

CORPORATE GOVERNANCE (BOARD OF DIRECTORS AND AUDIT COMMITTEE CHARACTERISTICS) AND FIRM PERFORMANCE

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ABSTRACT

The study aims to empirically investigate the relationship between corporate governance (Board and Audit Committee characteristics) and firm performance of firms listed on the Saudi Stock Exchange. The study will be based on the premise (agency theory) that corporate governance (board and audit committee characteristics) is associated with the firm performance. Data will be gathered from all companies during the year 2009. The board characteristics variables are independence, activities, size, stock ownership (at the level of the board) and board chairman stock ownership. The audit Committee characteristics are independence, activities, size, stock ownership (at the level of the audit committee), audit committee chair stock ownership, interactions with internal auditors and interactions with external auditors. Two measures of firm performance that are return on assets (ROA) and operating cash flow (OCF) will be considered.

Keywords: *Corporate Governance (Board of Directors, Audit Committee), Firm Performance*

Introduction

The corporate scandals such as Enron, Global Crossing, Tyco, and World com have shaken investors' confidence and made it difficult for companies to raise equity from the stock market (Agrawal, 2005). Many reports believed that the board and its committees do not supervise management properly. For example, Enron manipulated its financial statements through off-balance sheet financing. The board was unable to disclose the distorted statements because the board lacked independence from senior executives (Deakin & Konzelmann, 2004) Moreover, World Com materially overstated its earnings and finally filed for bankruptcy. The investigation showed that the audit committee failed to effectively oversee managers (Weiss, 2005). One of the corporate governance mechanisms is the board of director's role. Due to the separation of

ownership and control, the board of directors and its audit committee evolved as effective monitoring and control systems (Jensen & Meckling, 1976). The board of directors is at the apex of internal control systems and has final responsibility to shareholders (Jensen, 1993). The audit committee is part of the board of directors. Therefore, it is also the highest internal control system (Weiss, 2005). Since the Sarbanes-Oxley of 2002, the board of directors and its audit committee has gone through a rapid transformation.

Researchers have recognized the board of directors as the most important control mechanism in a company's internal governance structure (Fama & Jensen, 1983). Recommendations from the Cadbury Committee (1992) and the Blue Ribbon Committee (1999) presume that independent directors play more important monitoring roles than non-independent directors. Independent directors also have incentives to develop a reputation as experts in decision control and monitoring (Fama & Jensen, 1983). Haniffa & Hudaib (2006) showed that directors' independence does not seem to affect performance. Others such as Agrawal & Knoeber (1996), Klein (1998) and Black & Bhagat (2002) also stated that there is no association between independence of directors and firm's performance. Beasley (1996) finds a negative relation between the percentage of independent directors on the board and the likelihood of financial fraud. Dechow, Sloan, & Sweeney (1996) found that firms with a large percentage of independent directors on the board are less likely to be subject to Securities and Exchange Commission (SEC) enforcement actions for alleged violations of GAAP.

Another board characteristic associated with strong corporate governance is stock ownership by directors at the board level. Higher equity ownership on the part of the directors is likely to motivate them to question managerial policies (Patton & Baker, 1987). Prior studies have documented that larger stock ownership by directors is positively related to both firm's performance and financial reporting quality (Beasley, 1996; Shivdasani, 1993; Vafeas & Theodorou, 1998).

Board size is also potentially related to directors' ability to monitor and control managers (Lipton and Lorsch, 1992; Jensen, 1993), although the direction of influence is unclear. Some studies find a positive relation between the number of directors and both firm's performance (Chiang & Chia, 2005; Haniffa & Hudaib, 2006) and board monitoring (Anderson, Mansi, & Reeb, 2004; Williams, Fadil, & Armstrong, 2005). It is argued that larger boards possess more specialized skills and are better equipped to

monitor management (Williams et al., 2005). In contrast, other studies indicate that smaller boards are more efficient in discharging their responsibilities (Beasley, 1996; Jensen, 1993; Lipton & Lorsch, 1992).

Boards of directors need to be active to meet their corporate governance commitments, particularly in ensuring high-quality, transparent reporting in annual reports. Boards that meet frequently are more likely to perform their duties diligently and effectively, thereby enhancing their level of oversight (Conger, Finegold, & Lawler, 1998; Lipton & Lorsch, 1992; Vafeas, 1999; Yatim, Kent, & Clarkson, 2006).

