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PRACTICE AND EFFECTIVENESS OF INTERNAL CORPORATE GOVERNANCE MECHANISMS IN SAUDI ARABIA STOCK MARKET: A REVIEW OF EMPIRICAL EVIDENCE

The aim of this paper is to shed light on the Saudi corporate governance code, its practices and effectiveness. To do so, the paper conducted a detailed review of the articles of the code related to internal corporate governance mechanisms and the previous studies regarding its effectiveness in Saudi stock market context. The main finding is that the provisions of Saudi corporate governance code are adequate. Annual reports (2009-2014) show an increase in the level of the compliance by listed companies, indicating that the code is achieving its aims. However, the empirical evidence seems to suggest that the code has an insignificant impact on company's performance and mitigating earnings management. The main reasons behind that are the following: the code is still in its early stages, there is weak legal enforcement, and there are also some social, cultural, and economic factors. Therefore, the code needs more time for good practice and improvement to achieve its purposes.

Key words: *corporate governance, internal mechanisms, board of directors, audit committee, remuneration committee.*

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1. Introduction

Corporate governance plays a vital role for today's complex and dynamic business environment especially following the financial scandals around the world and the recent collapse of major corporate institutions/banks in the USA, South East Asia, Europe that have confirmed the need for the practice of good corporate governance.¹

Many stock market regulators around the world have adopted corporate governance guidelines to be implanted by listed companies as one of the most important monitoring system that insures investors protection, for example, the Cadbury Committee (1992) to the Combined Code (1998) in the UK, Sarbanes Oxley Act, 2002 in the US, Saudi corporate governance code in 2006, amongst others.

At the beginning of 2006 Saudi stock market faced extraordinary crash, which raised a serious question about the effectiveness of different monitoring devices, the level of transparency in the stock market as well as the overall integrity of financial reporting in Saudi Arabia.² As a result of this extraordinary crash, Board of Capital Market Authority (CMA) issued corporate governance guidelines on 12/11/2006, amended in 2010, in order to regulate and develop the Saudi capital market and increase the credibility and transparency of financial reporting.³

The code includes the rules and standards that regulate the management of listed companies to ensure their compliance with the best governance practices, therefore, it would ensure the protection of shareholders' rights as well as the rights of stakeholders;⁴ enhance the integrity of financial statements⁵ which bring forward the healthy development of the stock markets in Saudi Arabia. Considering the fact that corporate governance code in any stock market should be refined and practiced frequently within the current structure of the business, beside

¹ Kajola, S. O. (2008): "Corporate governance and firm performance: The case of Nigerian listed firms", *European Journal of Economics, Finance and Administrative Sciences*, 14(14), 16-28.

² Alkhalidi, B. A. (2015): "The Saudi capital market: The crash of 2006 and lessons to be learned", *International Journal of Business, Economics and Law*, 8 (4), 135-146; Al-Matari, Y. A., Al-Swidi, A. K., Faudziah Hanim Bt, F., Al-Matari, E. M. (2012b): "Board of directors, audit committee characteristics and the performance of Saudi Arabia listed companies" *International Review of Management and Marketing* 2 (4), 241-251; Al-Moghawli, M. (2010): "The Management of Reported Earnings to Avoid Political Costs: A Study of Saudi Arabian Firms", *International Journal of Management* 27 (2), 254-266.

³ According: Capital Market Authority - CMA (2011): Annual Report 2011, p.12.

⁴ Capital Market Authority - CMA (2006): The Saudi Corporate Governance Code 2006, Article 1: Preamble, p.3

⁵ Capital Market Authority - CMA (2006): The Saudi Corporate Governance Code 2006, Article 10, Paragraph 2, p.10

the shortage in literature that studies the effectiveness of corporate governance mechanisms in Saudi Arabia context.⁶ The aim of this paper is to shed light on the Saudi corporate governance mechanisms and its practices through reviewing the articles of the code and the previous literature regarding its effectiveness.

This paper starts with corporate governance definition and its important aspects followed by a discussion of monitoring bodies in Saudi Arabia; moreover, a detailed discussion of the Saudi corporate governance code and its recent changes by Saudi Arabian Capital Market Authority (CMA). Then, the paper ends with the literature review of the empirical evidence of corporate governance impact on Saudi business context.

2. Definition and mechanisms of corporate governance

Although there is no universally accepted definition for the concept corporate governance, some authors have worked to clarify this concept. For example, Solomon and Solomon (2004) defined corporate governance as “the systems of checks and balances, both internal and external to companies, which ensures that companies discharge their accountability to all their stakeholders and act in a socially responsible way in all areas of their business”.⁷

In addition, according to The Organisation for Economic Co-Operation and Development (2004) “Corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined. Good corporate governance should provide proper incentives for the board and management to pursue objectives that are in the interest of the company and its shareholders and should facilitate effective monitoring”.⁸

All aforementioned definitions address the main elements, such as systems of control inside the company, relationships between the company’s stakeholders, and transparency and accountability to help the users of information.

