BOARD OF DIRECTORS, AUDIT COMMITTEE CHARACTERISTICS AND THE PERFORMANCE OF PUBLIC LISTED COMPANIES IN SAUDI ARABIA

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By

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ABSTRACT

This studyexamines the relationship between the internal corporate governance mechanisms related to the board of directors, the audit committee characteristics and the performance of listed companies on Saudi Stock Market (TADAWL) in 2010, excluding financial companies.The theoretical foundation of this relationship was provided by the agency and institutional theory. The data on the relationship between the audit committee and internal audit function was collected through a mail questionnaire. Of the 135 questionnaires distributed, 73 questionnaires, representing a response rate of 54.07 percent, were returned of which 62 (45.93 percent) were usable responses. Other information on firm performance, board of directors and audit committees characteristics was obtained from the annual reports of the respective companies (year-ending 2010). By using the multiple regression analysis, the results show that the effect of internal corporate governance variables on return on assets and Tobin's Q was somewhat different. The results indicate that the proportion of non-executive directors was found to be positively significant to return on assets. However, the board size was found to be negatively significant to Tobin's Q. For audit committee characteristics, the extent of audit committee reviews of IA proposals variable was reported to be positively significant to both measures of firm performance (return on assets and Tobin's Q).In relation to the practical and theoretical contribution, this study provides theoretical validity by suggesting that institutional theory may be more appropriate than agency theory in describing the practices of corporate governance in developing countries such as Saudi Arabia. From a practical perspective, the findings of this study provide feedback to the regulators (e.g. Capital Market Authority) and the companies in Saudi Arabia in a number of ways.

Keywords:corporate governance, firm performance, board of directors, audit committee, Saudi Arabia

ABSTRAK

Kajian ini mengkaji hubungan antara mekanisme tadbir urus dalaman korporat yang berkaitan dengan lembaga pengarah, ciri-ciri jawatankuasa audit dan prestasi syarikat yang disenaraikan di Pasaran Saham Saudi (TADAWL) pada tahun 2010, tidak termasuk syarikat-syarikat kewangan. Asas teori hubungan ini telah disediakan oleh agensi dan teori institusi. Data mengenai hubungan antara jawatankuasa audit dan fungsi audit dalaman telah dikumpulkan melalui soal selidik mel. Daripada 135 soal selidik yang diedarkan, 73 soal selidik, mewakili kadar tindak balas 54,07 peratus, telah dikembalikan di mana 62 (45,93 peratus) adalah jawapan yang boleh digunakan. Maklumat lain mengenai firma papan prestasi, pengarah dan jawatankuasa audit ciri-ciri yang diperolehi daripada laporan tahunan syarikat masing-masing (tahun berakhir 2010). Dengan menggunakan analisis regresi berganda, keputusan menunjukkan bahawa kesan pembolehubah tadbir urus dalaman korporat pada return on assets dan Tobin's Q adalah agak berbeza. Keputusan menunjukkan bahawa perkadaran pengarah bukan eksekutif telah didapati signifikan secara positif kepada return on assets . Walau bagaimanapun, saiz papan didapati negatif yang ketara kepada Tobin's Q. Bagi ciri-ciri jawatankuasa audit, takat ulasan jawatankuasa audit cadangan pembolehubah IA telah dilaporkan signifikan secara positif kepada kedua-dua langkah prestasi firma (return on assetsdan Tobin's Q). Dalam hubungan sumbangan praktikal dan teori, kajian ini menyediakan kesahihan teori dengan mencadangkan bahawa teori institusi mungkin lebih sesuai daripada teori agensi untuk menerangkan amalan tadbir urus korporat di negara-negara membangun seperti Arab Saudi. Dari perspektif praktikal, dapatan kajian ini memberi maklum balas kepada pengawal selia (contohnya Pihak Berkuasa Pasaran Modal) dan syarikat-syarikat di Arab Saudi dalam beberapa cara.