An audit committee is an operating committee of the Board of Directors. The primary objective of the Audit Committee is to assist the Board in the effective discharge of its fiduciary responsibilities. The relationship between audit committee characteristics and corporate performance has become important following recent corporate failures. Therefore, it is appropriate to examine whether an audit committee as a governance mechanism results in higher wealth outcomes for investors (Turley & Zaman, 2004). However, prior research indicates that the construct of audit committee effectiveness over firm's performance is multidimensional and is affected by variety of audit committee characteristics such as committee size (AL-Manseb, 2010; Albeera, 2009), independence (Hsu, 2007; Ilona, 2008) and activity (Hsu, 2007; Vafeas, 1999).

Audit committees' interactions with internal auditors and external auditors are other important dimensions of audit committee effectiveness that has gained the attention of regulators and academics (Blue Ribbon Committee, 1999; Sarbanes-Oxley Act, 2002). DeZoort, Hermanson, Archambeault, & Reed, (2002) noted the need for additional research related to the relationships between audit committee members and internal and external auditors due to the dependencies between these groups. Audit committee effectiveness is much more likely in environments where audit committees have access to accurate, timely and complete updates from management and auditors on changes in significant accounting and auditing regulations, changes in the company's core business and current trends in corporate governance (Beasley, Carcello, Hermanson, & Lapedes, 2000). Audit committee effectiveness is influenced by the resources of its members (DeZoort et al., 2002). Resources include accessibility to management and both internal and external auditors. Prior research finds that audit committees lacking resources are more likely to have fraud at the company (Beasley et al., 2000). The Sarbanes-Oxley Act (SOX) required committees to select and communicate with the external auditor, approve audit services and

fees, establish and oversee company whistle blowing procedures and hire outside counsel. The SEC also specifies that the responsibilities of audit committees include appointing the external auditors, meeting with the auditors to evaluate the corporation's financial statements, interacting with the internal financial managers and internal auditors, and reviewing the firm's internal controls.

Problem Statement

Many previous studies have examined the relationship between corporate governance (board characteristics) and firm's performance (Barnhart & Rosenstein, 1998; Black & Bhagat, 2002; Bonn, Yoshikawa, & Phan, 2004; Brown Lawrence & Caylor, 2004; Haniffa & Hudaib, 2006; Klein, 1998; Vafeas & Theodorou, 1998). However, little attention has been devoted to investigate the association between audit committee characteristics (as a governance mechanism) and firm's performance (Hsu, 2007).

In addition, previous studies that examined the relationship between (corporate governance) audit committee and firm performance investigated some of audit committee characteristics: independence (Hsu, 2007; Ilona, 2008), size (AL-Manseb, 2010; Albeera, 2009), activities (Hsu, 2007; Vafeas, 1999) and experience (Hsu, 2007; Ilona, 2008). To my knowledge, none of the studies have examined the impact of the extent of interactions between audit committees and internal and external auditors on firm's performance.

Moreover, prior researches (Haniffa & Hudaib, 2006; Vafeas & Theodorou, 1998) have examined the relation between stock ownership by directors (at the board level) and firm's performance. No study to date (as far as the researcher is aware), has examined this association at the audit committee level and the key individual or "focal point" level (board chairman and audit committee chair).

Furthermore, most of the empirical studies in different countries around the world that examined the association between corporate governance (board characteristics) and firm performance provided mixed results (Agrawal & Knoeber, 1996; Black & Bhagat, 2002; Brickley, Coles, & Jarrell, 1997; Haniffa & Hudaib, 2006; Hermalin & Weisbach, 1991).

Finally, previous research on the relationship between corporate governance (especially board characteristics) and firm performance has focused primarily on strong and developed capital markets (USA and UK). Little research has been conducted in countries with emerging

markets that are usually characterized by concentrated stock ownership and significant government ownership in listed firms (Haniffa & Hudaib, 2006). These differences between developing capital markets and other developed markets may influence how boards of directors govern their firms.

