CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT IN SAUDI LISTED FIRMS

ALSHAMMARI AHMAD JASSIM H

UNIVERSITI UTARA MALAYSIA
2010

CORPORATE GOVERNANCE AND EARNINGS MANAGMENT

IN SAUDI LISTED FIRMS

A Thesis Submitted to College Business in Partial

Fulfillment of the Requirement for the Degree Master

Science of International Accounting

Universiti Utara Malaysia

By

ALSHAMMARI AHMAD (803847)

ALSHAMMARI AHMAD JASSIM H

KOLEJ PERNIAGAAN
(College of Business)
Universiti Utara Malaysia

PERAKUAN KERJA KERTAS PROJEK
(Certification of Project Paper)

Saya, mengaku bertandatangan, memperakukan bahawa
(I, the undersigned, certified that)
ALSHAMMARI AHMAD (803847)

Calon untuk Ijazah Sarjana
(Candidate for the degree of) **MASTER OF SCIENCE (INTERNATIONAL ACCOUNTING)**

telah mengemukakan kertas projek yang bertajuk
(has presented his/her project paper of the following title)

CORPORATE GOVERNANCE AND EARNINGS MANAGEMENT IN SAUDI LISTED FIRMS

Seperti yang tercatat di muka surat tajuk dan kulit kertas project
(as it appears on the title page and front cover of the project paper)

Bahawa kertas projek tersebut boleh diterima dari segi bentuk serta kandungan dan meliputi bidang ilmu dengan memuaskan.
(that the project paper acceptable in the form and content and that a satisfactory knowledge of the field is covered by the project paper).

Nama Penyelia *(Name of Supervisor)* : **PROF. DR. ZAKARIA ABAS**

Tandatangan *(Signature)* :

Tarikh *(Date)* : **1 APRIL 2010**

PERMISSION TO USE

In presenting this thesis in partial fulfillment of the requirements for the postgraduate degree of Master of Science (International Accounting) from the Universiti Utara Malaysia, I agree that the University's library may take it freely available for inspection. I further agree that the permission for copying of this thesis in any manner, in whole or in part, for scholarly purpose may be granted by my supervisor or, in his absence, by the Dean of the College of Business. It is understood that any copy or publication or use of this thesis or parts thereof for financial gain shall not be allowed without my written permission. It is also understood that due recognition shall be given to me and to the Universiti Utara Malaysia for any scholarly use which may be made of any material from my thesis.

Request for permission to copy or make other use of material in this thesis in whole or in part should be addressed to:

Dean (Research and Post-Graduate)

College of Business

Universiti Utara Malaysia

06010 UUM Sintok

Kedah Darul Aman

Malaysia

Abstract

The system of corporate governance is designed for the effective and efficient operation of corporations on behalf of stakeholders as a mean of enabling various stakeholders to monitor managers effectively against opportunistic behavior. The corporate governance mechanisms have shown in other context of different organizations to affect firms' behavior particularly the earnings management practices. The issue has been tested worldwide and it was shown that earnings management could be affected by the structure of corporate governance of the firms. Therefore, this study aims to investigate the impact of corporate governance mechanisms (i.e. independent director, Board size, board meetings and audit committee characteristics) on earnings management activities in Saudi listed firms for the year 2008. The study is significant due to the lack of empirical studies in the field of corporate governance and earnings management since the Saudi code of corporate governance has been enacted in the late 2006. More interesting this study will be of significant since it tests the period following the financial crisis in order to show whether the earnings management activities have experienced a change during this period compares to the past period as well as whether the corporate governance enhance the earnings quality and help in curbing earnings management in such critical period. The results of the study show that earnings management activities do not experienced any change post enactment of corporate governance code for Saudi listed firms. Furthermore, the corporate governance mechanisms have shown to have no impact on earnings management except for the board meetings which show negative relationship with earnings management. The impactions of the study for regulations are to help them in assessing whether the corporate governance achieved its objectives in order for them to take the corrective actions wherever necessary.

ACKNOWLEDGEMENT

In the name of Allah the most gracious, the merciful.