Kata kunci:tadbir urus korporat, prestasi firma, lembaga pengarah, jawatankuasa audit, Saudi Arabia

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LIST OF ABBREVIATIONS

AC	:	Audit committee
ACIAM	:	Audit committee meeting with the chief internal auditor.
ACIND	:	Audit committee independence.
ACMEET	:	Audit committee meeting.
ACOWN	:	Shareholdings held by audit committee
ACREV1	:	Audit committee reviews of internal auditorprogrammes and plans.
ACREV2	:	Audit committee reviews of the result of internal auditoractivities
BODCOM	:	Board composition
BOWN	:	Shareholdings held by directors.
BSIZE	:	Board size
CEO	:	Chief Executive Officer
CG	:	Corporate Governance
COWN	:	Shareholdings held by Chairman
DUAL	:	Role duality
EPS	:	Earnings per share
IA	:	Internal auditor
ICG	:	Internal Corporate Governance
IIA	:	Institute of Internal Auditors
NASD	:	National Association of Securities Dealers

NEDs	:	Non-executive directors
NYSE	:	New York Stock Exchange
ROA	:	Return on Assets
SEC	:	Securities and Exchange Commission
SOCPA	:	Saudi Organization of Certified Public Accountants
SOX	:	Sarbanes-Oxley Act
SSM	:	Saudi Stock Market
TQ	:	Tobin's Q

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CHAPTER ONE

INTRODUCTION

1.0 Background of the Study

Corporate scandals, such as Enron (2001), Global Crossing (2002), Tyco (2002), and Worldcom (2002), have shaken investor confidence and made it difficult for companies to raise equity from the stock market (Agrawal, 2005). Zubaidah, Nurmala, & Kamaruzaman (2009) believed that the board of directors and its committees do not have good supervision of the management. For example, Enron manipulated its financial statements through off-balance sheet financing. The board was unable to disclose the distorted statements because of the lackofboard independence from senior executives (Deakin & Konzelman, 2004). Moreover, WorldCom materially overstated its earnings and finally filed for bankruptcy. The investigation showed that the audit committee failed to effectively oversee the managers'duties (Weiss, 2005).Consequently, these well-publicized corporate scandals,together with the Asian financial crisis in 1997, havehighlighted the importance of good corporate governance practices for the long-term survival of companies (Mokhtar *et al*., 2009).

Regulators around the world are increasingly looking to set standards or codes of best practice for corporate governance to attract more capital or foreign investment to the country (Agrawal, 2005). For example, following the Sarbanes-Oxley Act (SOX, 2002), the New York Stock Exchange (NYSE) and National Association of Corporate Directors (NASD) proposed a new corporate governance listing-standard,which was approved by

Securities and Exchange Commission (SEC) on November 4, 2003. The new listing standards include provisions regarding board composition and structure, audit committee composition and responsibilities, and other corporate governance matters.

In general, corporate governance (CG) provides a complete foundation to assiststakeholders to exercise their rights, protect theirinterests and mitigate potential conflicts between themand the managers. In recent years, both developed and developing countries have taken initiatives to continuouslyimprove their system of CG to enhancethe performance of companies and to recover investorconfidence in financial reports. For example, the USAintroduced the Sarbanes Oxley Act (SOX) in 2002 andcreated the Public Company Accounting Oversight Board(PCAOB) in 2004 to help improveCG practice. Malaysiadeveloped the Malaysian Code onCorporate Governance(MCCG) in 1999 and enforced it in 2001. Interestingly, the importance of having audit committees was acknowledged as early as 1993 in Malaysia. In August 1993, the Malaysian Securities Commission gave notice to all companies listed on the KLSE to form audit committees in their organization. A grace period of one year was given for the companies to comply with the requirement.

In Saudi Arabia, the Saudi Stock Market (SSM) also faced an extraordinary crash at the beginning of 2006, which led the Capital Market Authority (CMA) to suspend the trading of two firms, Bishahand Anaam International Holding Group.These events created serious questions about the effectiveness of different monitoring devices that were presumed to protect investor interests in Saudi Arabia. In response to critics of the management of Saudi corporation after the 2006 crash, the Corporate Governance Regulation was issued by

CMA in November 2006to enhance the companies CG. The objectives of the CG resolution are toenhance the efficiency of market mechanisms, buildinvestor confidence, and to provide a mechanism to assistin evaluating the performance of companies.

Based on the premises of the agency theory, Jensen and Meckling (1976) and Shleifer and Vishny (1986) pointed out that there may be conflicts between the interests of management and shareholders, as owners of the company, when the management roles are separated from the shareholders roles.Conflicts may include management's pursuit of personal financial interests including entrenchment, leading to diminished firm performance. Therefore, different internal and external mechanisms have been considered via corporate governance to prevent agency conflicts as well as to reduce costs associated with such agency.

