, in such a context, tribal, family and personal relationships might be given more importance and priority than formal corporate governance mechanisms such as board responsibilities in the Saudi firms (Hussainey & Al-Nodel, 2008; Al Nasser, 2020). However, the implications of the domination of families in the Saudi firms appear in the structure of the corporate boards. As mentioned in the chapter five, the board of directors of Saudi firms is dominated by family members. On average, 22.44% of the board directors in Saudi firms are family members. Furthermore, half of the Saudi firms (50%) have a family member who occupies the board's chairman position. One of the negative implications of the presence of family members on the board is that they can influence the process of electing and nominating the independent directors on the board (Jaggi et al., 2009; Al-Okaily et al., 2020). As a result, independent directors of family firms are expected to be less objective and independent because their appointment and reappointments on the board might depend on the discretion of

controlling family members (Bao and Lewellyn, 2017). Additionally, the independent directors in family firms might have an implicit relationship with the controlling family members (Prencipe and Bar-Yosef, 2011). Such a relationship might increase the risk of collusion between the independent directors and controlling families in the firms (Prencipe and Bar-Yosef, 2011). Additionally, controlling families in the firms might tend to appoint their relatives as CEO or as board members (Anderson & Reeb, 2003). This implies that the individual's appointment in the family firms might not occur based on their qualifications or merit but instead on the informal and personal relationship with controlling families (Al-Bassam et al., 2015). Regarding the influence of the controlling families on the firms, prior studies show that the effectiveness of the corporate governance mechanisms is reduced in family-controlled firms (Prencipe and Bar-Yosef, 2011; Jaggi et al., 2009; Wan Mohammad and Wasiuzzaman, 2019). Therefore, based on the above discussion, this study is motivated to examine the effectiveness of the 2017 Saudi Corporate Governance Code in constraining earnings management practices in Saudi firms that are highly dominated by family members.

3. Saudi Arabia is one of the most important and largest economies in the world as it is part of the G20 (World Bank, 2021). The Gross Domestic Product (GDP) of Saudi Arabia was worth \$700.12 billion in 2020, making it the world's 19th largest economy (World Bank, 2021). Furthermore, Saudi Arabia is the second-largest oil producer globally, and it holds around 17% of the world's oil reserves (OPEC, 2021). Therefore, Saudi's economy depends heavily on oil revenues as they account for 70% of the country's export earnings and around 50% of its GDP (OPEC, 2021). Accordingly, to reduce the country's dependency on oil resources, Saudi Arabia in 2016 launched Saudi Vision 2030, which aims to increase non-oil international trade, increase the contribution of the private sector, diversify the Saudi economy, and make it a sustainable economy (Vision 2030, 2021). Additionally, in line with the Saudi vision, the Saudi government aims to diversify the funding sources for its government sector by encouraging the privatisation of state-owned firms through IPOs on the Saudi Stock Exchange (Vision 2030, 2021). This practice, in turn, is expected to increase the market capitalisation of the Saudi Stock Exchange (Vision 2030, 2021). Recently, the Saudi market has been included in the world's largest index providers such as MSCI, S&P Dow Jones and FTSE Russell (Inside 200 listed securities, 2021). This, in turn, has increased the contribution of foreign investors in the Saudi capital market as Saudi Stock Exchange has become accessible to

international investors (Inside 200 listed securities, 2021). It is worth mentioning that the Saudi stock market is the 9th largest stock market among the 67 members of the World Federation of Exchanges, and it accounts for 78% of the total market capitalisation of all MENA exchanges (Saudi Exchange, 2021). Additionally, the Saudi stock exchange is the largest in the Middle East (Saudi Exchange, 2021). Therefore, given the importance of the Saudi economy to the global economy and the importance of the Saudi capital market, it is crucial to examine the effectiveness of the corporate governance system in Saudi firms, since any failure in the governance mechanism in Saudi Arabia might lead to negative implications that extend beyond the Middle East and emerging markets. For instance, an ineffective corporate governance system in Saudi firms might result in losses to both local and foreign investors (Al-Bassam et al., 2015). Hence, the study is motivated to examine the effectiveness of corporate governance in constraining earnings management practices in the Saudi context.

4. The Saudi corporate governance regulations have witnessed remarkable reforms after the announcement of the Saudi Vision 2030 in 2016 (Alregab, 2021; Rizvi & Hussain, 2022). These reforms manifested in the release of novel corporate governance regulations by CMA (Algoere & Ali, 2019; Al-Faryan, 2020). In 2017, CMA introduced a new Saudi corporate governance code that replaced the previous corporate governance code issued in 2006 (Algoere & Ali, 2019). The purpose of introducing the new Saudi corporate governance code is to strengthen the governance practices of the Saudi companies, ensure uniformity of the local governance practices with international governance standards, promote accountability and transparency in the Saudi listed firms, attract foreign investors and boost the investors' confidence in the Saudi capital market (Rizvi & Hussain, 2022; Algoere & Ali, 2019; Alregab, 2021). Therefore, the current study is motivated to investigate the effectiveness of the new implemented corporate governance regulations in the Saudi listed firms. To achieve this aim, the study constructed a broad Saudi Corporate Governance Index (SCGI) that contains 142 corporate governance provisions extracted from the 2017 Saudi corporate governance code. The SCGI is used in this study to measure the compliance of the Saudi firms with the requirements of the 2017 Saudi corporate governance code. Furthermore, the study examines the effect of the compliance with the provisions of the 2017 Saudi corporate governance code on constraining earnings management practices in Saudi listed firms. Conducting this research will provide a clear picture of the effectiveness of the newly implemented governance practices in

the Saudi firms and will facilitate the evaluation of the efficiency of the new governance regulations in the Saudi context. Hence, the results of this study are expected to be of great benefit to policymakers and regulators as these results will demonstrate whether the current Saudi governance code has enhanced the governance practices in Saudi companies. In addition, the empirical results of this study might assist investors in making rational decisions regarding investment in the Saudi stock market.

5. Saudi Arabia is a developing country characterised by having (i) solid hierarchical social structure, (ii) concentrated ownership, (iii) lack of effective enforcement of governance practices, (iv) weak shareholder activism, (v) low level of foreign investors, (vi) weak market for managerial labour and corporate control, (vii) high influence of government and royal family in the stock market, and (viii) weak protection of the rights of minority shareholders (Al Nasser, 2020; Alhebri & Al-Duais, 2020; Al-Bassam et al., 2015; Al-Janadi et al., 2016; Habbash & Alghamdi, 2016). Accordingly, these factors mentioned above might induce managers of firms operating in developing countries to involve themselves in earnings management practices without the fear of being legally liable (Bao and Llewellyn, 2017; Ali et al., 2007; Chi et al., 2015). In this regard, Leuz et al. (2003) documented that earnings management practices are higher in developing countries that have concentrated ownership, weak investors' rights and ineffective regulations. Therefore, the contextual challenges embedded in developing countries like Saudi Arabia raise an important empirical question about the effectiveness of the governance mechanisms in constraining earnings management practices in Saudi listed firms. Hence, the current study aims to investigate the effectiveness of the 2017 Saudi governance code in improving the corporate governance standards in the Saudi context. The findings of this study are expected to provide new insights regarding the effectiveness of corporate governance practices in developing countries.

1.3 Research objectives

The main aim of this study is to examine the effect of corporate governance mechanisms on earnings management practices in the Saudi context. Five objectives are drawn from this main aim as follows:

First, this study intends to examine whether better-governed firms are associated with lower levels of earnings management practices. To achieve this aim, the researcher conducts SCGI to measure the compliance of the Saudi firms with the governance provisions provided in the 2017 SCGC. Then, the researcher studies the association between SCGI and earnings management practices in Saudi firms.

Second, this study attempts to ascertain how the board of directors' characteristics can explain the observable changes in firm-level earnings management practices. To achieve this aim, the researcher examines the effect of strict board independence, board size, board meetings, multiple directorships and the presence of family members on the board on earnings management practices in Saudi firms.

Third, this study examines the association between audit committee characteristics and earnings management practices. Hence, to achieve this aim, the researcher studies the effect of strict audit committee independence and audit committee meeting on earnings management practices in Saudi firms.

Fourth, this study attempts to ascertain whether ownership structures can explain the observed variability in the levels of earnings management practices. Hence, to achieve this aim, the researcher examines the effect of several types of ownership structures: government, institutional, family, and blockholders ownership, on constraining earnings management practices.

Finally, this study seeks to investigate the role of family ownership in the association between the level of compliance with Saudi governance provisions and earnings management practices.

1.4 Research Questions

Given the unique aspects of the Saudi corporate context discussed above (section 1.2), this study aims to investigate how a broad composite SCGI and other corporate governance variables can explain the observable changes in firm-level earnings management practices in Saudi firms. To achieve this aim, this study seeks to answer the following research questions:

1. What is the association between the level of compliance with the Saudi Corporate Governance Code (SCGI) and earnings management practices?
2. What is the association between the board of directors' characteristics and earnings management practices?
3. What is the association between audit committee characteristics and earnings management practices?
4. What is the association between ownership structures and earnings management practices?
5. What is the family ownership's effect on the association between firm-level corporate governance and earnings management practices?

1.5 Contributions of This Study

The current study aims to contribute to the literature that investigates the association between corporate governance mechanisms and earnings management practices in the international and Saudi contexts.

First, this study contributes to the literature by examining the influence of corporate governance practices on earnings management, using both the equilibrium-variable model (individual corporate governance characteristics as the main independent variables in the model) and the compliance-index model (a composite governance index as the main independent variable in the model). The majority of prior studies in the literature examine the influence of corporate governance on earnings management practices by using either the individual corporate governance characteristics (Sáenz González & García-Meca, 2014; Rahman & Ali, 2006; Jamaludin et al., 2015; Peasnell et al., 2005; Saona et al., 2020) or by using a corporate governance index as a proxy for the corporate governance system in the companies (Larcker et al., 2007; Bowen et al., 2008; Lehmann, 2016). However, there are limited studies that combine the two methods (e.g., Elghuweel et al., 2016; Feng & Huang, 2020). It is fundamental to the study results to examine the influence of corporate governance on earnings management by using both the individual corporate governance characteristics and the composite governance index. This is because both approaches have

deficiencies that can be eased if they are used jointly³. Hence, using both the equilibrium-variable model and the compliance-index model will help the researcher to capture more precisely the role of corporate governance in earnings management practices, since each approach will offset the limitations of the other.