In addition, corporate governance consists of external and internal mechanisms. External control mechanisms include the market for corporate control, legal system, and the stock market,⁹ whereas internal control mechanisms

⁶ Al-Matari, Y., Al-Swidi, A., Fadzil, F. (2012a): “Corporate Governance and Performance of Saudi Arabia Listed Companies”, *British Journal of Arts & Social Sciences*, 9(1), 1-30.

⁷ Solomon, J. Solomon, A. (2004): *Corporate Governance and Accountability*, Chichester: John Wiley & Sons, p. 14

⁸ Organisation for Economic Co-Operation and Development - OECD (2004): *Principles of Corporate Governance*, OECD Publications Service, p. 11

⁹ Cremers, M., Nair, V. B. (2003): “Governance mechanisms and equity prices”, *Journal of Finance*, 60, 2859-2894; Bushman, R. M., Smith, A. J. (2001): “Financial accounting information and corporate governance”, *Journal of Accounting and Economics*, 32(1), 237-333.

including board of directors, managers compensation, audit committee, remuneration committee, ownership structure and financial policies.¹⁰

Furthermore, good corporate governance practices bring certain benefits like the availability of lower cost of capital; it has the ability to meet the expectations of society/public, better competitiveness and increase financial performance and also sustainable long term growth of the business.¹¹

3. Saudi Arabia Corporate governance Code

Corporate governance code was established by the Board of Capital Market Authority on 12/11/2006 and amended in the following years in order to regulate and develop the Saudi stock market and increase the credibility and transparency of financial reporting.¹²

In more details, the code contains 18 articles, which deal with a variety of corporate governance aspects.¹³ Article 1 introduces the code and Article 2 provides definitions for the technical expressions associated with the code. Articles 3, 4, 5, 6 and 7 provide general rights of shareholders; facilitation of shareholders' exercising of rights and access to information; shareholders rights related to the general meeting; voting rights and dividend rights of shareholders.¹⁴ Articles 8 and 9 afford policies and procedures related to disclosure and transparency as well as disclosure in the Board of Directors' report. Consequently, Articles 10, 11, 12, 13, 14, 15, 16, 17 and 18 provide the main functions, responsibilities, formation, meetings and committees of the board, the audit committee, the nomination and remuneration committee, remuneration and indemnification of board members and conflict of interest within the board.¹⁵

¹⁰ Denis, D. K., McConnell, J. J. (2003): "International Corporate Governance", *The Journal of Financial and Quantitative Analysis*, 38(1), 1-36; Hermalin, B. E., Weisbach, M. S. (1991): "The Effects of Board Composition and Direct Incentives on Firm Performance", *Financial Management*, 20 (4), 101-112; Dalwai, T. A. R., Basiruddin, R., Abdul Rasid, S. Z. (2015): "A critical review of relationship between corporate governance and firm performance: GCC banking sector perspective", *Corporate Governance*, 15(1), 18-30.

¹¹ Shil, N. C. (2008): "Accounting for good corporate governance", *Joaag* 3(1), 22-31

¹² According: Capital Market Authority - CMA (2011): Annual Report 2011, p.12.

¹³ Capital Market Authority - CMA (2006): The Saudi Corporate Governance Code 2006, p.10.

¹⁴ Ibidem

¹⁵ Ibidem

3.1 Board of directors

Function

According to Article 10 of the code among the main functions of the Board is the fallow following: (a) approval of strategic plans and main objectives and supervision of their implementation; (b) adoption of rules for internal control systems and supervision of them; (c) drafting of a corporate governance code and supervision and monitoring of its effectiveness; (d) creation and implementation, after approval by the general assembly, of policies, procedures and standards for membership on the board of directors; (e) outlining a written policy to regulate the relationship with stakeholders with a view to protecting their respective rights; and (f) deciding policies and procedures to ensure the company's compliance with the laws and regulations and the company's obligation to disclose material information to shareholders, creditors and other stakeholders.¹⁶

Responsibilities of the Board

Article 11 contains the detailed list of responsibilities of the board.¹⁷ In general, the board of directors of a company assumes all the powers necessary for the efficient conduct of the business of the company. However, these powers are subject to the competencies of the general assembly of the company. Even if there are committees outside the board, set up for looking after specific functions, the ultimate responsibility for these functions would still lie with the board. This is the case even when the board has delegated some of its powers to third parties. It is in the best interests of the company that the board of directors should refrain from issuing general or indefinite power of attorney to any third parties.

Board size

The article 12, paragraphs (a, band h), of the corporate governance code has mentioned the following criteria regarding the formulation of the board of directors:¹⁸

- 1) The board of directors should contain at least three members and no more than eleven members.
- 2) The board of directors should be appointed by the General Assembly for the duration provided for in the Articles of Association of the company. Such duration shall not exceed three years if it s not contradict with Arti-

¹⁶ Ibidem, p.12.

¹⁷ Ibidem, p.10.