The study of this issue in an emerging market such as Saudi Arabia is interesting for two reasons. Firstly, Saudi Arabia is the largest economy in the Middle-East and an important country in the world. It is a member of many worldwide organizations including the United Nation (U.N), the International Monetary Fund (IMF), the World Bank (WB), and the World Trade Organization (WTO). Economically, it is the largest oil producer and a founder member of Organization of the Petroleum Exporting Countries (OPEC). Recently, after the global financial meltdown, Saudi has become a member of the G20 as being one of the top twenty economies in the world. Secondly, corporate governance in Saudi Arabia is still evolving. Under the Saudi Companies Law, the Board of Capital Market Authority (CMA) in Saudi Arabia issued its first resolution on 10/11/2008 making a set of recommendations mandatory on all companies listed on Exchange effective from the year 2009.

Research Questions

The research questions that will be investigated in this research are:

1. What is the extent of the board and audit committee effectiveness with the firm's performance?
2. Are board of directors characteristics, namely, their independence, size, activities, and stock ownership associated with firm performance?
3. Are audit committees characteristics, namely, their independence, size, activities, and their interactions with internal and external auditors associated with firm performance?
4. Is stock ownership by board chairman and audit committee chair associated with firm performance?

Research Objectives

The objectives of the current study are as follows:

1. To describe the extent of the board and audit committee effectiveness with firm's performance in Saudi Arabia.

2. To examine the association between the board of directors' characteristics, namely, their independence, size, activities, and stock ownership and firm's performance.
3. To investigate the association between audit committees' characteristics, namely, their independence, size, activities and their interactions with internal and external auditors and firm's performance.
4. To examine the association between stock ownership by board chairman and audit committee chair and firm's performance.

Significance of the Study

The significance of the study can be seen from both theoretical and practical perspectives. From a theoretical perspective, this study will support the literature by providing further evidence on the impact of the interactions between audit committees and internal, external auditors (agency role) on firm's performance.

This study will also provide evidence to the impact of stock ownership at the board level and at the audit committee level. In addition to examining stockownership at the level of the board and audit committee, this study will examine the impact of stock ownership of key members of the board - the audit committee chair and the chairman.

To the practitioners, the expected findings of the study will be useful for the policy makers and regulators in Saudi Arabia (for example, CMA, SACPA) in terms of the effectiveness of the board of directors and the audit committees and their effect on firm's performance.

Definitions of Terms

For the purposes of this research, the following terms will be defined:

Corporate governance: The system by which companies are directed and managed. It influences how the objectives of the company are set and achieved, how risk is monitored and assessed, and how performance is optimized. In this study, it covers the characteristics of the Board of Directors (independence, size, activities, and stock ownership) and Audit Committee Members (independence, size, activities and their interactions with internal and external auditors).

Audit committees: An audit committee is one example of a corporate governance control and has been defined as a committee of the board of directors that assists the directors to discharge the board's responsibilities of oversight and corporate governance.

Audit Committee Effectiveness: This study defines audit committee effectiveness as a committee that has qualified members with the authority and resources to protect stakeholder interests by ensuring reliable financial reporting, internal controls and risk management, and the appointment of a competent auditor through its diligent oversight efforts as suggested by DeZoort et al. (2002).

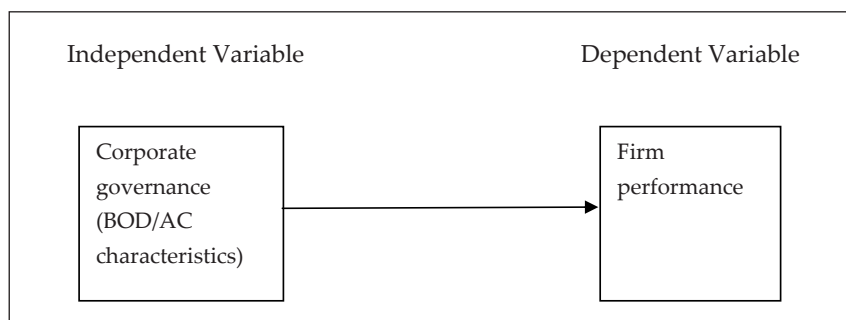
Organization of The Study

This study is organized into three chapters. Chapter one provides the background of the study, problem statement, research questions, research objectives, research significance, and definitions of terms and organization of the remaining chapters.

Chapter two contains literature review and previous research that are related to this study. The review presented in this chapter includes corporate governance in Saudi Arabia, Agency theory and board, audit committee, previous studies on board of directors, audit committees and firm performance.

Chapter three describes the research framework and methodology employed in the study. Hypothesis, research design, sample and data collection, research instrument, operational definition and measurement of the variables, method of data analysis are also discussed in this chapter.

Research Framework



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