Second, the study contributes to the literature by developing a measure to act as a proxy for strict board independence. This measure is used to evaluate the strict independence of each declared independent director on the board of directors /audit committee by using 11 formal independence criteria extracted from the 2017 Saudi Corporate Governance Code. Next, the study uses this measure to examine the impact of strict board/audit independence on constraining earnings management practices in Saudi listed firms. Therefore, this study differs from prior studies that examine the effectiveness of board independence on reducing earnings management practices by using the percentage of independent directors declared by the firms as a proxy for board independence (e.g., Park and Shin, 2004; Peasnell et al., 2005; Saona et al., 2020; Suyono and Farooque, 2018). These studies assume that the higher the proportion of independent directors on the board, the more the board is independent and effective in performing its monitoring tasks (Stockmans et al., 2013). These studies do not consider the quality of the directors' independence when they are computing the ratio of the independent directors (Crespí-Cladera and Pascual-Fuster, 2014; García-Meca and Sánchez-Ballesta, 2009). In this regard, Baker and Anderson (2011) argue that using the percentage of independent directors as a proxy for the board's independence might not be an accurate measure, since not all independent directors have a similar level of independence, as their independence might be negatively affected by other factors in the firms. Consequently, their effectiveness will be questionable too. Furthermore, it is not accurate to treat all the independent directors in the firms as a homogenous group in terms of their independence and effectiveness, since prior studies (Francis et al., 2012; Coles et al., 2014) find that not all independent directors are effective monitors. For example, Coles et al. (2014) examine whether the effectiveness of the monitoring differs between independent directors who are appointed by the CEO of the firms (co-opted by the CEO) and independent directors who are not appointed by the CEO (non-co-opted). In contrast to independent directors who are co-opted by the CEO, the study found that independent directors who are non-co-opted by the CEO (truly independent directors) are associated with a lower level of CEO pay, a higher sensitivity of CEO turnover to performance and lower investment. This result indicates that non-co-opted independent directors are more effective in monitoring the CEOs of the firm

³ For further details for how using the equilibrium-variable model and the compliance-index model complement each other, please see section (2.2.1) in chapter two.

than independent directors who are co-opted by the CEO. Therefore, due to the variations in the level of the independent directors, and the inability of the traditional measure of board independence used in prior studies to capture these variations (Baker and Anderson, 2011), one should exercise caution in attempting to draw inferences regarding the effectiveness of board independence in reducing earnings management practices. Hence, based on the above discussion, it is recommended to construct an encompassing measure of board independence that distinguishes between independent directors with strong independence and those with weak independence. Therefore, the current study defines strict independent directors as those independent directors who meet all the 11 formal independence criteria recommended by the 2017 Saudi corporate governance code. Any independent directors who violate at least one of the 11 independence criteria will not be considered as strict independent directors and will be excluded from the measure of strict board independence. This measure is expected to function precisely as a proxy for the board independence of the Saudi firms. Additionally, by using this measure, the current study is expected to provide accurate results regarding the effectiveness of board independence in constraining earnings management practices. Accordingly, the study's findings show that strict board/audit independence is effective in reducing earnings management practices. In contrast, non-strict board/audit independence is not effective in reducing earnings management practices.

Third, this study contributes to the body of literature by examining the effect of firm-level corporate governance in constraining earnings management practices in the family firm. Firm-level corporate governance is measured by constructing a comprehensive governance index. Prior studies examined the effectiveness of corporate governance in family firms by using only the individual corporate governance characteristics, such as board independence and audit independence, as a proxy for the overall governance system (e.g., Prencipe and Bar-Yosef, 2011; Jaggi and Leung, 2007; Jaggi et al., 2009; Wan Mohammad and Wasiuzzaman, 2019) . According to the researcher's knowledge, no single study exists which examines the effectiveness of corporate governance in reducing earnings management practices in family firms by constructing a comprehensive governance index.

Using a comprehensive governance index is fundamental to the study's results, since using individual corporate governance characteristics as a proxy for the overall governance system in the firms is subject to considerable criticism in the literature. For example, Agrawal and Knoeber (1996) argue that it is not an accurate practice to use individual corporate governance characteristics as a proxy for firm governance, since corporate governance mechanisms might interrelate with each other. Furthermore, Bekiris and Doukakis (2011)

and Jiang et al. (2008) state that single corporate governance measures cannot capture the multidimensional aspects of a corporate governance system. In the same vein, Brown et al. (2011) state that measuring only a single component of corporate governance characteristics (e.g., board independence) cannot reflect on its own the overall quality of corporate governance systems in the companies. Unlike using individual corporate governance characteristics, using a corporate governance index has several advantages. For instance, Pergola and Joseph (2011) state that using a corporate governance index that incorporates the assessment of various corporate governance mechanisms might offer reliable criteria for ranking the companies based on the strengths of their corporate governance systems. Moreover, proponents of the use of a corporate governance index for measuring corporate governance mechanisms in a company state that a governance index provides more convincing evidence regarding the effect of corporate governance factors on the quality of earnings than individual corporate governance characteristics (Jiang et al., 2008; F. Bekiris & Doukakis, 2011; Brown et al., 2011). This is because a corporate governance index is more comprehensive by virtue of incorporating several individual measures of the corporate governance system into one index. Additionally, such an index might account for the interrelation effect between different corporate governance mechanisms (Elghuweel et al., 2016; Agrawal and Knoeber, 1996). Hence, the current study will contribute to the existing literature by studying the influence of family ownership on the association between corporate governance mechanisms (measured by the comprehensive governance index) and earnings management practices in Saudi listed firms. The findings of this study are expected to be more convincing, since the corporate governance index will be better able to capture the quality of the governance mechanism in the firms. In addition, the conclusion of the current study regarding the effectiveness of corporate governance will not be limited to certain components of corporate governance, such as audit committee characteristics or board composition (Bekiris and Doukakis, 2011).

Fourth, the study contributes to the literature by using a self-constructed comprehensive corporate governance index that derives from Saudi governance regulations. Prior studies (e.g., Bekiris and Doukakis, 2011; Abbadi et al., 2016) could be criticised as adopting governance indices based on international governance codes and using such indices to measure the corporate governance quality for firms located in different countries. Such a practice is problematic because the governance index developed based on the international governance codes might not accommodate the governance arrangements needed for firms located in developing countries (Bhagat et al., 2008). Cuervo (2002), in his study, demonstrates that there are numerous differences between the corporate governance systems

of Anglo-American countries (developed countries) and the governance system in developing countries. Hence, different corporate governance arrangements are needed for companies in each of these systems (Bozec and Bozec, 2012). For example, in developing countries, due to the concentrated ownership and the possible influence of these controlling shareholders on the board of directors, Bozec and Bozec (2012) suggest that companies with controlling shareholders should focus on governance arrangements that ensure the independence of the board of directors from the controlling shareholders. However, companies with dispersed ownership structures, such as in developed countries, should focus on the independence of the board of directors from the management. Furthermore, the procedures used to monitor the management of firms operating in developed countries are different from those used in firms in developing countries. For example, effective monitoring of the managers in firms located in developed countries can be achieved through the risk of hostile takeover, independent boards, incentive payments, and a high level of disclosure and transparency (Schnyder, 2012). In contrast, due to the absence of the threat of hostile takeover, effective board independence, and a high level of disclosure and transparency in developing countries, monitoring of managers can be practised by larger shareholders (Schnyder, 2012). However, both combinations of governance arrangements might be equally effective, and all of them may provide effective monitoring of the managers (Bhagat et al., 2008).⁴

In addition, another reason for the inefficiency of using governance indexes developed based on international governance codes is that these governance regulations are designed based on what are considered good governance practices in developed countries; thus, they are not suitable for firms located in developing countries. For instance, Bhagat et al. (2008) argue that governance regulations in the US, such as the Sarbanes-Oxley act (SOX act), provide mandatory regulations which are suitable for firms operating in developed countries. For example, this regulation requires firms to have a majority of independent directors on their boards, as this is considered good governance practice for US firms. However, in developing countries, this practice might not be considered suitable for the firms because the board of

⁴ It is worth mentioning that neither governance system is perfect, and each has some limitations (Cuervo, 2002). For example, in developed countries, the market for corporate control is expensive, and it requires a huge deviation from what is considered as acceptable behaviours of the managers in order to function appropriately (Cuervo, 2002). Another limitation of this mechanism is that firms might adopt anti-takeover defences that aim to protect the managers (Jensen, 1993). However, in developing countries, monitoring by large shareholders might be limited since large shareholders might pursue their personal interests at the cost of minority shareholders (Claessens and Fan, 2002; Shleifer & Vishny, 1997).

directors usually is not effective in developing countries, due to several factors such as the presence of effective monitoring by large shareholders, which might reduce the need for independent directors in monitoring the managerial practices (the substitution effect, e.g., Rediker & Seth, 1995). Additionally, the board of directors in developing countries might not be effective, as they are controlled by large shareholders (Jaggi et al., 2009; Abu Siam et al., 2018; Jaggi and Leung, 2007). Consequently, the SOX requirements for majority independent directors on the board might not be considered good and relevant governance practices in firms operating in developing countries, since what matters the most in these firms is not the number of independent directors on the board but to what extent those independent directors are independent from controlling shareholders (Bozec and Bozec, 2012). Therefore, using the indices constructed in developed countries to evaluate the governance quality of firms in developing countries might harm the internal validity of the governance indices (Bozec and Bozec, 2012). Two factors explain the inefficiency of these governance indices. First, such a governance index will rank the firms by how closely their governance practices adhere to what the regulations define as good governance practices rather than by whether these governance practices are suitable to the firms or not (Bhagat et al., 2008). Second, these indices might give more weight to governance arrangements that are not relevant to firms operating in developing countries, such as takeover defences or monitoring by the board of directors (Bebchuk & Hamdani, 2009). Hence, Bhagat et al. (2008), in this regard, state that the most efficient corporate governance measure is the measure that depends on the context of the firms and accommodates the firms' specific circumstances and governance arrangements. Hence, Bhagat et al. (2008) recommended measuring corporate governance mechanisms by constructing a governance index that accommodates the firms' specific circumstances and their governance needs.