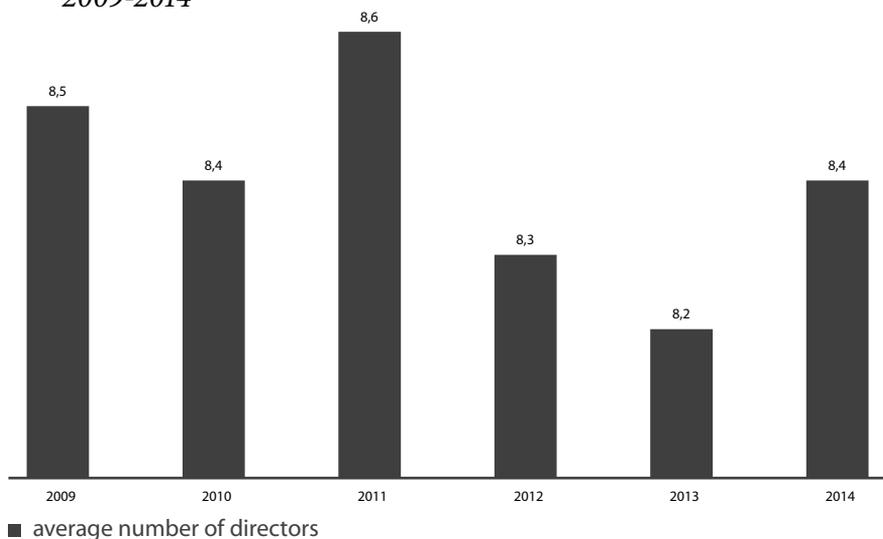
¹⁸ Capital Market Authority - CMA (2006): The Saudi Corporate Governance Code 2006, p.13.

cles of Association of the company, members of the Board may be reappointed.

- 3) A member of the board of directors should not act as a member of the board of directors of more than five joint stock companies at the same time.

Figure 1 shows the average number of board directors in Saudi listed companies according to Capital Market Authority (CMA) from 2009 to 2014. As it can be seen, the average number is around 8 members. Generally, it indicates the most listed companies fulfill the requirements of the code in terms of the board size.

Figure 1: *The Average Number of Board Directors in Saudi Listed Companies 2009-2014*



Source: The author preparation based on CMA annual reports 2009-2014

Board independent

According to the Corporate Governance article 12 paragraphs (c, d and e); the majority of the board of directors (one-third) should be non-executive. A non-executive member is a member of the board of directors who does not have a full-time management position at the company, or does not receive a monthly or yearly salary.¹⁹

It is not allowed for the position of the Chairman of the board of directors to be conjoined with any executive position such as Chief Executive Officer (CEO).²⁰

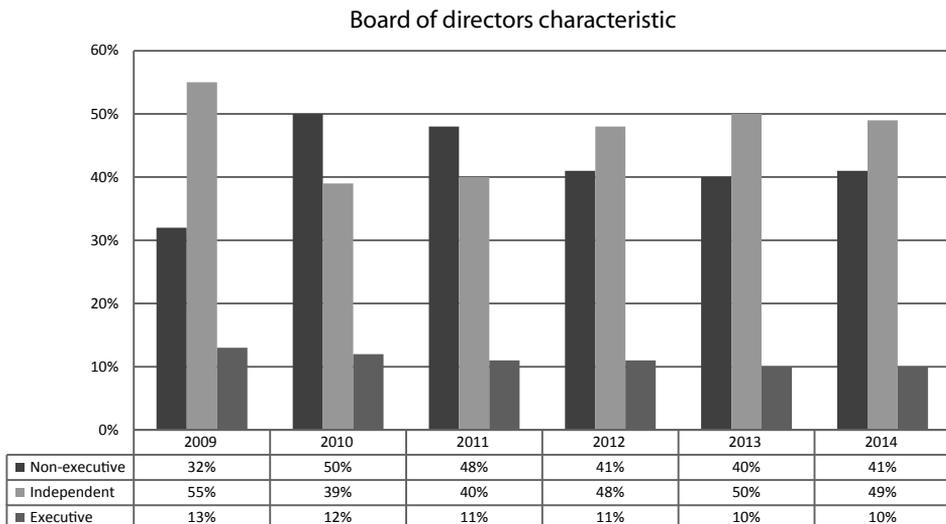
¹⁹ Capital Market Authority - CMA (2006): The Saudi Corporate Governance Code 2006, p.10.

²⁰ Ibidem

One-third of the members should be fully independent. An independent member is a member of the Board of Directors who enjoys complete independence. By way of example, the following shall constitute an infringement of such independence:²¹

1. He/she holds a five percent (5%) or more of the issued shares of the company or any of its group.
2. Being a representative of a legal person that holds a five percent (5%) or more of the issued shares of the company or any of its group.
3. He/she, during the preceding two years, has been a senior executive of the company or of any other company within that company's group.
4. He/she is a first-degree relative of any board member of the company or of any other company within that company's group.
5. He/she is first-degree relative of any of senior executives of the company or of any other company within that company's group.
6. He/she is a board member of any company within the group of the company whereby he is nominated to be a member of the board.
7. If he/she, during the preceding two years, has been an employee with an affiliate of the company or an affiliate of any company of its group, such as external auditors or main suppliers; or if he/she, during the preceding two years, had a controlling interest in any such party.²²

Figure 2: Board of Directors' Characteristic in Saudi Listed Companies 2009-2014



Source: The author preparation based on CMA annual reports 2009-2014

²¹ Ibidem

²² Ibidem

Figure 2 illustrates board characteristic of the Saudi listed companies from 2009 to 2014. It shows percentage of independent directors, executives and non-executives directors on the board during this period. It is clear from Figure 2 that the percentage of independent directors and the majority of non-executives required by the code are satisfied among the listed companies; while the average of percentage of independent directors is between 39% and 55%, and the percentage of non-executives is ranging from 32% to 50%.

