

MONITORING MECHANISMS AND EARNINGS INFORMATIVENESS IN THE
SAUDI STOCK MARKET

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ABSTRACT

The impact of monitoring mechanisms on financial reporting continues to be a topic of debate among academics, regulators and practitioners. This study focuses on whether internal and external monitoring mechanisms are related to financial reporting credibility. The study seeks to answer the main research question - to what extent are board of directors and audit committee characteristics, disclosure of internal control weaknesses, audit quality and institutional and bank monitoring associated with financial statement credibility. The study also examines whether some control mechanisms substitute or complement other control mechanisms. Hence, this study also attempts to answer the research question - to what extent board of directors, audit committee characteristics and audit quality influence the disclosure of internal control weaknesses. This study utilized a pooled sample of Saudi listed companies in the years 2007 and 2008. Two proxies of earnings informativeness are used to measure the credibility of reported earnings, namely (i) volatility of stock returns during the earnings announcement period and (ii) announcement period cumulative excess returns. The findings support the hypotheses on the association between board independency, audit quality, internal control system, and institutional ownership and earnings informativeness. The finding fails to support a direct impact of audit committee independence on earnings informativeness. However, the result shows that audit committee independence has significant impact on the disclosure of internal control system weaknesses and the disclosure of internal control system weaknesses has significant impact on earnings informativeness. This implies the indirect effects of audit committee independence on the credibility of reported earnings, consistent with the explanation that controls are complementary. The study extends the limited literature on earnings informativeness in Saudi Arabia, and assists the regulators in understanding the effects of monitoring mechanisms on the credibility of financial statement.

Keywords: Credibility of Financial Statements, Monitoring Mechanisms, Corporate Governance

ABSTRAK

Kesan mekanisma pemantauan ke atas pelaporan kewangan terus menjadi topik perdebatan di kalangan ahli akademik, penggubal undang-undang dan praktisioner. Kajian ini menjurus kepada persoalan sama ada mekanisma pemantauan dalaman dan luaran mempengaruhi kredibiliti pelaporan kewangan. Soalan utama yang dikemukakan dalam kajian ini adalah sejauh manakah Lembaga Pengarah, Jawatankuasa Audit, pendedahan kelemahan dalam kawalan dalaman, kualiti pengauditan, pelabur institusi dan pemantauan pihak bank mempengaruhi kredibiliti penyata kewangan. Kajian ini turut mengkaji kemungkinan wujudnya hubungan penggantian atau hubungan saling-melengkapi di antara beberapa mekanisma kawalan. Oleh itu, kajian ini turut menjawab persoalan - sejauh manakah Lembaga Pengarah, Jawatankuasa Audit, dan kualiti pengauditan mempengaruhi pendedahan kelemahan dalam sistem kawalan dalaman. Kajian ini menggunakan sampel yang terdiri daripada syarikat-syarikat yang tersenarai di Bursa Saudi pada tahun 2007 dan 2008. Dua proksi digunakan untuk mencerminkan kredibiliti penyata kewangan, iaitu (i) tahap ketidakstabilan pulangan stok ekoran dari perolehan yang dilaporkan dan (ii) kesan kumulatif lebih pulangan stok dalam tempoh pengumuman ekoran dari perolehan yang dilaporkan. Hasil kajian ini menyokong hipotesis bahawa kebebasan Lembaga Pengarah, kualiti pengauditan, pendedahan kelemahan dalam sistem kawalan dalaman, dan pemilikan saham oleh pelabur institusi mempengaruhi kredibiliti penyata kewangan. Hasil kajian ini tidak memaparkan kesan langsung yang signifikan di antara kebebasan Jawatankuasa Audit dan kredibiliti penyata kewangan. Namun, hasil kajian ini menunjukkan bahawa kebebasan Jawatankuasa Audit memberikan kesan signifikan ke atas pendedahan kelemahan dalam sistem kawalan dalaman, dan kelemahan sistem kawalan dalaman pula memberi kesan signifikan ke atas kredibiliti penyata kewangan. Hasil kajian ini menunjukkan wujudnya kesan tidak langsung kebebasan Jawatankuasa Audit ke atas kredibiliti penyata kewangan dan selaras dengan pernyataan bahawa kawalan adalah bersifat saling-melengkapi. Kajian ini menyumbang kepada literatur berkaitan dengan kredibiliti penyata kewangan di Saudi yang amat terhad, dan dari segi membantu penggubal selia memahami kesan mekanisma pemantauan terhadap kredibiliti penyata kewangan.

Katakunci: Kredibiliti Penyata Kewangan, Mekanisma Pemantauan, Tataurus Korporat

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LIST OF ABBREVIATIONS

AUDQ	External Auditor quality
BOSIZ	Board size
CEOD	Chief Executive Officer duality
CMA	Capital market authority
CPA	Certified public accountants
ERC	Earnings response coefficient
GDP	Gross domestic product
GRWTH	The market value of the firm's equity scaled by its book value
ICS	Internal Control System
IDAC	Independent directors on the audit committee
IND	Independent non-executive directors
INSHARE	Institutional Ownership
RISK	Market beta
SAR	The sum of the abnormal returns in the five day earnings announcement period.
SOCPA	Saudi organization for certified public accountants
SSM	Saudi Stock Market
UE	Unexpected earnings
VSR	The volatility of stock returns in the five day earnings announcement period
WTO	World Trade Organization

CHAPTER ONE

OVERVIEW

1.1 Introduction

In today's modern businesses, investors need useful, accurate and relevant information to make better investment decisions. Financial transparency and financial credibility have received much attention as a result of financial scandals associated with accounting irregularities and other frauds by top management (e.g. Enron, WorldCom, Adelphia, and Transmile). These scandals have led most investing communities to request for the enhancement of the quality of financial statements since financial statements are the main sources of information to investors. The credibility and transparency of company's financial reports increase the confidence of market participants on the stock exchange, and this leads to rise in trading volume and prices of company stock.

Teoh and Wong (1993) and Dey (2005) have used earnings informativeness as a proxy of financial reporting credibility. According to Dey (2005), the credibility of financial statement and reported earnings is based on investors' evaluation of reported earnings numbers i.e. the extent to which investors perceive those numbers as reflecting the current change in shareholder value. According to Lee *et al.* (2005), when a company's information is incomplete or not considered to be credible, investors will protect themselves by requiring a higher expected rate of return (e.g., lowering the price that

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