Therefore, to address the limitations of prior studies that used governance indices developed based on international governance codes (e.g., Bekiris and Doukakis, 2011; Abbadi et al., 2016), the current study uses a self-constructed corporate governance index derived mainly from the 2017 Saudi Corporate Governance Code. This index might be considered broad in scope and applicable to the Saudi context since it is derived from Saudi governance regulations. In this regard, Black et al. (2017) empirically found that constructing a governance index by using country-specific governance elements leads to an increase in the construct validity of the governance index. This is because these country-specific governance elements reflect the local norms, institutions, and data availability of the governance arrangements in the company. Furthermore, constructing a governance index based on the local governance regulations means that the governance index will incorporate

governance provisions that deal with the required governance arrangements that should be available in the firms. For example, the highly concentrated ownership found in Saudi Arabian listed companies might create the conditions of a new agency problem (agency problem type II), where there is a conflict of interest between majority and minority shareholders (Aguilera et al., 2012). Aguilera and Desender (2012) argue that, due to the possible existence of a different agency problem, the governance index should contain governance provisions that deal with the specific type of agency problem. Otherwise, the governance index would suffer from major limitations. Hence, listed companies in Saudi Arabia require governance arrangements that solve the agency problem found in these companies (agency problem type II). The 2017 Saudi governance code developed by the Capital Market Authority in Saudi Arabia has introduced specific corporate governance provisions to solve the type II agency problem.

The 2017 Saudi corporate governance code requires specific terms of independence to be met by the independent directors. For instance, it requires that (i) independent directors shall not own 5% or more of the company's shares, (ii) in order to prevent possible collusion between the independent directors and the majority shareholders in the companies, the independent directors shall not have a blood relationship with shareholders who own 5% or more of the shares of the company, and (iii) the independent directors shall not have a blood relationship with any of the other independent directors and executives of the company. The focus on the blood relationship in these requirements stems from the fact that Saudi listed companies have concentrated ownership mainly in the hands of families (Alhebri and Al-Duais, 2020).

These requirements are in line with the Bozec and Bozec's (2012) suggestions that companies with controlling shareholders should focus on governance arrangements that ensure the independence of the board of directors from the controlling shareholders in companies. These terms of independence, which are required for independent directors, will be placed in the current study index (provisions no. 7-17) in order to check the independence of the independent directors of Saudi companies. In addition, in order to protect minority shareholders' interests, the Saudi corporate governance code (2017) focuses on increasing the disclosure and transparency of the company. For example, the Saudi code requires the board to disclose the procedures adopted to inform its members of suggestions and notes provided by the shareholders about the performance of the company. In addition, the dividends policy and related party transactions should be disclosed in the annual reports of the companies. These requirements are transferred in the form of governance provisions in

this study's governance index (provisions no. 80, 100 and 102 respectively). Hence, the Saudi corporate governance index used in this study will be relevant for assessing the corporate governance system in the Saudi listed companies, since it covers the governance provisions designed to solve the specific type of agency problem that exists in developing countries like Saudi Arabia.

There are a limited number of Saudi studies that examine the effect of corporate governance mechanisms on earnings management practices (e.g., Alshetwi, 2018; Baatour et al., 2017; Al Nasser, 2021; Al-thuneibat, 2016; Habbash, 2012). These studies can be classified into two groups. The first group consists of studies that examine the effect of the several individual corporate governance characteristics on constraining earnings management practices (e.g., Alshetwi, 2018; Baatour et al., 2017; Al Nasser, 2021; Habbash, 2012). The second group includes studies that test the effect of corporate governance mechanisms on earnings management practices by constructing a governance index (e.g., Al-thuneibat, 2016). The current study extends and contributes to all Saudi studies in both groups.

Regarding the Saudi studies in the first group, reviewing these studies shows that they have mainly focused on examining the effect of board and audit committee characteristics on constraining earnings management practices. These studies, in general, suggest that better-governed firms tend to have lower earnings management practices than their poorly governed counterparts (e.g., Alshetwi, 2018; Baatour et al., 2017; Al Nasser, 2021; Al-thuneibat, 2016; Habbash, 2012). Nevertheless, these studies suffer from several limitations. First, these studies examine the effect of the relatively limited number of corporate governance factors on earnings management practices. For instance, Alshetwi (2018) and Baatour et al. (2017) examine the effect of only one corporate governance mechanism in relation to earnings management practices. Baatour et al. (2017) examine the effectiveness of multiple directorships on reducing accrual-based earnings management and real earnings management practices. Alshetwi (2018) examines the effect of board independence on constraining earnings management practices. Furthermore, according to the researcher's knowledge, there is no single Saudi study in the literature investigating the effect of ownership structures on earnings management practices. Second, prior Saudi studies used a small sample size and a short time scale, covering only one or five years. For instances, Al Nasser (2021) used a sample of 97 Saudi listed firms during the period from 2009-2013, and Al-thuneibat (2016) used a sample of 90 Saudi listed companies for the year 2011. Consequently, using such a small sample size and short time scale in the analysis may negatively impact the generalisability of the findings of these studies for all Saudi listed

companies. Third, prior Saudi studies did not attempt to address the endogeneity problem in their researches. Therefore, their results regarding the effect of corporate governance mechanisms on earnings management might not be accurate, since the endogeneity problem affects the estimates of the parameters of the OLS model and renders them biased and inconsistent (Heij et al., 2004).

Hence, to address the above-mentioned limitations, the current study extends the previous Saudi studies in several ways. First, this study examines the effect of seven individual governance characteristics and four ownership types on constraining earnings management practices in Saudi listed companies. The governance characteristics examined in this study are strict board independence, strict audit committee independence, board size, board meeting, audit meeting, multiple directorships and family members on the board. Accordingly, this study can be considered broader in scope than previous Saudi studies, which examine the effect of a limited number of corporate governance factors on earnings management practices (e.g., Alshetwi, 2018; Baatour et al., 2017; Al Nasser, 2021; Al-thuneibat, 2016; Habbash, 2012) .

This study is the first study that examines the effect of several types of ownership structure which are government, institutional, family, and blockholders ownership on constraining earnings management practise using Saudi data. Thus, this study provides new evidence regarding the effectiveness of these several types of ownership in the Saudi context, which has institutional environments remarkably different from the US or UK⁵. Second, the current study has a larger sample size and longer time scale than prior Saudi studies (e.g., Alshetwi, 2018; Baatour et al., 2017; Al Nasser, 2021; Al-thuneibat, 2016; Habbash, 2012), since all listed companies (except firms belonging to the financial and insurance industries) from the years 2006 to 2017 have been included in the study's sample. Therefore, the study sample consists of 112 Saudi listed firms for a total of 994 firm-year observations. Such a large sample size will improve the generalisability of the results for all Saudi listed companies because all the firms, which have different sizes, will be included in the sample, thus helping to avoid the sample selection bias (Omar & Simon, 2011). Third, unlike prior Saudi studies that ignore the endogeneity problem, this study addresses the endogeneity problem in this research by applying two-stage least squares (G2SLS) regression and uses the instrumental variable for the compliance index model. The researcher has constructed an instrument for the Compliance-Index Model because the Saudi corporate governance index (SCGI) is the

⁵ Please see section 1.2 for detailed explanation of the uniqueness of the Saudi context.

main interest of this study. Furthermore, the study accounts for any possible endogeneity in the equilibrium-variable model (EVM) by regressing the lagged values of the independent variables on the dependent variable in the model. Accordingly, the results of the study were constant after controlling for the endogeneity problem. Hence, the evidence provided in this study regarding the effect of corporate governance mechanisms on earnings management practices in Saudi listed firms is reliable and unbiased.

Regarding the Saudi studies in the second group, Al-thuneibat's (2016) study is the only study in the literature that examines the effect of corporate governance mechanism on earnings management practices by constructing a governance index. Al-thuneibat (2016) examines the effect of the compliance of Saudi listed companies with corporate governance requirements regarding the internal audit, board of directors and audit committee on reducing earnings management practices. The study used a questionnaire-based governance index that consisted of 54 questions to collect data from financial managers and internal auditors related to the compliance of 90 Saudi listed companies for the year 2011. However, this study could be criticised for using a small sample size (only 90 companies) and covering only one year. Additionally, the study did not cover compliance with other important corporate governance requirements, such as the disclosure and transparency section in the Saudi corporate governance code. Moreover, this study may not accurately measure the extent of the compliance of the corporate governance mechanism for Saudi firms because its measure of compliance is based on the perception of financial managers and internal auditors of the companies, which may involve considerable subjective judgment. This view is supported by Bozec & Bozec (2012), who criticise questionnaire-based indices of corporate governance as involving a great deal of bias since companies tend to provide inaccurate information about their compliance. Bozec & Bozec (2012) argue that companies might overestimate the quality of their corporate governance, or they may not acknowledge the deficiencies in their corporate governance system. Such practices might make the measure of corporate governance quality subject to respondents' bias (Klapper & Love, 2002). Therefore, a better way to capture compliance would be to collect the governance information from the companies' annual reports.