Meetings of the Board

The code of corporate governance emphasized the importance of board meetings; however, it does not specify the annual number of meetings. Article Sixteen of the Corporate Governance code indicates that the board of directors should dedicate sufficient time in order to discharge their responsibilities, including preparing for the meetings of the board and its committees and endeavoring to attend such meetings.²³ The board shall convene its ordinary meetings regularly upon a request by the chairman; he should consult the other members of the board and the CEO when preparing a specified agenda to be presented to the board.

Table 2 Average Number of Yearly Meetings by Sector from 2009 to 2014

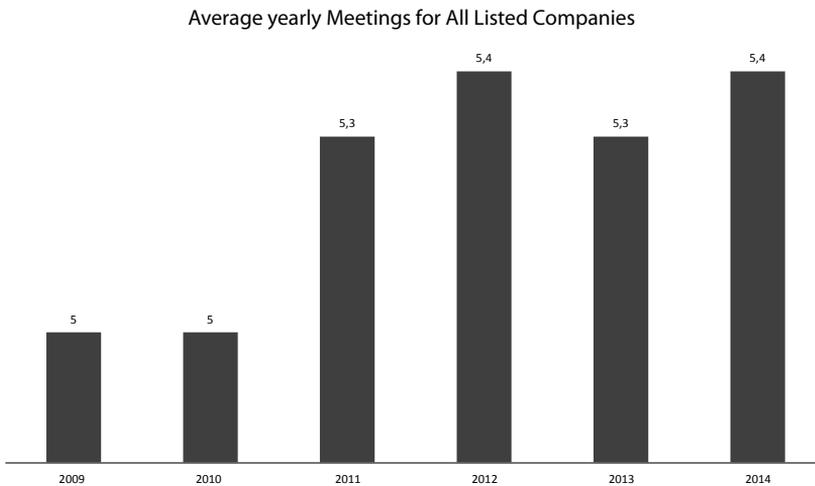
| Sector | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 |
|--|------|------|------|------|------|------|
| Banks and Financial Services | 5 | 5 | 5 | 5 | 5.5 | 5.3 |
| Petrochemical Industries | 4 | 4 | 4 | 4 | 4.4 | 4.5 |
| Cement | 5 | 5 | 6 | 6 | 5.2 | 5.5 |
| Retail | 4 | 3 | 5 | 5 | 4.3 | 4.7 |
| Energy & Utilities | 9 | 9 | 9 | 10 | 10.5 | 10 |
| Agriculture and Food Industries | 6 | 6 | 6 | 6 | 5 | 5.8 |
| Telecommunication & Information Technology | 5 | 7 | 7 | 7 | 7.5 | 8.3 |
| Insurance | 5 | 5 | 5 | 5 | 5 | 5.1 |
| Multi-Investment | 5 | 6 | 5 | 5 | 5.6 | 4.9 |
| Industrial Investment | 5 | 5 | 5 | 5 | 5 | 5.1 |
| Building & Construction | 5 | 5 | 5 | 6 | 5.9 | 5.7 |
| Real Estate Development | 6 | 5 | 5 | 6 | 6.4 | 6.3 |
| Transport | 5 | 7 | 8 | 7 | 7 | 5.8 |
| Hotel and Tourism | 6 | 5 | 4 | 5 | 6 | 7.3 |
| Media and Publishing | 4 | 4 | 5 | 6 | 5.7 | 3.8 |
| Meetings Average for All Listed Companies | 5 | 5 | 5.3 | 5.4 | 5.3 | 5.4 |

Source: Capital market authority various annual reports 2009-2014

²³ Ibidem, p. 17.

Table 2 shows Average number of yearly meeting by sector from 2009 to 2014. In addition, Figure 3 reveals the average number of yearly meetings for the all listed companies for the same period. The highest number of meetings was by Energy and Utility sector with an average of around 10 meetings a year. The telecommunication sector and transports sector came the second with an average of 7 meetings a year. On the other hand, petrochemical industries had the lowest number of yearly meetings. However, the average number of meetings for all listed companies was around 5 meetings a year from 2009 to 2014, which may indicate that the board of directors of the listed companies dedicates satisfactory time in order to discharge their responsibilities.

Figure 3 Average Yearly Meetings for Saudi Listed Companies 2009-2014



Source: The author preparation based on CMA annual reports 2009-2014

Disclosure in the Board of Directors' Report

The rules of corporate governance were initially not compulsory but the Capital Market Authority required the listed firms to comply with certain rules of the Corporate Governance Regulations in order to enhance the transparency and protect the shareholder's rights. The Capital Market Authority required the listed firms to include information in their annual report about compliance with the corporate governance regulations.²⁴

The composition of the board of directors and the balance between executive and non-executive (including independent) directors, and the other joint-stock companies directors holding a seat in its board of directors.