The audit committee is an important mechanism available to the board of directors to limit conflicts of interest and reduce information asymmetry between managers and stockholders (Menon & Williams, 1994),and, therefore, mitigates agency problems. Research has found that firms without audit committees are more likely to have fraudulent financial reporting (Dechow, Sloan, & Sweeney, 1996) and earnings overstatement (DeFond & Jiamnalvo, 1994).

The board of directors of companies in Saudi Arabia are responsible for establishing an audit committee through Article14(a) of the Code of Corporate Governancein 2006, which states that the board of directors shall "set up an audit committee comprising of non-executive directors".However, the mandatory requirement for the formation of an

audit committee for listed companies in Saudi Arabiaonly came later in 2009.The board of the Capital Market Authority issued resolution number (1-36-2008) dated 12/11/1429H corresponding to 10/11/2008G making Article 14 of the Corporate Governance Regulations mandatory for alllisted companies on the Saudi Stock Market.

There is a common understandingthat the mere existence of an audit committee does not guarantee that it will beeffective (Miettinen, 2008). Thus, the literature determines several attributes that are needed toachieve audit committee effectiveness. Most of the audit committee effectiveness literature has focused on one or more of the fundamentaldeterminants of audit committee effectiveness, namely, composition, authority, resources and diligence(Al-Lehaidan, 2006). Thesefour fundamental determinants have been frequently used in the literature to evaluateauditcommittee effectiveness in different contexts.According to DeZoort *et al.* (2002), auditcommittee effectiveness is dependent on its composition (the independence andexpertise of its members), its authority (responsibilities and influence) and itsresources (number of members and access to other governance parties).

Prior research indicated that the construct of audit committee effectiveness via firm performance is multidimensional and is affected by a variety of audit committee characteristics, such as committee independence (Al-Matari *et al.*, 2012; Chan & Li, 2008; Erickson, Park, Reising, & Shin, 2005; Hsu, 2007; Ilona, 2008; Nuryanah & Islam, 2011), meetings (Al-Matari *et al.*, 2012; Hsu, 2007) and shares ownership (Vafeas, 2005; Yang & Khirshnan, 2005; Yermack, 2004). However, the Blue Ribbon Committee (1999) and Sarbanes-Oxley Act (2002) noted another crucial dimension of audit committee

effectiveness that has attracted the focus of regulators and academics that of the audit committeerelations with the internal auditors.

The study by DeZoort, Hermanson, Archambeault, and Reed (2002) made it known that the effectiveness of the audit committee depends on its members' resources, which has to do with accessibility to management and auditors both internal and external. That is why Beasley, Carcello, Hermanson, and Lapides (2000) asserted in their study that audit committees without adequate resources stand the chance of having fraud in the company. Therefore, SOX expects audit committees to choose and relate with the auditors both internal and external, consider the audit services and fees for approval, prepare and supervise the company procedures, and hire counsel from outside.The SEC also specified that the responsibilities of audit committees include 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.

Researchers have also recognized the board of directors as an importantmechanism of internal corporate governance for monitoring the performance of managers and protecting the interests of shareholders (Fama & Jensen, 1983).To ensure theeffectiveness of the board, the Cadbury Committee (1992) recommended the inclusion of a sufficient number of non-executive directors who would bring independence to the board's judgment. For directors to be more effective and act in the interests of the shareholders,there should be a higher proportion of non-executive directors on the board. Fama andJensen (1983) argued that non-executive directors on the board are more effective in making optimal decisions, which can lead to improved firm performance.

Another corporate governance mechanism advocated by the agency perspective is the separation of the roles of the chief executive officer (CEO)and chairman.Fama and Jensen (1983), and Jensen (1993) argued that the separation between the CEO and chairman roles facilitates the reduction of the agency costs and increases firm performance. Moreover, they argued that duality decreases firm performance and increase the agency problems due to CEO entrenchment and a decline in board independence from the management. These arguments have been supported by the study of Yermack (1996) who found that firms are more valuable when the CEO and board chair positions are separate.Other advocates of the separation between the two roles, Blackburn (1994), and Stiles and Taylor (1993), pointed out that checks and balances with respect to the performance of the management will be ensured if there is a separation of the two roles.