The current study uses a self-constructed corporate governance index, which is distinct from Al-thuneibat's (2016) study and depends on the disclosure of corporate governance information in the companies' annual reports for the collection of governance data. Unlike the use of a questionnaire-based index, in which the corporate governance data are collected from the respondents, collecting corporate governance disclosure data from annual reports

gives a higher degree of objectivity because the research measures the quality and compliance of corporate governance based on the disclosure of governance information in the annual reports, without any subjective interference from the researcher or the respondents (Florou & Galarniotis, 2007). Furthermore, the current study extends Al-thuneibat's (2016) study by constructing an SCGI that contains 142 corporate governance provisions covering five broad aspects (sub-indices), namely (i) The Board of Directors; (ii) Board Sub-Committees; (iii) The Disclosure and Transparency; (iv) The Internal Control; (v) The Rights of Shareholders; and (vi) The Implementation of Corporate Governance. Accordingly, the current study provides a more comprehensive picture of the level of compliance of Saudi companies with the 2017 Saudi corporate governance code, because the majority of the governance requirements set out in this code have been added to the index in the form of governance provisions. In addition to the 2017 Saudi corporate governance code, the study derives some of the SCGI provisions from the 2016 Listing Rules issued by the Capital Markets Authority of Saudi Arabia (CMA) and the 2015 Companies Act issued by the Ministry of Commerce in Saudi Arabia. However, since the SCGI has 142 governance provisions, this is considered the largest governance index currently employed in Saudi studies, which might open up new avenues for future research.

Furthermore, the study makes other contributions to the existing Saudi studies. For instance, the Saudi corporate governance code (used in constructing the SCGI in this study) is primarily derived from the UK governance code (Al-Bassam et al., 2015), and adopts the UK's 'comply or explain' style (Al-Bassam et al., 2015). However, prior studies indicate that there are institutional differences between Saudi Arabia and the UK in terms of the legal system, accounting standards, the effectiveness of the governance system, and cultural practices (Al-Bassam et al., 2015; Haniffa & Hudaib, 2006)⁶. Hence, this study contributes to the existing literature by providing evidence regarding the effectiveness of adopting the UK-style governance regime in Saudi Arabia. Overall, the findings suggest that well-governed firms (firms that have a high score in complying with Saudi corporate governance provisions as measured by SCGI) perform better than poorly-governed firms in reducing earnings management practices.

⁶ Please see section 1.2 for detailed explanation of how the Saudi context is different from US and UK context.

1.6 Organisation of the Thesis

This thesis is organised into six chapters to investigate the effect of corporate governance mechanisms on earnings management practices in Saudi-listed firms. The purpose of the first chapter is to discuss the research problem of the study, present the study's primary motivations, articulate the research objectives, present the research questions and discuss the study's contribution. The chapter concludes with a concise summary of how this thesis is structured

Chapter two reviews the theoretical and empirical literature on the relationship between corporate governance mechanisms and earnings management practices. This chapter commences by discussing the underlying theories, which are the signalling theory, stewardship theory and agency theory, that explain the impact of corporate governance on earnings management practices. Following this discussion, this chapter presents the reasons behind selecting agency theory as the main theory for this research. Also, chapter two reviews the literature on the associations between corporate governance mechanisms and earnings management practices to identify gaps that the current study could help to close.

Chapter three provides an in-depth discussion regarding the development of the 13 hypotheses in this study. Specifically, the chapter discussed the theoretical and empirical links that show the connection between corporate governance mechanisms and earnings management practices based on the agency theory perspective.

Chapter Four presents the research design, methodology and data used in this study. This chapter begins by discussing the research paradigms, research strategy and research approach and their applications within the study context. Then, this chapter discusses the sample selection criteria and the data sources of this research. Also, the chapter discusses the measurement of the variables used in the compliance-index model and the measurement of the variables used in the equilibrium-variable model. Specifically, chapter four discusses the most used earnings management models in the literature and discusses their limitations. Then the justifications for the earnings management model used in this study and the robustness tests applied are discussed in the chapter. Moreover, the chapter demonstrates the process of constructing SCGI and presents the findings of the reliability and validity tests conducted for SCGI.

Chapter Five reports and discusses the empirical results of this study. The chapter begins by presenting the descriptive statistics of the variables used in the regression analysis of this study. Then the chapter discusses the OLS assumptions to determine whether the OLS regression is an appropriate estimation method for the study's primary analysis. Additionally, chapter five discusses the results of the compliance-Index model that examines the relationship between SCGI and earnings management practices. Also, the chapter exhibits the findings of the equilibrium-variable model that examine the association between individual corporate governance variables and earnings management practices. Also, chapter five presents the results of the robustness tests and the findings of sensitivity analyses that confirmed that endogeneity does not seem to impact the findings of this study excessively.

Finally, Chapter Six discusses the conclusion of the study. Specifically, it provides a brief summary of the research. Then this chapter presents an overview of the findings obtained from the compliance-index model and the equilibrium-variable model used in this study to investigate the nexus between corporate governance mechanisms and earnings management practices. Furthermore, the chapter summarises the contributions of the research and highlights the implications and recommendations of the findings for Saudi policymakers and investors. The chapter concludes by demonstrating the study's limitations and offering suggestions for future studies.



FACULTY OF
BUSINESS & LAW

School of Accounting & Finance

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At
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By

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MAcc (Master of Accountancy), Gonzaga University (U.S.A.)

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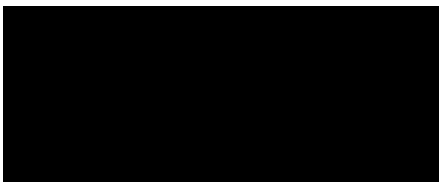
**BSc. In Accounting, King Saud University (Saudi Arabia)
MAcc (Master of Accountancy), Gonzaga University (U.S.A)**

2006

DECLARATION

This work has not previously been accepted in substance for any degree and is not being concurrently submitted in candidature for any degree. This thesis is the result of my own investigations, except where otherwise stated. Other sources are acknowledged giving explicit references. A bibliography is appended.

Signed

A black rectangular box redacting the signature of the candidate.

(Khalid Al-turki – Candidate)

Date

15-11-06

DEDICATION

**This Thesis Is Dedicated With All My Love And Respect
To My Parents, My Brother, My Sisters, My Wife And My
Beloved Children, Tala, Hamad and Alwaleed**

ACKNOWLEDGEMENT

I am grateful to Allah almighty for his guidance and blessings of my efforts during the course of this study.

Then, I wish to express my special appreciation to a number of individuals and organizations that have invaluable contributed to this thesis.

First, special thanks go to my supervisor, Professor Robert Clift, to whom I owe greatly for his sustained interest and help as well as friendly encouragement during my study at Victoria University, Melbourne.

Second, I would like to extend my deepest gratitude to the government of Saudi Arabia for the financial assistance provided by King Saudi University (Al-Qassim University, hereafter) without which this thesis would never have been written.

Third, I would like to stress my gratitude to all members of the College of Economics and Administration (my home college) for their continuous support. Sincere thanks go to Dr Obaid Al-Motairy, Head of Accounting Department, for his kindly support and encouragement, and all members of the Accounting Department.

Fourth, special thanks go to all those who helped me in the course of my fieldwork in Saudi Arabia to gather the needed data for this study.

Most importantly, I would like to emphasise the heartfelt debt I owe to my mother and father for their love, prayer, encouragement and support, and to all my family members in Saudi Arabia for their encouragement and moral support.

Very lovely thanks are due to my beloved family here with me in Australia, to my lovely wife for her care, patience and understanding. She sacrificed a great deal and worked so hard to provide the right environment for the success of my research. My love also goes to my children, Tala, Hamad and Alwaleed, who gave me enormous joy and pleasure by just being here.

ABSTRACT

The primary objectives of this thesis are: (i) to review the ongoing practices of corporate governance in six developed and emerging markets that represent a broad and diverse sample that varies in terms of historical, legal, economic and cultural systems; (ii) to assess comprehensively the effectiveness of corporate governance in a unique developing country, Saudi Arabia; and (iii) to identify whether there are significant differences in the perceptions among the involved four samples (board of directors' members, chief executive officers 'CEOs', audit committee members and shareholders) towards the four mechanisms of corporate governance investigated in this study, namely: shareholders' rights; board of directors; audit committees and internal audit; and disclosure and transparency.

A mail-out questionnaire methodology was used. The populations in this study have been divided into two categories: (i) the entire board of directors' members, chief executive officers and audit committee members of the 71 listed Saudi joint stock companies; and (ii) 400 randomly selected shareholders.

Saudi joint stock corporations generally were found to be doing relatively well in allowing shareholders to exercise some shareholders' rights such as secure registration, sharing in profits and participating in general meetings. Minority shareholders, however, seem to encounter difficulties in understanding their rights, calling special shareholders' meetings, putting issues on meeting agendas, obtaining timely information and taking little part in the process of selecting directors. The size and composition of boards varied widely among Saudi joint stock corporations. The boards were generally weak in performing some of their functions and the independence of independent directors was questionable. They also tend not to have independent board committee for remuneration and nomination. Although the existence of an audit committee was mandatory in all listed Saudi corporations, the number of members in those committees was less than four. Virtually all the audit committees had accounting or finance specialists; are chaired by an independent director; take minutes of committee meetings; and had written rules governing the overall audit function. Audit committees, however, were weak in approving the appointment and replacement of the internal audit head and in discussing with him related matters; reporting on audit committee's activities provided at annual shareholder meeting; and accessing relevant information. Sample firms performed relatively poorly in the areas of information disclosure and transparency, particularly in relation to matters such as disclosing material foreseeable risk factors, providing channels for disseminating information for fair, timely and cost-efficient access to relevant information by users, disclosing governance structures, disclosing the remuneration of the board members and disclosing the financial and operating results of the company in the English language. Firms also were not yet making full use of web sites to disclose information in a timely fashion and to enhance transparency.