²⁴ Capital Market Authority - CMA (2006): The Saudi Corporate Governance Code 2006, p.8.

A brief description in respect of the composition of committees formed by the board of directors, such as audit, nomination and remuneration committees.

The details of compensation and remuneration paid to the chairman, board members and the highest-paid five executives (the chief executive officer and chief financial officer if they are not amongst the highest-paid five executives); and any punishment, penalty or restrictions imposed on the company by any regulatory, executive or judicial authority and the annual review of the effectiveness of its internal audit.²⁵

The Capital Market Authority will penalize companies that do not comply with the above requirements. For instance, a fine of 50,000 Saudi Real will be imposed on a Saudi firm if it does not include in the annual report information about the compliance with the Corporate Governance Regulations.

3.2 Board of Directors' Main Committees

Audit Committee

Article 14 of the Corporate Governance Regulations came into effect on 1/1/2009; it stipulates that the board of directors should set up an audit committee, issue rules for appointing the members of that committee, define its work procedure, and identify duties and responsibilities thereof. The Article also states that the committee members should not be less than three, including a specialist in financial and accounting. Executive board members are not eligible for audit committee membership. In the context of Saudi Arabia, the corporate governance guidelines address the duties and responsibilities of audit committee as following:

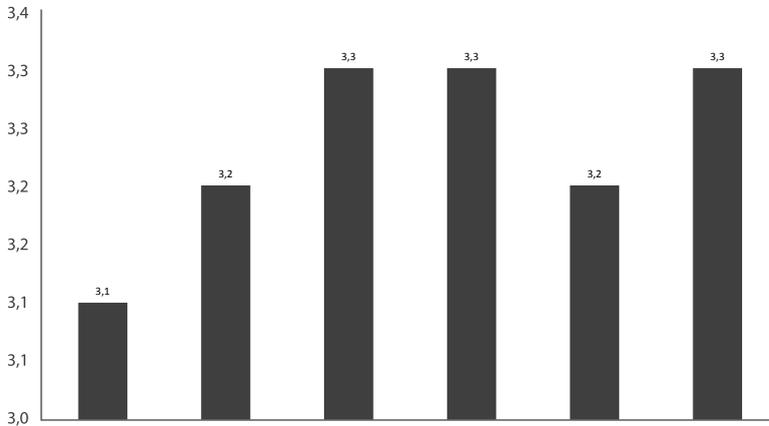
1. To supervise the company's internal audit department to ensure its effectiveness in executing the activities and duties specified by the Board of Directors.
2. To review the internal audit procedure and prepare a written report on such audit and its recommendations with respect to it.
3. To review the internal audit reports and pursue the implementation of the corrective measures in respect of the comments included in them.
4. To supervise the activities of the external auditors and approve any activity beyond the scope of the audit work assigned to them during the performance of their duties.
5. To review together with the external auditor the audit plan and make any comments thereon.

Figure 4 shows the average number of audit committee numbers on Saudi listed companies. From the figure, the average number is about three members

²⁵ Capital Market Authority - CMA (2009): Annual Report 2009.

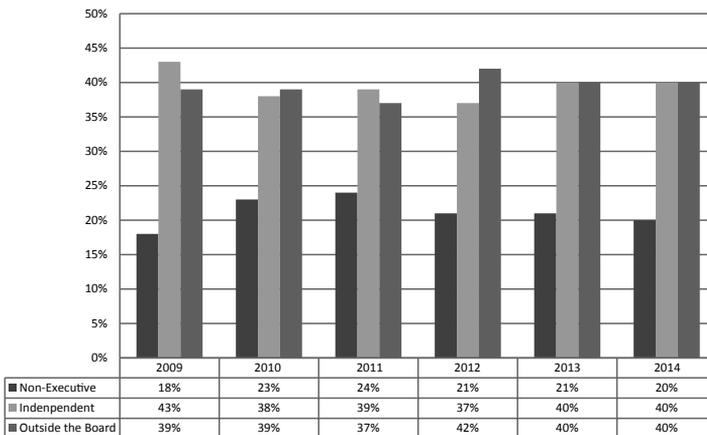
from 2009 to 2014. This indicates that the companies comply with the requirements of corporate governance code.

Figure 4 The average number of audit committee members on Saudi listed companies 2009-2014



Source: The author preparation based on CMA annual reports 2009-2014

Figure 5 The audit committee characteristic in Saudi listed companies 2009-2014



Source: The author preparation based on CMA annual reports 2009-2014

Nomination and Remuneration Committees

Figure 5 illustrates audit committee characteristic of the Saudi listed companies from 2009 to 2014. It shows percentage of independent, executives and non-executives members of audit committee. According to Figure 5, the percent-

age of independent directors and the majority of non-executives required by the code are fulfilled by the listed companies. The average of percentage of independent directors is between 37% and 43%, and the percentage of non-executives is ranging from 18% to 24%.

Article 15 of Saudi corporate governance states that the board of directors of listed companies shall set up a committee, which is to be named "Nomination and Remuneration Committee".

On 1/1/2011 Article 15 (Nomination and Remuneration Committee) of the Corporate Governance Regulations has become mandatory for all listed companies.