I praise Allah and thank him for the blessings of completing this study.My special thanks to the following, to reach this stage of my Master. First, I feel proud to express my deepest gratitude, profound and deepest sense of appreciation to my supervisor prof. Zakaria bin Abas for his planning the project paper, his thoughtful guidance, sagacious advices, his valuable suggestions, his precious comments during discussions , his kind supervision with me and his continuous encouragement to make my research successful, this thesis would not have become a reality.

I express my special gratitude to my beloved father, who, since my mother's passing, has taken care of me and my brothers and sisters and guided us with his prayers and perseverance. My sincere appreciation also goes to my brothers and sisters for their encouragement. My highest regards and deepest appreciations go to my dearest wife Emain and my dearest kids Naife, Fadah and Lamar for their encouragement, moral support, patience and understanding it was utmost essential.

Finally, if this modest effort is successful, it is by Allah's grace and guidance and if it is falls short of the readers' expectations, we can only pray and hope that Allah will forgive me.

Alshammari Ahmad Jassim H.

May 2010

TABLE OF CONTENT

LIST OF TABLES

CHAPTER ONE

INTRODUCTION

1.0 Background of the study

The chapter provides an introduction of the study. In the first section 1.1 of the chapter, an overview of the study is provided. In Section 1.2 the problem statement is presented. The motivation of the study is highlighted in section1.3. The objectives of the study are highlighted in the section 1.4. It follows by section 1.5 which discusses the contribution of the study. Finally section 1.6 proposes the organization of the report.

1.1 Overview

Corporate governance has become a popular issue in the last few decades. It started in 1992 with the Cadbury report in the UK. Cadbury committee for corporate governance was the result of several high profile company collapses is concerned primarily with protecting weak and widely dispersed shareholders against self-interested Directors and managers. In response to the corporate scandals, congress enacted the Sarbanes-Oxley (SOX) Act on July 30, 2002. The act specifically targets corporate governance reform and has created a reporting system that now makes corporate governance more transparent to the public. In addition, the development of rating schemes for corporate governance has added to its transparency.

While previous research suggests a relation between good governance practices and less fraudulent financial reporting (Beasley, 1996). Corporate governance issues are sparse and no definitive relationship has been determined. Most other developed and emerging market countries have adopted best practices Codes e.g. Combined Code in the UK, Cromme Code in

The contents of the thesis is for internal user only

BIBLIOGRAPHY

Abdul Rahman, R. and Ali, F.H.(2006). Board, Audit Committee and Culture and Earnings Management: Malaysian Evidence. Managerial Auditing Journal, Vol, 21, No. 7, pp.783-804.

Abduallah,S. (2004). Board Composition, CEO Duality and Performance among Malaysian Listed Companies. Corporate Governance, Vol. 4 No. 4, pp. 47-61.

Abdullah, S. N. and Nasir, N. M. (2004). Accruals Management and the Independence of the Boards of Directors and Audit Committees. IIUM Journal of Economics and Management. Vol. 12, No. 1, pp.1-31.

Abbott, L.,Parker, S.and Peter, G. (2002). Audit Committee Characteristics and Financial Misstatement: A Study of the Efficacy of Certain Blue Ribbon CommitteeRecommendations. Papers.ssrn.com/sol3/papers.cfm?abstract_id=319125.

Al-Abbas (2009). Corporate Governance and Earnings Management: An Empirical Study of the Saudi Market VOLUME 15 * NUMBER 1 * September 2009ISSN 1540 - 1200

Aljifri,K.(2007). Measurement and Motivations of Earnings Management: A Critical Perspective. Journal of Accounting – Business & Management, Vol. 14, pp. 75-95.

Andres, P., Azofra, V.and Lopez, F. (2005). Corporate Boards in OECD Countries: Size, Composition, Functioning and \Effectiveness. Corporate Governance, Vol. 13, No.2, pp.197-210.

Bangoli, M., & Watts, S. G.(2000). The Effect of Relative Performance Evaluation on Earnings Management: A Game-Theoretic Approach. *Journal of Accounting and Public Policy* , 19, 377-397.