The mean values of the responses obtained from the first two samples (board of directors and CEOs) were higher than the mean values of the responses obtained from the last two samples (audit committee members and shareholders). That was a clear indication that the board of directors' members and the chief executive officers were more confident about the effectiveness of corporate governance in Saudi joint stock corporations than the audit committee members and the shareholders.

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CHAPTER ONE:

INTRODUCTION

1.1. BACKGROUND

The subject of corporate governance has attracted increasing attention on both sides of the Atlantic in recent years (Aguilera and Jackson, 2003). Corporate governance is now the subject of much discussion in boardrooms, classrooms and the media (Cheffins, 1999).

Corporate governance received more attention due to a series of corporate failures that affected not only those directly connected with the companies concerned (i.e., directors, shareholders and auditors) but also those affected by its existence like employees, customers, suppliers and the environment. The first well-documented failure of governance was the South Sea Bubble in the 1700s, which revolutionized business laws and practices in England (Iskander et al., 1999).

The Asian financial crisis, which started with the devaluation of the Thai baht in July 1997, brought to the foreground the common occurrence of weak corporate governance which had allowed companies to engage in excessive over-leverage, some of which were aided by implicit state guarantees. The concepts of transparency, disclosure and accountability were largely ignored in the lead-up to the crisis as investors assumed a short-term outlook in order to derive increasing profits from the steadily rising regional financial markets.

The issue transcends national boundaries. Both the United States and Europe have had their share of questionable management decisions leading to the loss of billions of dollars, including Enron Corp. and Long Term Credit Management in the United States and Morgan Grenfell in Europe (Chambers, 2002). Australia has also not been immune as evident from the recent collapses of One.Tel Ltd and HIH Insurance Limited, a telecommunications and an insurance company, respectively. These are but a few of the more recent well documented cases that highlight the increasing importance of effective corporate governance. The financial crises in Asia,

Russia, United States and Australia, amongst others, have shown that a lack of regard for core values of corporate governance does have a negative impact globally. Countries, markets and companies that have not been able to survive or that have fared badly in a crisis have one thing in common: poor corporate governance standards (Keong, 2002). Those financial crises showed that even strong economies lacking transparent control, responsible corporate boards and shareholder rights collapse quite quickly as investor's confidence erodes.

Empirical evidence (Fremond et al., 2002) suggests that good corporate governance increases the efficiency of capital allocation within and across firms, reduces the cost of capital for issuers, helps broaden access to capital, reduces vulnerability to crises, fosters savings provisions and renders corruption more difficult.

A careful study of corporate governance is important at the present time in Saudi Arabia because the future will be even more competitive than it is now. In emerging market economies the business environment lacks many elements needed for a competitive market and a culture of enforcement and compliance (Iskander et al., 1999). Saudi Arabia needs to take a long hard look at the way other countries' systems work and keep their own under review.

To remain competitive in a changing world, Saudi corporations must innovate and adopt their corporate governance practices so that they can meet new demands and new opportunities. The Saudi government also has an important responsibility for shaping an effective regulatory framework that provides for sufficient flexibility to allow the Saudi market to function effectively and to respond to expectations of shareholders and other stakeholders. The way these principles should be adopted is the responsibility of the government and the market participants.

1.2. OBJECTIVES OF THE STUDY

The main aims of this thesis are: (i) to review the ongoing practices of corporate governance in six developed and emerging markets that represent a broad and diverse sample that varies in terms of historical, legal, economic and cultural systems; (ii) to assess comprehensively the effectiveness of corporate governance in a

unique developing country, Saudi Arabia; and (iii) to identify whether there are significant differences in the perceptions among the involved four samples (board of directors' members, chief executive officers, audit committee members and shareholders) towards the four mechanisms of corporate governance investigated in this study, namely: shareholders' rights; board of directors; audit committees and internal audit; and disclosure and transparency.

Saudi is a unique developing country because: (i) little is known about corporate governance in this country since this thesis, to the author's best knowledge, is the first to assesses comprehensively corporate governance practices in Saudi Arabia; (ii) Saudi Arabia has never had typical institutions (outside influences) of corporate governance, has never had a Code of corporate governance best practices and has never adopted the Principles of Corporate Governance that have been developed by the Organization of Economic Cooperation and Development (OECD) (1999, 2004), the International Monetary Fund (IMF), the World Bank and others; (iii) the influence of Islam, given that Saudi Arabia is the heartland of Islam, the birthplace of its history, the site of the two holy mosques and the focus of Islamic devotion and prayer.

This thesis is among the few comparable studies that have been conducted using developing or transition country data to analyse corporate governance systems and one which will add to the growing pool of scattered cross-country evidence. Example studies in the literature investigating corporate governance in developing countries are those with respect to Russia (Blasi and Shleifer, 1996; Black, 2001), Czech and Slovak Republics (Claessens, 1997; Claessens et al., 1996), China (Xu and Wang, 1997), a cross-section of transition economies (Aoki and Kim, 1995; Gray and Hanson, 1993), India (Chhibber and Majumdar, 1999; Khanna and Palepu, 1998; Sarkar and Sarkar, 1999; CII, 1998; Choudhury, 1999), Korea (Black, Jang and Kim, 2003) and others.

The assessment of the effectiveness of corporate governance is the outcome of the assessments of four corporate governance mechanisms, namely: shareholder rights; board of directors; audit committees and internal audit; and disclosure and transparency. As the intensity of adoption of these mechanisms in the Saudi publicly

traded, joint stock, corporations increases corporate governance becomes more effective.

In other words, it is an objective to provide evidence from a developing and emerging Islamic economy, Saudi Arabia, on the role of shareholders, board of directors, audit committees and disclosure and transparency in enhancing the effectiveness of corporate governance in the Saudi joint stock corporations.

The characteristics of the four mechanisms of corporate governance being discussed in this thesis will be adopted from the recommendations of some international organizations such as the Organization of Economic Cooperation and Development (OECD) (1999, 2004), the International Monetary Fund (IMF), the World Bank, the Treadway Commission (1987), the Cadbury Committee (1992), the Blue Ribbon Committee (1999), The International Corporate Governance Network (ICGN) and other recommendations. However, more emphasis will be given to the OECD (1999, 2004) Principles of Corporate Governance since the OECD Principles have been widely accepted by many countries, organizations and regulators around the world and because the Principles were intended to assist non-members, too, as it has been stated by the OECD (1999: p.11) that;

The Principles are intended to assist member and non-member governments in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries, and provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance.

The International Corporate Governance Network (ICGN) in their Statement on Global Corporate Governance Principles that was adopted in 1999 applauds the OECD Principles as a declaration of minimum acceptable standards for companies and investors around the world. The ICGN (1999: p.1) stated:

The ICGN applauds the OECD Principles as a declaration of minimum acceptable standards for companies and investors around the world. Much of the document reflects perspectives promoted by ICGN representatives serving on the OECD's Ad Hoc Task Force on Corporate Governance, relying on the draft principles under discussion at the ICGN. The ICGN welcomes the OECD Principles as a remarkable convergence on corporate governance common ground among diverse interests, practices and cultures.

The World Bank also assists its client countries in the assessment of their corporate governance institutional frameworks and practices by preparing country corporate governance assessments using the OECD (1999) as a benchmark. The activities of the World Bank in corporate governance focus on the rights of shareholders, the equitable treatment of shareholders, the treatment of other stakeholders, disclosure and transparency and the duties of board members.

Since the publication of the OECD Principles in 1999, they have become the most widely accepted corporate governance benchmark and have influenced the drafting of other codes issued by international organizations, countries, companies and stock exchanges. Therefore, as has been said earlier, a special emphasis will be given to these principles as a benchmark to the Saudi corporate governance practices.

1.3. CONTRIBUTION TO KNOWLEDGE

This thesis differs from the related literature in several ways: by investigating the effectiveness of corporate governance; firm-level issues; all listed Saudi firms; no typical institutions (outside influences) of corporate governance; and religion effects.

First, most of the empirical literature on corporate governance has focused on the relationship between corporate governance and performance (Durnev and Kim, 2002; Klapper and Love, 2002; and Gompers et al., 2003), shareholder rights and performance (Holthausen et al., 1999; and Claessens et al. 2002), board of directors and performance (MacAvoy et. al., 1983, 1999; Black, 2000; and Burton, 2000), audit committee and performance (Wild, 1994; Klein, 2002; Vafeas and Theodorou, 1998) and disclosure and transparency and performance (Leuz et al. 2000; and Healy et al. 1999)

However, few authors have investigated the effectiveness of corporate governance and its elements discussed in this study, namely: shareholder rights, board of directors, audit committees and disclosure and transparency. In the Saudi Arabia case, it was thought to be too early to link corporate governance to firm performance because corporate governance in Saudi is still developing. Moreover, Saudi Arabia has not adopted any international recommendations or principles and, furthermore, Saudi has not yet produced its own best practices of corporate governance. Corporate

governance in Saudi Arabia seems to be weak and the focus at this stage should be towards assessing corporate governance practices, helping regulators, organizations and corporations in understanding what has been meant by good corporate governance and providing the Saudi economy with some recommendations to develop and enhance corporate governance.

Second, previous authors have shown that better legal protection for investors is associated with higher valuation of listed firms relative to their assets or changes in investments (Claessens et al., 2002; La Porta et al., 2002; Wurgler, 2000), higher market value (La Porta et al., 1997) and larger listed firms in terms of their sales and assets (Kumar et al., 1999). Rajan and Zingales (1998) and Demirgüç-Kunt and Maksimovic (1998) also found that industries and firms that had better legal protection for investors rely more on external financing to fund their growth. Although these studies provide valuable insights into the effects of regulatory environments on stock markets, valuation and corporate financing, they do not address firm-level issues such as how corporate governance affects individual firm valuation within a country and they do not assess the effectiveness of corporate governance mechanisms.