In addition, the article illustrates the following responsibilities and duties of the Nomination and Remuneration Committee:²⁶

1. Recommend the Board of Directors appointments to membership of the Board.
2. Conduct annual review of the requirement of suitable skills for the board membership and the preparation of a description of the required capabilities and qualifications for such membership.
3. Determine the points of strength and weakness in the Board of Directors and recommend remedies that are compatible with the company's interest.
4. Ensure the independence of the independent members.

3.3 The main changes of the articles of corporate governance regulation in Saudi Arabia (2006 - 2014)

The board of the CMA issued resolution No. (1-36-2008) on 10/11/2008 making the following articles of corporate governance regulations mandatory: Article 9: disclosure in the board of directors' report. Article 12, which contains two mandatory paragraphs: (c) the majority of the members of the board of directors shall be non-executives members; (e) the independent members of the board shall not be less than two members, or one-third of the members, whichever is great. Article 14, which stipulates setting up an audit committee, issuing rules for appointing the members of the audit committee, defining the term of the office and the procedure to be followed by the committee, and determining its duties and responsibilities.

On 16/3/2010, the board of CMA issued resolution No. (1-10-2010) making article 15 of corporate governance regulation on the nomination and remuneration committee mandatory for all companies listed on Saudi stock exchange, effective from 1/1/2011.

On 30/10/2011, the Board of the CMA issued Resolution No. (1-33-2011) making paragraph (b) in Article 10 of the Corporate Governance Regulations

²⁶ Capital Market Authority - CMA (2006): The Saudi Corporate Governance Code 2006, p.16.

(laying down rules for internal control systems and supervising them as part of the main functions of the board of directors) mandatory for all companies listed on the Exchange.

On 30/12/2012, The Board of the Capital Market Authority issued resolution No. (3- 40-2012) making paragraphs (i) (Shareholders shall be enabled to peruse the minutes of the General Assembly; the company shall provide the Authority with a copy of those minutes within 10 days of the convening date of any such meeting) and (j) of Article 5 of the Corporate Governance Regulations mandatory for all companies listed on the Exchange (The Exchange shall be immediately informed of the results of the General Assembly). On the same date and resolution, the paragraphs (c) and (d) of Article 10 of the Corporate Governance Regulations had become mandatory for all companies listed on the Exchange effective (Drafting a Corporate Governance Code for the company that does not contradict the provisions of this regulation, supervising and monitoring in general the effectiveness of the code and amending it whenever necessary) (Laying down specific and explicit policies, standards and procedures, for the membership of the Board of Directors and implementing them after they have been approved by the General Assembly). Furthermore the resolution made paragraph (g) of Article 12 of the Corporate Governance Regulations mandatory for all companies listed on the Exchange effective from (The Board of Directors shall ensure that sufficient information about the company is made available to all members of the Board of Directors, generally and, in particular, to the non-executive members, to enable them to discharge their duties and responsibilities in an effective manner).

4. Corporate governance practices and effectiveness in Saudi context empirical evidence

Empirically, there is a shortage of literature that examines the effectiveness of corporate governance mechanisms in Saudi Arabia context.²⁷ According to a recent review of previous literature conducted by Dalwai et al. (2015), the existing studies in Saudi context and Gulf Countries Council subjected to several limitations such as a single-period study, combined financial and non-financial firms and limited data.²⁸

Whilst some studies have focused on the corporate governance perceptions, practices and investigating the level of compliance with the code among

²⁷ Al-Matari, Y., Al-Swidi, A., Fadzil, F. (2012a): "Corporate Governance and Performance of Saudi Arabia Listed Companies", *British Journal of Arts & Social Sciences*, 9(1), 1-30.

²⁸ Dalwai, T. A. R., Basiruddin, R., Abdul Rasid, S. Z. (2015): "A critical review of relationship between corporate governance and firm performance: GCC banking sector perspective", *Corporate Governance*, 15(1), 18-30

the listed companies, other studies have tested the relation between corporate governance and firm performance and its effect on earnings management and reporting quality. A review of these studies presented as follows:

To begin with, the previous literature focusing on the relation between corporate governance and firm performance, Fallatah and Dickins (2012) examine the association relation between a weighted index of corporate governance characteristics and firm performance using 94 companies listed in Saudi stock market during the period from 2006 to 2009. The study results indicate that company performance measured as return on assets is not associated with corporate governance level. However, the positive association does exist when company performance measured as Tobin's Q and market value of equity.²⁹

In the same vein, Al-Matari et al. (2012b) test the role of corporate governance mechanisms in mitigating agency cost problems using sample of 135-listed company in Saudi stock market in 2010. The findings do not support the agency theory assumptions regarding the role of board of directors (board size, CEO duality,) and audit committee (audit committee size, audit committee independent, audit meeting). Surprisingly, the results indicate positive relation between percentage of non-executive directors on the board and firm performance.³⁰

Similarly, Ghabayen (2012) investigates the impact of several corporate mechanisms mainly audit committee size, audit committee composition, board size, and board composition on firm performance measured as return on assets. The study covers 102 Saudi listed companies in the year 2011. The findings show no relation between the aforementioned mechanisms and firm performance except for board composition that has a significant negative relationship with firm performance.³¹