Beasley, M.S. (1996). An Empirical Analysis of the Relationship between the Board of Director Composition and Financial Statement Fraud. The Accounting Review, Vol. 71, No. 4, pp.443

Bedard, B., Chtourou, S. M., & Courteau,M.(2004). The Effect of Audit Committee Expertise, Independence, and Activity on Aggressive Earnings Management. Auditing: *A Journal of Practice and Theory*, 23 (2), 13-35.

Beneish, M. (2001). Earnings management: A perspective. Working paper.

Bryan, D., Liu, M.H. and Tiras, S. (2004). The Influence of Independent and Effective Audit Committees on Earnings Quality.

Cadbury, A. (1992).Report of the Committee on the Financial Aspects of Corporate governance. London

Carter, D.,Simkins, B. and Simpson, W.(2003). Corporate Governance, Board Diversity and Firm Value. . The Financial Review, Vol.38, pp.33-53.

Chen,G., Firth,M., Gao, D. and Rui,O. M.(2006). Ownership structure, Corporate Governance, and Fraud: Evidence from China. Journal of Corporate Finance, Vol. 12,pp. 424-448.

Cheng, S. (2008). Board Size and the Variability of Corporate Performance. Journal of Financial Economics,Vol. 87, pp. 157-176.

Chtourou, S. M., Bedard, J. and Courteau, L. (2001). Corporate Governance and Earnings Management. Available online at Papers.ssrn.Com/ abstract /2750553.

Coles, J. L., Daniel, N.D. and Naveen, L. (2008). Boards :Does One Size Fit All? Journal of Financial Economics. Vol.87, No. 2, pp. 329-356.

Conger, J. A., Finegold, D. and Lawler III, E.E. (1998). Appraising Boardroom Performance. Harvard Business Review, Vol. 75, No. 1, pp. 136-148.

Dechow, P., Sloan, R. and Sweeney, A. (1996). Causes and Consequences of Earnings Manipulation: An Analysis of Firms Subject to Enforcement Actions by the SEC. Contemporary Accounting Research Vol.13 No. l, pp. 1-36.

Dehaene, A., Vuyst, V., & Ooghe, H. (2001). Corporate Performance and Board Structure in Belgian Companies. *Long Rang Planning*, 34, 383-398.

Dhaliwal, D., Naiker, V., & Navissi, F. (2006). Audit Committee Financial Expertise, Corporate Governance and accruals Quality: An Empirical Analysis. http://papers.ssrn.com/sol3/papers.cfm?abstract_id=906690

Emma, G., Meca, and Juan P. Sánchez-Ballesta (2009). Corporate Governance and Earnings Management: A Meta-Analysis, Vol 17, No, 5, pp. 594–610

Fama,E.F.(1980). Agency Problems and the Theory of the Firm. Journal of Ploitical Econmomy.Vol, 88, No, 2, pp. 288-307.

Fama,E.E. and Jensen, M. C.(1983). Separation of Ownership and Control. Journal of Law and Economics, Vol. 26, No. 2, pp. 301-325.

Gaa, J., & Dunmore, P.(2007, September). The Ethics of Earnings Management. *Chartered Accountants Journal*, pp.60-62.

Garg, A. G. (2007). Influence of Board Size and Independence on Firm Performance: A Study of Indian Companies. ViKALPA, Vol.32, No. 3, pp.39- 60.

Collier, P., & Gregory, A. (1999). Audit Committee Activity and Agency Costs. *Journal of Accounting and Public Policy*, 18, 311-332.

Jensen, M. C. (1993). The Modern Industrial Revolution, Exit and the failure of International Control System. *Journal of Finance*, 48 (3), 831-880.

John, K. and Sanbet, L.W. (1998). Corporate Governance and Board Effectiveness. Journal of Banking & Finance, Vol.22, pp. 371-403.

Jirapom, P., Kim, Y., & Davidson, W. (2008). Multiple directorships and corporate diversification. *Journal of Empirical Finance,* 15, 418-435.