Third, the data source for this study is all listed Saudi firms, both large and small, which enhances the generalizability of this study. The other researchers on emerging markets, however, either use a small single-country sample (Black, 2001) or multi-country samples that contain only the largest firms in each country (Durnev and Kim, 2002; Klapper and Love, 2002).

Fourth, the most widely known guidelines and principles of corporate governance are those developed by three international organizations, namely, the World Bank, the International Monetary Fund (IMF) and the Organization for Economic Co-operation and Development Principles of Corporate Governance (OECD) (PCSU, 2000). Countries adopting corporate governance rules more or less follow the standards set by those organizations. However, Saudi Arabia is not one of these countries and does not adopt or follow any of these organizations. Although some authors have investigated corporate governance in developing markets, this study will be the first to investigate how good corporate governance is in a developing

country that does not adopt the corporate governance principles and does not have typical institutions (outside influences) of corporate governance.

Finally, this study could be classified as the first study investigating how religion (Islam) affects the adoption of such principles. Islam guides not only the lives of the people, but also the policies and functions of the government, which, in turn, regulate and impose corporate governance.

1.4. RESEARCH METHODOLOGY

The research methodology is a very important step in the research design process. The use of a particular methodology for a research project depends on the scope, purpose, target, population, etc. of the study as well as the resources available to the researcher. It is essential, therefore, that in order to achieve their objectives, researchers adopt the right methodology and select the right data collection techniques through which they can collect the required data within their available resources (Gill and Johnson, 2002).

In the process of the construction of the methodology, the author considered various factors that best reflect corporate governance practices in Saudi Arabia. The choice of the variables is based on the corporate governance mechanisms, namely: shareholders' rights, board of directors, audit committees and internal audit and disclosure and transparency.

Survey methodology currently is the most common approach used in a variety of fields ranging from economics and political science to environmental studies, marketing research, voting behaviour and health, among others, to study empirically the characteristics and interrelations of sociological and psychological variables (Roberts, 1999; Marsh, 1982; Young, 1996). The great advantage of this method is that it allows us to measure the attitudes and behaviours of large populations (e.g., country, state or city) by questioning a relatively small number of people, who are chosen through statistical/probabilistic procedures. Surveys, indeed, provide an efficient and economical means of determining facts about the economy and about people's attitudes, expectations and behaviours.

One of the most critical decisions in many social research investigations is the selection of the appropriate type of survey. However, the researcher has chosen the mail-out questionnaire survey method as the best method for this study relying on very few simple rules that made this decision easier. The researcher has used this judgment to balance the advantages and disadvantages of different survey types. In the decision process, the researcher asked a number of questions that guided this decision (see Chapter 6: Section 6.4.1).

The populations in this study have been divided into two categories: the entire (71) listed Saudi joint stock companies and 400 randomly selected shareholders. The subjects have also been classified into four groups: board members; chief executive officer CEO; audit committee members; and shareholders.

All questions in this instrument were constructed according to the Five-Point Likert Scale with a value of 1 indicating that the respondent strongly disagrees with a factor or statement and the highest number, 5, indicating that the respondent strongly agrees with a factor or statement based on the actual practice. The use of the standardised questions in this study allowed the findings from a number of respondents to be summarised, and this was also facilitated by the use of questions, which are amenable to numerical analysis such as rating scales. The Likert scale allows the respondent to choose one of five degrees of feeling about a statement from strong approval to strong disapproval. The questions were in the form of statements that seemed either definitely favourable or definitely unfavourable toward the matter under consideration.

The questionnaire has been divided into four parts, namely: shareholder rights, board of directors, audit committee and internal audit and disclosure and transparency, preceded by some short demographic (general) questions in order to provide sufficient motivation for the respondents to complete and to reduce the possibility of boredom which might induce the respondent to give up. The demographic questions have also been used in this questionnaire to break down the data when the survey was complete.

The pilot test was conducted to assure the clarity and effectiveness of the survey questions and to test the reliability and validity in order to revise the survey

prior to final administration. To determine the effectiveness of the present survey questionnaire, the author pre-tested it before actually using it. The pilot test helped to determine the strengths and weaknesses of the survey concerning question format, sequence, wording, order, layout, validity, reliability and other matters.

Validity and reliability, the two major issues that a researcher must take into consideration when he or she uses a data gathering or measurement instrument, have been checked. The validity determines whether the research truly measures that which it was intended to measure or how truthful the research results are. In other words, does the research instrument allow the researcher to hit "the bull's eye" of the research objective. Reliability, on the other hand, is concerned with the accuracy and precision of a measurement procedure.

1.5. LIMITATIONS OF THE STUDY

The study has several limitations that should be taken into consideration at all levels of the research and analysis. First, the study was intended to evaluate the effectiveness of corporate governance in the Saudi joint stock corporations based on four mechanisms of corporate governance, namely: shareholders' rights, board of directors, audit committees and internal audit and disclosure and transparency. Other mechanisms that may be related to the effectiveness of corporate governance were not considered.

Second, the study focuses on the effectiveness of corporate governance of Saudi joint stock corporations. It does not deal with proprietorships, partnerships and close-held companies.

Third, the survey questionnaire reflects only the views, experiences and opinions of the targeted groups (board of directors, chief executive officers, audit committee members and shareholders) in Saudi joint stock corporations, which were restricted by the choice of questions used.

Fourth, the ANOVA test was based on an overall mean of a number of variables used for each corporate governance mechanism. Hence, the researcher is treating each variable as being of equal importance which might be debatable.

Fifth, any generalisation derived from the study's results is restricted to Saudi Arabia; cultural differences, social, accounting, corporate governance and investment environment distinctiveness from other countries may prevent wider generalisations.

Sixth, although tests for non-response bias were carried out using firm characteristics of industry and category of respondent and using late responses as a proxy for non-responses, the research lacks some other explicit controls for responder bias such as 'social desirability response bias'. Finally, other difficulties encountered in the study will be noted throughout the remaining chapters.

1.5. OUTLINE OF THE REMIANING CHAPTERS

This thesis is organized into nine chapters. The present chapter provides a background of the study, the objectives, research methodology and limitations of the study.

Chapter 2 provides an overview to corporate governance, including: definition of corporate governance; who sets corporate governance; the trends in corporate governance in a number of developed and developing countries, with emphasis that corporate governance of a particular country reflects its history, culture, regulatory structures and capital market characteristics.

Chapter 3 provides a background on the Saudi Arabian economy and development of corporate governance in the country by: discussing the development of the Saudi economy, highlighting the country's constitution, legislation and five-year development plans; providing some important facts relating to the Saudi Arabian oil and non-oil economy; clarifying that Saudi Arabian corporate governance is governed by four bodies: the Ministry of Commerce, the Saudi Arabian Monetary Agency (SAMA), the Saudi Stock Exchange (Tadawul) and some professional bodies; and explaining how Islam effects corporate governance in Saudi.

Chapter 4 investigates four mechanisms for effective corporate governance in Saudi Arabia. The chapter starts by developing a "four-legged chair" model that supports responsible, reliable, fair, accountable and transparent corporate governance system. Shareholders, board of directors, audit committees and disclosure and

transparency are the four legs of the chair, supporting the one top goal of producing an effective corporate governance system in a firm.

Chapter 5 provides an overview of the theories, hypotheses and the literature that have been conducted in the field of corporate governance. The author relies on two related theories: the no one size fits all theory and the agency theory. The chapter finally introduces the hypotheses involved with this research.

Chapter 6 focuses on the methodology used to examine the effectiveness of corporate governance in Saudi Arabia. The chapter starts by providing different types of research methodologies and then concludes that the written survey method was the most appropriate methodology to be used in this study. Some characteristics, rules, ethics, strengths and weaknesses of survey research methodology were also discussed. The chapter is then divided into six major sub-sections, each of which discusses a different major step in administering the survey methodology used in this thesis.

The results of the study are detailed in Chapters 7 and 8. The analysis in the seventh chapter concentrates on the exploratory data analysis focusing on univariate and bivariate data analyses. The author looks at four main groups of techniques when considering the exploratory data analysis approach, which are frequencies, cross-tabulation, measuring location (central tendency) and measuring dispersion (spread). Chapter 8 relates to the hypotheses testing which could be referred to the second type of analysis, the confirmatory data analysis.

Chapter 9 presents a brief summary of the overall study and highlights its findings. Furthermore, a number of recommendations and suggestions for further research are provided.

CHAPTER TWO:

CORPORATE GOVERNANCE OVERVIEW

2.1. INTRODUCTION

In our new millennium, the world is experiencing an unprecedented transition. The winds of sweeping changes have been reshaping the world politics, economies, environment, culture, and many other aspects. The end of the Cold War and the ensuing proliferation of the market economy, the resurgence of the world economic prowess, the economic conglomeration of Europe, the rise, fall and recovery of some economies, the rapid advancement in technology and the explosion of e-commerce are some of the highlighted events the world has been witnessing over recent decades. One of the significant implications of all these changes is that they pose a big challenge to business enterprises, particularly for those in developing countries and large global corporations that operate beyond national borders and play multiple functions with increasing power and influence. (Vernon, 1971; Ohmae, 1990; Korten, 1996; Karliner, 1997; Morss, 1997; and Clarke, 1998).

Monks and Minow (1995) defined a corporation as a mechanism established to allow different parties to contribute capital and expertise, for the maximum benefit of all of them. Oliver et al. (2003) suggested that corporations be governed by a system of checks and balances to make sure that their actions do not incur losses to the shareholders and stakeholders.

Corporations exist in different cultures with different norms and standards. It is therefore critical to recognize that managers, employees, business partners and other corporate stakeholders make decisions and choices that draw upon their cultural background and identity-group perspectives (Thomas and Ely 1996). The corporate governance of a particular country reflects its history, culture, regulatory structures and capital market characteristics (Keong, 2002). As a Saudi

academic, this thesis will be about a system by which companies are directed, controlled and operate in Saudi Arabia.