Adding ownership structure impact on the relation between corporate governance and firm performance, Al-Ghamdi and Rhodes (2015) compare 55 family-firms and 44 non-family firms in Saudi Arabia during the period 2011–2013. The results indicate a strong relationship between performance and managerial ownership only in family firms whether performance is measured using return on assets or Tobin's Q. Moreover, the findings support the relation between firm performance, board size and CEO non-duality in family firms.³²

²⁹ Fallatah, Y., Dickins, D. (2012): "Corporate governance and firm performance and value in Saudi Arabia", *African Journal of Business Management*, 6 (36), 10025-10034

³⁰ Al-Matari, Y. A., Al-Swidi, A. K., Faudziah Hanim Bt, F., Al-Matari, E. M. (2012b): "Board of directors, audit committee characteristics and the performance of Saudi Arabia listed companies" *International Review of Management and Marketing* 2 (4), 241-251.

³¹ Ghabayen, M. A. (2012): "Board Characteristics and Firm Performance: Case of Saudi Arabia", *International Journal of Accounting and Financial Reporting*, 2(2), 168-200.

³² Al-Ghamdi, M., Rhodes, M. (2015): "Family Ownership, Corporate Governance and Performance: Evidence from Saudi Arabia", *International Journal of Economics and Finance*, 7(2), 78.

Regarding the corporate governance perceptions, practices and the compliance with the code among the listed companies, a study by Falgi (2009) examined the understanding of corporate governance, the current practice, and the impact of the social, cultural and economic aspects on corporate governance perceptions in Saudi Arabia. The study used semi-structured interviews and a questionnaire survey with wide groups of stakeholders. The findings suggest that corporate governance in Saudi Arabia is in its early stages and is characterized by a lack of accountability, a weak legal framework and poor protection of shareholders. The influence of the social, cultural and economic factors is evident.³³

Furthermore; Al-Qarni (2010) explores the causes of non-compliance of the Saudi listed companies with Corporate Governance's requirements. To determine these causes, he uses a questionnaire which was distributed to a number of auditors and some of the listed company's representatives such as general managers or executive officer etc. Al-Qarni concluded that the main reasons are the modern aspects of the code of corporate governance; the code does not mention any penalties in case of non-compliance and the compliance with the code needs financial, managerial and legal expertise which do not exist in Saudi companies.³⁴

With reference to studies related to the impact of corporate governance mechanisms on information disclosure of financial reporting quality in Saudi context, Hussainey and Ali (2008) examine the extent to which Saudi listed companies report online information about their corporate governance practice in light of the guidance issued by the Saudi Arabian Capital Market Authority.³⁵ The study revealed that the level of online reporting of corporate governance varies between sectors. This could be for the reason of various factors such as the nature of control over the sector, the involvement of government in the ownership and management of businesses and some social assumptions.

Moreover, Al-Janadi et al. (2013) investigate the effectiveness of corporate governance mechanisms on providing quality voluntary disclosure. The study covers 87 companies from the Saudi Stock Market during 2006 to 2007.³⁶ The findings show that the corporate governance mechanisms, especially non-executive directors, board size, CEO duality, audit quality, and government ownership have an important role in providing quality reporting. Accordingly, they perceive that the adapting of corporate governance as a mechanism of monitor-

³³ Falgi, K. I. (2009): Corporate governance in Saudi Arabia: a stakeholder perspective, Unpublished PhD. (Durham University Business School), 285-290.

³⁴ Al-Qarni, A. A. (2010): "The Causes of Non-Compliance of the Saudi Listed Companies with Corporate Governance's Requirements: An Empirical Study" (English), *Journal of King Abdulaziz University: Economics & Administration*, 24 (2), 111-157.

³⁵ Hussainey, K., Ali, A.-N. (2008): "Corporate Governance Online Reporting by Saudi Listed Companies", *Research in Accounting in Emerging Economies*, 8, 39-64.

³⁶ Al-Janadi, Y., Rahman, R. A., Omar, N. H. (2013): "Corporate governance mechanisms and voluntary disclosure in Saudi Arabia", *Corporate Governance* 4(4), 25-36

ing in stock market would make information released by the companies more adequate and sufficient for users.

A recent comprehensive study conducted by Marai (2014) investigates the relation between corporate governance mechanisms and earnings management practice in 67 Saudi listed companies from 2004 to 2012.³⁷ The findings of the study indicate that the proportion of outside directors on the board has no significant relation with this downward trend and such effect is increased significantly during the years when the code was compulsory from 2010 to 2012. The size of the board of directors has negative association with the magnitude of earnings management from the time when the corporate governance code is issued and such relation does not significantly affected when the code became compulsory from 2010 to 2012. However, the results show that there is no significant relation between board meeting, audit committee size, audit committee independent, audit committee meeting, ownership concentration and the level of earnings management neither during the full period of applying the code from 2006 to 2012 nor during the period when the code was compulsory from 2010 to 2012.