Klein, A. (2002). Audit Committee, Board of Director Characteristics, and Earnings Management. Journal of Accounting and Economics, Vol, 33, pp.375-400.

Lin, J.W., Li, J.F.& Yang, J.S. (2006). The Effect of Audit Committee Performance on Earnings Quality. *Managerial Auditing Journal.* 21 (9), 921-933

Linck, J. S., Netter, J. M., and Yang, T.(2008). The Determinants of Board Structure. Journal of Financial Economics, Vol. 87, pp. 302-328.

Liu, Q. and Lu, Z. (2007).Corporate Governance and Earnings Management in the Chinese Listed Companies: A Tunneling Perspective. Journal of Corporate Finance, Vol. 13, pp. 881

Mak, Y.T. and Li Y. (2001). Determinants of Corporate Ownership and Board Structure: Evidence from Singapore. Journal of Corporate Finance, Vol.7. pp. 235-256.

Mallin, C., Mullineux A., and Wihlborg C. (2005).The Financial Sector and Corporate Governance: the UK Case, Corporate Governance, Vol. 13, No. 4, pp. 532-541.

Osma, B. G. and Noguer, B. G. (2007). The Effect of the Board Composition and its Monitoring Committees on Earnings Management: evidence from Spain Corporate Governance, Vol. 15, No. 6, pp. 1413-1428.

Park, Y. W. and Shin, H. (2004). Board Composition and Earnings Management in Canada . Journal of Corporate Finance,Vol. 10, pp. 431-457.

Peasnell, K.V., Pope, P. F. and Young,S.(2005). Board Monitoring and Earnings Management: Do Outside Directors Influence Abnormal Accruals?Journal of Business Finance & Accounting , Vol. 32, No.(7) & (8), pp. 1311-1346.

Peng, M.W., Buck,T. and Filatotchev, I.(2003). Do Outside Directors and New Managers Help Improve Firm Performance? An Exploratory Study in Russian Privatization. Journal of World Business, Vol. 38, pp.348-360.

Peng,M.W.,Zhang,S. and Li, X. (2007).CEO Duality and Firm Performance During China's Institutional Transitions. Management and Organization Review, Vol. 3, No. 2, pp.205-225.

Reitenga, A., & Tearney, M. (2003). Mandatory CEO Retirements, Discretionary Accruals, and Corporate Governance Mechanisms', *Journal of Accounting, Auditing, and Finance* 18 (2), 255-280.

Saleh, N., Iskandar, T., & Rahmat, M. (2005). Earnings Management and Board Characteristics: Evidence from Malaysia. *Jurnal Pengurusan*, 24, 77-103.

Sarkar, J., Sarkar, S. and Sen, K. (2006). Board of Directors and Opportunistic Earnings Management: Evidence from India.Available.

Vafeas, N. (1999). Board Meeting Frequency and Firm performance. Journal of Financial Economic, Vol. 53, No. 1, pp. 113-142.

Watts, R., Zimmerman, J. (1986). Positive Accounting Theory", Englewood Cliffs, Prentice-Hall, Inc.

Weir, C., & Laing, D. (2001). Governance Structures, Director Independence and Corporate Performance in the UK. *European Business Review*, 13 (2), 86-94.

Weir, C., Laing, D. and McKnight, P. J. (2002). Internal and External Governance Mechanisms: Their Impact on the Performance of Large UK Pubic Companies. Journal of Business Finance & Accounting, Vol. 29, No. 5&6, pp. 576-611.

Wild, J. (1996). The audit committee and earnings quality. *Journal of Accounting, Auditing and Finance*, 11, 247-276.

Xie,B., Davidson, W. and DaDalt, P.(2003) Earnings Management and Corporate Governance: the Role of the Board and the Audit Committee. Journal of Corporate Finance, Vol.9, pp. 295-316.

Yermack, D. (1996).Higher Valuation of Companies With Small Board of Directors. Journal of Financial Economics. Vol. 40, No. 2, pp. 185-211.

Zhao, Y. and Chen,K.H. (2008). Staggered Boards and Earnings Management. The Accounting Review, Vol. 83,No. 5, pp 1347-1381.