In this chapter, an overview of corporate governance is carried out including: definition of corporate governance; who sets corporate governance; and the trends in corporate governance in a number of developed and developing countries.

2.2. DEFINITION

The etymology of “governance” comes from the Latin words *gubernare* and *gubernator*, which refer to steering a ship and to the steerer or captain of a ship. The word “governance” comes from the old French “gouvernance” and means control and the state of being governed (Farrar, 2001).

Corporate governance has succeeded in attracting a good deal of public interest because of its importance for the economic health of corporations and the welfare of society, in general. However, the concept of corporate governance is defined in several ways because it potentially covers many activities having direct or indirect influence on the financial health of corporate entities. As a result, different people and organizations have presented different definitions, which basically reflect their special interests in the field.

Milton Friedman (2002), an economist and Noble laureate, said that corporate governance is to conduct the business in accordance with owners or shareholders’ desires, which generally will be to make as much money as possible, while conforming to the basic rules of the society embodied in law and local customs. This definition is based on the concept of market value maximization that underpins shareholder capitalism.

The Organization for Economic Co-operation and Development (OECD) (1999) defined corporate governance as the system by which business corporations are directed and controlled. According to them the corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, and spells out the rules and

procedures for making decisions on corporate affairs. By doing this, it provides the structure through which the company objectives are set, and also provides the means of attaining those objectives and monitoring performance.

The World Bank (1999) defined corporate governance from two different perspectives. From the standpoint of a corporation the emphasis is put on the relationships between the owners, management board and other stakeholders (the employees, customers, suppliers, investors and communities). Major significance in corporate governance is given to the board of directors and its ability to attain long-term, sustained value by balancing these interests. From a public policy perspective, corporate governance refers to providing for the survival, growth and development of the company, and at the same time its accountability in the exercise of power and control over companies. The role of public policy is to discipline companies and, at the same time, to stimulate them to minimize differences between private and social interests (World Bank, 1999).

Monks and Minow (2001: p.1) defined corporate governance

(Corporate governance) is the relationship among various participants in determining the direction and performance of corporations. The primary participants are (1) the shareholders, (2) the management, and (3) the board of directors.

An article published in the June 21, 1999 issue of the *Financial Times* quoted J. Wolfensohn, President of the World Bank, as saying that “Corporate Governance is about promoting corporate fairness, transparency and accountability”.

According to some other authors, corporate governance means doing everything better, improving the relationships between companies and their shareholders, improving the quality of outside directors, encouraging people to think long-term, ensuring that the information needs of all stakeholders are met and ensuring that executive management is monitored properly (Monks and Minow 2001; Keong, 2002; Chambers 2002; and Charkham 1995).

Gregory (2001) in her very-well-done comparison study entitled, “International Comparison of Corporate Governance Guidelines and Codes of Best Practice: Developed Markets,” described corporate governance as,

“Corporate Governance refers to that blend of law, regulation, and appropriate voluntary private-sector practices which enables the corporation to attract financial and human capital, perform efficiently, and thereby perpetuate itself by generating long-term economic value for its shareholders, while respecting the interests of stakeholders and society as a whole” (Gregory, 2001, pp. i).

According to Olin (2001) corporate governance is a broad term that encompasses rules and market practices that determine how companies make decisions, the transparency of their decision-making processes, the accountability of their directors, managers and employees, the information they disclose to investors and the protection of minority shareholders. From the author’s point of view, corporate governance can be defined as the set of rules and incentives by which the management of a company is directed and controlled in order to maximize the profitability and long-term value of the firm.

In Saudi Arabia, the contractual governance of management behavior, as one example, is necessarily incomplete and direct monitoring will be underprovided (Al-tweejri, 2002). Hence, management is in the position to seize residual control rights and may appropriate the shareholders’ investment returns. If left unregulated, shareholders will under-provide finance and companies will not be able to take advantage of all value enhancing investment opportunities. Thus the codification of corporate governance into national law or codes of best practice in Saudi Arabia becomes a necessary and effective means of alleviating under-investment and limiting the implied agency costs.

2.3. CODES OF GOOD CORPORATE GOVERNANCE

Codes of good corporate governance present a comprehensive set of norms on the role and composition of the board of directors, relationships with shareholders and top management, auditing and information disclosure, as well as the selection, remuneration and dismissal of directors and top managers. The codes serve to improve the overall corporate governance of corporations,

especially when legal environments fail to ensure adequate protection of shareholders' rights (OECD, 1999; Aguilera et al., 2000; Keong, 2002).

An important factor affecting the issuance of the codes is the issuer (Sullivan, 2000). Issuers can be stock exchanges, governments, director associations, manager associations, professional associations or investors. Differences in who issues the code denote differences in the enforcement of the codes. For instance, government and stock market issuers might exert coercive pressure for the adoption of the codes of good governance, whereas associations and investors might apply normative pressures for adoption (Sullivan, 2000).

2.3.1. Who sets the codes of corporate governance?

The majority of countries adopting corporate governance rules more or less follow the standards and guidelines of corporate governance set by three international organizations: the Organization for Economic Co-operation and Development Principles of Corporate Governance (OECD), the World Bank and the International Monetary Fund (IMF).

2.3.1.1. The Organization for Economic Co-operation and Development (OECD)

In 1998, the Organization for Economic Co-operation and Development (OECD) established an Ad-Hoc Task Force on Corporate Governance to develop a set of non-binding core principles on corporate governance that reflected the views of its 30 member countries.¹ The Task Force concluded its work in April 1999. The Principles and associated recommendations were subsequently approved by the OECD and endorsed by ministerial level representatives of member nations at their annual meeting on May 26 and 27, 1999.

The OECD principles of corporate governance are general guidelines for regulating the entity (Fremond et al., 2002). According to the OECD Task Force

¹ Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Japan, Korea, Luxembourg, Mexico, Netherlands, New Zealand, Norway, Poland, Portugal, Slovak Republic, Spain, Sweden, Switzerland, Turkey, United Kingdom, and the United States

that drafted them, the Principles were devised with four fundamental concepts in mind: responsibility, accountability, fairness and transparency. The OECD principles are primarily concerned with listed companies. They are organized into five sections, (I) the rights of shareholders, (II) the equitable treatment of shareholders, (III) the role of shareholders in corporate governance, (IV) disclosure and transparency and (V) the responsibilities of the board (OECD, 1999).

2.3.1.1.I. The Rights of Shareholders

The rules emphasize that shareholders have secure ownership, the right to full disclosure of information, voting rights and participation in decisions concerning fundamental corporate changes such as the sale or modification of corporate assets including mergers and new share issues. Markets for corporate control should be efficient and transparent and shareholders should consider the costs and benefits of exercising their voting rights (OECD, 1999).

2.3.1.1.II. The Equitable Treatment of Shareholders

“All shareholders of the same class should be treated equally” (OECD, 1999: p.19), including minority and foreign shareholders and should have the opportunity to obtain effective redress for violation of their rights. This principle emphasizes the protection of minority and foreign shareholders rights with full disclosure of material information. It ensures the setting up of systems that keep insiders, including managers and directors, from taking advantage of their roles, insider trading is prohibited and members of the board and managers should be required to disclose any material interest in transactions (OECD, 1999).

2.3.1.1.III. The Role of Stakeholders in Corporate Governance

In addition to the shareholders, the OECD also recognizes the right of stakeholders. The principles stress that stakeholders (in particular creditors, employees and consumers) play an integral part in shaping the decisions of a company. Principle III states that,

...the corporate governance framework should encourage active co-operation between corporations and stakeholders in creating wealth, jobs and the sustainability of financially sound enterprises (OECD 1999: p. 35).

Employees are usually the important stakeholders that determine how companies perform and take decisions. Thus the corporate governance framework must ensure that the rights of stakeholders are protected by law and respected. Stakeholders participating in the corporate governance process should have access to relevant information (OECD, 1999).

2.3.1.1.IV. Disclosure and Transparency

The OECD principles ensure that “...timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership and governance of the company” (OECD, 1999: p.21) including board of directors and their remuneration. The guidelines also specify that annual audits should be performed by independent auditors in accordance with high quality standards of accounting, financial and non-financial disclosure. Channels for disseminating information should provide fair, timely and cost efficient access to relevant information by users (OECD, 1999).

2.3.1.1.V. The Responsibilities of the Board

The corporate governance framework should ensure the strategic guidance of the company, the effective monitoring of management by the Board, and the Board's accountability to the company, shareholders and stakeholders (OECD, 1999: p. 22).

These include concerns about corporate strategy, risk, executive compensation and performance, as well as accounting and reporting systems. Board members should act on a fully informed basis, in good faith, with due diligence and in the best interests of the company and its shareholders. The Board should also ensure compliance with applicable laws and take into account the interests of the stakeholders. Finally, the Board should be able to make objective judgments on corporate affairs, independent from management (OECD, 1999).

The OECD principles are not binding. Their purpose is to serve as a reference point. They are evolutionary in nature and should be reviewed in light

of significant changes in circumstances (OECD, 1999). The Principles are primarily intended to provide assistance to governments as they pursue their own efforts to evaluate and improve the legal, institutional and regulatory framework that affects corporate governance. They also provide guidance and direction for stock exchanges, investors, corporations and other parties that have a role in developing good corporate governance.

The OECD Principles were based on different views from a number of various developed countries. Thus, they represent a basic consensus on corporate governance requirements and describe existing rules, rather than propose radical changes. As a result, the OECD Principles are an excellent starting point for the examination of a sound framework in emerging countries. The principles mainly focus on publicly traded companies. However, to the extent they are deemed applicable, they may be also useful for non-traded companies, such as privately held and state-owned enterprises. In brief, the OECD Principles emphasize that good corporate governance can be achieved through a combination of regulatory and voluntary private actions.