Conclusion

Corporate governance code in Saudi market was issued in 2006 and it has been in practice for almost 10 years. During this period, it has witnessed major changes, which can be summarized as follows: since November 10th, 2008, it has become compulsory for all listed companies to include in the board of directors' report the applicable provisions of corporate governance code as well as the provisions, which have not been applied, and the reasons for not applying them. In addition to establishing an audit committee, the independent members of the board shall not be less than two members, or one-third of the members, whichever is great.

Since 1/1/2011, it has become compulsory for all listed companies to establish nomination and remuneration committee. One year later, on 1/1/2012, it has become mandatory for all companies to lay down rules for internal control systems and supervise them as part of the main functions of the board of directors.

Since 30/12/2012, it has become mandatory for listed companies to draft a Corporate Governance Code for the company and amend it whenever necessary. Laying down specific and explicit policies, standards and procedures, for the membership of the board of directors, likewise, sufficient information about the company shall be made available to all members of the board of directors to enable them to discharge their duties and responsibilities in an effective manner.

³⁷ Marai, A. (2014): Earnings management and corporate governance mechanisms Applied study in Saudi Arabia stock market, Unpublished PhD. Megatrend University, Graduate School for Business Studies, Belgrade, Serbia

Generally, the analysis of Saudi stock market authority (SMA) annual reports (2009 - 2014) indicate that the most listed companies fulfill the requirements of the code regarding the board size with average of 8 members on the board of directors. Similarly, the reports show that the percentage of independent directors and the majority of non-executives required by the code are satisfied among the listed companies. Moreover, the analysis reveals that the boards of directors of the listed companies devote reasonable time with average of 5 meetings yearly from 2009 to 2014. Furthermore, the analysis indicates that the companies comply with the requirements of corporate governance code with about 3 members on average for all listed companies from 2009 to 2014. Moreover, it shows that the percentage of dependent non-executives members of audit committee is fulfilled by the listed companies.

Despite the shortage in literature that examines the impact of Saudi corporate governance code, most of previous studies reveal insignificant relation between corporate governance and firm performance in Saudi market. For example, Fal-latah and Dickins (2012), Al-Matari et al. (2012b), and Ghabayen (2012) found no relation between governance mechanisms and firm performance such as board size, board independent, board meeting, audit committee size and audit independent. However, Al-Ghamdi and Rhodes (2015) found positive and significant relation between the aforementioned mechanisms and firm performance especially in family firms.

The previous literature indicates insufficient compliance with the requirements of the code by listed companies. The main reasons behind that is, firstly, the trend of adapting the code. At the beginning in 2006, it was optional for companies to follow the code until 2010 when it became compulsory for all listed companies, secondly, the weak legal enforcement, and the effect of some social, economic and culture factors.

As for the expected role of corporate governance in enhancing the quality of financial reporting, Hussainey and Ali (2008) and Al-Janadi et al. (2013) found that corporate governance mechanisms namely non-executive directors, board size, CEO duality and audit quality have an important role in providing useful information for users.

All in all, the provisions of Saudi corporate governance code are suitable if they are applied by listed companies. SMA annual reports show an increase in the level of the compliance by listed companies, indicating that the code is achieving its aims. However, evidence from empirical studies reveals that it has insignificant impact on company's performance and mitigating earnings management. The main reasons behind that is the regulations of corporate governance still in its early stages, weak legal enforcement, and some social, culture, economic factors. Therefore, the code needs more time and improvement to achieve its purposes.

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PRAKSA I EFIKASNOST INTERNIH MEHANIZAMA KORPORATIVNOG UPRAVLJANJA NA SAUDIJSKO ARABIJSKOJ BERZI: PREGLED EMPIRIJSKIH ISTRAŽIVANJA

Cilj ovog rada je da se ocene prakse i efikasnost Kodeksa korporativnog upravljanja u Saudijskoj Arabiji. U tom cilju, analizirane su odredbe Kodeksa koje se odnose na interne mehanizme korporativnog upravljanja i izvršen je pregled istraživanja efikasnosti korporativnog upravljanja u Saudijskoj Arabiji. Rezultati istraživanja ukazuju da su odredbe saudijskog Kodeksa korporativnog upravljanja adekvatne. Analiza godišnjih izveštaja (2009-2014) pokazuje porast nivoa usklađenosti listiranih kompanija, što ukazuje na to da su ciljevi Kodeksa korporativnog upravljanja u ovom delu postignuti. Međutim, empirijska istraživanja ukazuju da primena Kodeksa korporativnog upravljanja nema značajnog uticaja na performanse kompanija, niti doprinosi smanjenoj primeni politike upravljanja dobitkom. Glavni razlozi za navedeno leže u činjenici da je primena praksi korporativnog upravljanja u Saudijskoj Arabiji još uvek u ranoj fazi, da je slaba primena usvojenih propisa, kao i u pojedinim socijalnim, kulturnim i ekonomskim faktorima. Usled toga, ocenjuje se da je neophodno još vremena kako bi se unapredila praksa dobrog korporativnog upravljanja, odnosno da bi Kodeks korporativnog upravljanja postigao svoje ciljeve.

Ključne reči: korporativno upravljanje, interni mehanizmi, odbor direktora, odbor za reviziju, odbor za nagrađivanje.