2.3.1.2. The World Bank

The Financial Stability Forum, the G7 (Canada, France, Germany, Italy, Japan, UK and USA)², the G20 (G7 plus Argentina, Australia, Brazil, China, India, Indonesia, Korea, Mexico, Russia, Saudi Arabia, South Africa, Turkey and EU)³ and the G22 (G7 plus Argentina, Australia, Brazil, China, Hong Kong SAR, India, Indonesia, Korea, Malaysia, Mexico, Poland, Russia, Singapore, South Africa and Thailand) have emphasized the role of minimum standards and codes in strengthening international corporate governance.

At the international level, standards enhance the transparency, identify weaknesses that may contribute to economic and financial vulnerability and foster market efficiency and discipline. At the national level, standards provide a benchmark to identify vulnerabilities and guide policy reform. To serve best these

² Russia joined as full participant in 1998, which marked the establishment of the Group of Eight (G-8).

³ G20 was formally established at the G-7 Finance Ministers' meeting on September 26, 1999 (www.g20.org).

two objectives, the scope and application of such standards need to be assessed in the context of a country's overall development strategy and tailored to individual country circumstances (Fremond et al., 2002).

The World Bank has always encouraged developing countries to adopt international best practices and implement legal and regulatory reforms. It is not in the business of setting standards or creating codes, rather it gives necessary support on national, regional and global levels (Iskander et al., 1999).

At the national level, the World Bank has supported a series of country self-assessments that identify strengths and weaknesses in corporate governance that helped countries to establish priorities. The objective of the assessments is to strengthen regulatory reform and enforcement while fostering private voluntary actions. This is consistent with the Bank's comprehensive development framework that emphasizes good corporate governance as a key factor in development effectiveness. The framework stresses the importance of the private sector (local and foreign), as a major player in the development process. It also calls for the participation of stakeholders in the design and implementation of a comprehensive reform strategy (Iskander et al., 1999).

At the national level, the World Bank has co-sponsored with other multinational agencies (e.g., OECD) a series of round-tables addressing government officials, legislators, regulators, local and foreign firms, investors and rating agencies to help craft a consensus for reform. The World Bank has worked closely with the OECD to broaden the corporate governance beyond OECD countries (Iskander et al., 1999).

2.3.1.2.1. The Report on Observance of Standards and Codes (ROSC)

The corporate governance team of the Private Sector Advisory Services Department (PSAS) after consultations with a number of emerging market governments uses the OECD Principles as the benchmark in the assessment process. The OECD Principles were agreed upon by a large number of countries (30) of varied legal, economic and cultural traditions and after extensive consultation with the World Bank, the IMF and representatives of the business

community from Japan, Germany, France, UK and the US, as well as international investors, trade unions and other interested parties. As such, they represent the minimum standard that countries with different traditions could agree upon, without being unduly prescriptive.

To assess countries, the World Bank has produced a questionnaire in the form of a template. It is structured along the five chapters of the OECD Principles. The objective of having the template is to facilitate the gathering of information necessary to formulate a diagnostic of the institutional framework underlying corporate governance, as well as prevailing practices and enforcement. For each OECD Principle, a set of questions has been prepared to assess the compliance of the country under assessment. Most of the questions could be answered in “yes” or “no”, to allow benchmarking (Fremond et al., 2002).

The template includes a section on the ownership structure of the assessed country because this is an important determinant of corporate governance practices. It endeavors to identify pyramid structures, cross-shareholdings and business groups and gathers information on the divergence between cash flow rights and voting rights. While the OECD Principles are mainly concerned with the rights of shareholders and stakeholders, disclosure and the responsibilities of insiders, the template also addresses the issue of institutional capacity (Fremond et al., 2002).

The format of the assessments allows for systematic benchmarking across countries and regions. It is divided into four parts: (i) executive summary; (ii) capital market overview and institutional framework; (iii) principle by principle review including policy recommendations; and (iv) institutional strengthening.

2.3.1.2.2. Insolvency and transparency in codes of corporate governance

The World Bank has emphasized the inclusion of insolvency and creditors rights besides transparency in codes/rules of corporate governance.

2.3.1.2.2.1. Insolvency and creditors rights

In an effort to improve the stability of the international financial system after the South East Asian Crisis, the World Bank led an initiative to identify principles and guidelines for meaningful insolvency systems and for the strengthening of related debtor-creditor rights in emerging markets.

Insolvency systems provide a pre-determined set of rules and institutions concerned with the recognition of insolvency, the resultant liquidation or rehabilitation of the insolvent firm and the allocation of the financial consequences between the stakeholders. The insolvency systems also permit lenders to price risk more accurately and encourage cash flow lending rather than relationship or politically directed lending and discipline managers to allocate scarce resources efficiently.

2.3.1.2.2.2. Transparency in accounting and auditing systems

In order to have transparent, timely and reliable corporate financial reporting and as part of the Reports on the Observance of Standards and Codes (ROSC) initiative, the World Bank is undertaking reviews of compliance with accounting and auditing standards in a number of countries. It is intended to provide a basis for comparing practice in the countries reviewed to both national and international accounting and auditing standards which, in turn, will facilitate cross-country comparison and the design of programs to strengthen corporate financial reporting. More specifically, the objectives of the review are to assess the comparability of national accounting and auditing standards with International Accounting Standards (IAS) and International Standards on Auditing (ISA), respectively; and the degree to which corporate entities comply with established accounting and auditing standards in the country.

Furthermore, the International Finance Corporation (IFC), being a member of the World Bank Group, has also promoted better corporate governance by requiring that the firms in which it invests, practise sound corporate governance and insist on proper internal controls and reporting. This applies particularly on developing stock and bond markets (Iskander et al., 1999).

2.3.1.3. International Monetary Fund (IMF)

The IMF is an international organization of 184 member countries. It was established in 1945 to promote international monetary cooperation, exchange stability, and orderly exchange arrangements; to foster economic growth and high levels of employment; and to provide temporary financial assistance to countries to help ease balance of payments adjustment (IMF).

In addition to the IMF's contribution in the Report on Observance of Standards and Codes (ROSC) of the World Bank, the IMF has developed codes of good practice mainly for the transparency of governments' fiscal and monetary policies.

2.3.1.3.1. Greater Fiscal Transparency

The IMF is encouraging its member countries to implement a Code of Good Practices on Fiscal Transparency. The Code stresses: responsibilities of government should be clear; information on government activities should be provided to the public; budget preparation, execution and reporting should be undertaken in an open manner; and fiscal information should attain widely accepted standards of quality and be subject to independent assurances of integrity. The Code sets out what governments should do to meet these objectives in terms of principles and practices.

The Code of Good Practices on Fiscal Transparency is based on four general principles:

- ❑ *Clarity of Roles and Responsibilities.* The government sector and/or its public sector agencies should be distinguished from the rest of the economy. Policy and management roles within the public sector should be clear and publicly disclosed. There should be a clear legal and administrative framework for fiscal management.
- ❑ *Public Availability of Information.* The public should be provided with full information on the past, current and projected fiscal activity of the

government. A commitment should be made to the timely publication of fiscal information.

- *Open Budget Processes.* The budget documentation should specify fiscal policy objectives, macroeconomic framework and policy basis for the budget as well as identifiable major fiscal risks. Budget information should be presented in a way that facilitates policy analysis and promotes accountability. Procedures for the execution and monitoring of approved expenditure and for collecting revenues should be clearly specified. There should be regular fiscal reporting to the legislature and the public.
- *Assurance of integrity.* Fiscal data should meet accepted data quality standards and fiscal information should be subjected to independent scrutiny. There should be mechanisms in place which provide assurances to the public about data integrity.

2.3.1.3.2. Code of Good Practices on Transparency in Monetary and Financial Policies

The IMF has developed a Code of Good Practices on Transparency in Monetary and Financial Policies. The design of good transparency practices in the Code rests on two principles. First, monetary and financial policies can be made more effective if the public knows the goals and instruments of policy and if the authorities make a commitment to meeting them. Also good governance calls for central banks and financial agencies to be accountable, particularly where the monetary and financial authorities are granted a high degree of autonomy.

The Code was developed in the context of the development of standards and codes for public disclosure and transparency practices designed to strengthen the international monetary and financial system. It calls for greater transparency of commercial banks, securities firms, insurance firms, central banks etc.

An increasing number of countries are taking the next step of participating in a fiscal module of a *Report on Observance of Standards and Codes* (ROSC), which the IMF and the World Bank have developed as a means of assessing the

extent to which countries meet the requirements of standards and codes in core areas and providing information to the public. Fiscal ROSCs comprise a summary description of practices prepared by the IMF staff based on the completed questionnaire, together with a staff commentary including recommendations for improvement. When fiscal ROSCs become out of date, a ROSC reassessment will be done to replace the original ROSC.

As of March 2003, 48 ROSC fiscal transparency modules have been published on the IMF website, and 11 have published updates. Around 20 new or revised fiscal transparency ROSCs are planned for each year (IMF, 2003).

2.4. CORPORATE GOVERNANCE WORLD WIDE

In the late 1990's, the issue of corporate governance has received more global attention than it would have in the light of a series of corporate failures (Iskander et al., 1999). Furthermore, the recent crises and bankruptcies faced by various firms in different countries, including East Asia, Russia, United States, United Kingdom, Australia and others raises a question: what went wrong?

Those failures, amongst others, have shown that a lack of regard for core values of corporate governance does have a negative impact globally. Countries, markets and companies that have not been able to survive or that have fared badly in a crisis have one thing in common: poor corporate governance standards (Keong, 2002).

Over the last decade a number of reports has been commissioned into the subject of corporate governance and as a result a number of codes of best practice has emerged. The purpose of these codes of best practice is to increase transparency and accountability in the manner in which companies are governed. By 2004, thirty-seven countries had issued codes of good governance (Appendix 5). This excludes other developed and emerging countries that are in the process of issuing their Code of Good Practice for Corporate Governance. A complete list of these countries can be found at the World Bank, OECD, and European Corporate Governance Networks.

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