Next, board size is also potentially related to the ability of directors to monitor and control managers (Lipton & Lorsch, 1992; Jensen, 1993), even though the direction of the influence is unclear.Zubaidah*et al.* (2009), Chiang and Chia (2005) and Haniffa and Hudaib (2006) provided evidence in their research that the number of directors has a positive association with firm performance. In addition, Anderson, Mansi, and Reeb (2004), and Williams, Fadil, and Armstrong (2005) found that the number of directors is positively related to board monitoring.

On the other hand, De Andres, Azofra, and Lopez (2005) revealed that the benefits of better management control by a larger board of directors are offset by the potential disadvantages from coordination, communication, and decision making problems. This argument has

been supported by the study of Hermalin and Wiesbach (2003) who found that a smaller board size leads to better performance.Moreover, studies carried out by Abdullah (2010), Chauhan and Dey (2009), Berghe and Levrau (2004), Ibrahim and Abdul Samad (2011), Kota and Tomar (2010),Lipton and Lorsch(1992), and Wei Hu, Tam, and Tan (2010) proved that small boards are better for the efficient discharge of duties and responsibilities.

On the issue of stock ownership, Patton and Baker (1987)showed that if the directors have higher equity ownership,there is tendency for them to be geared toward questioning managerial policies. In the previous studies conducted by Beasley (1996), Shivdasani (1993), and Vafeas and Theodorou (1998), it has also been indicated that board of directors with large stock ownership has a positive association with the performance of the firm as well as quality financial reports.

1.1 Motivation for the Current Study

There are a number of motivations for examining this study, as follows. First, due to the role of the audit committee as a mechanism of corporate governance, Bradbury (1990) and Dezoort (1997) claimed that audit committees have the capability to ensure that the processed financial reports are credible by monitoring and facilitating communication between the management and auditors (external and internal). The study by Beasley et al.(2000) also found that audit committees that are lacking resources (accessibility to internal and external auditors) are more likely to have fraud in the company.

Previous studies,such asAbdurrouf (2011), Kang (2011) and Swamy (2011),mostly focused on the mere presence of the audit committee when they examined the effect of the audit committee on firm performance. However, studies testing the association between audit committee effectiveness and firm performance alone are not sufficient (Al-Matari *et al.*, 2012; Kota & Tomar, 2010).

Second, a comprehensive review of the literature pertaining to the performance implications of corporate governance shows that many studies have examined the relationship between corporate governance (board characteristics) and firm performance (Abdurrouf, 2011;Bhagat& Black, 2002; Bonn, Yoshikawa, & Phan, 2004; Brown & Caylor, 2004; Haniffa & Hudaib, 2006;Ibrahim&Abdul Samad, 2011; Kamardin, 2009; Klein, 1998; Kota& Tomar, 2010; Vafeas & Theodorou, 1998; Yasser, Entebang & Mansor, 2011; Zubaidah *et al.*, 2009). However, little attention has been devoted to investigate the association between audit committee characteristics (as a governance mechanism) and firm performance (Al-Matari *et al.*, 2012; Kota& Tomar, 2010). A study by Chan and Li (2008) also stated that further studies on the impact of the composition of the audit committee on firm value are needed.

Finally,interactions between internal audit and the audit committee are an important element of sound corporate governance (Scarbrough, Rama, & Raghunandan, 1998; Turley & Zaman, 2007). An effective audit committee can strengthen the position of the internal audit function by acting as an independent forum for internal auditors to raise matters affecting management (Goodwin & Yeo, 2001; Braiotta, 1999). At the same time, internal audit can be of considerable assistance to the audit committee in its

oversight of reporting and risk management and control (Goodwin, 2003; Mat Zain, Subramaniam, & Stewart, 2006). The internal audit function (IAF) has also been long acknowledged as one of the cornerstones in an entity's corporate governance and its important role in monitoring internal controls in the entity is a key aspect of fraud prevention and detection (Gramling, Maletta, Schneider,& Church, 2004; Prawitt, Smith,& Wood, 2009). Moreover, Codes and regulations (e.g., SaudiCorporate Governance Code) stress the importance of the audit committee's relation with the internal auditors through expanding the functions of the audit committee (Al-Matari *et al.*, 2012).

A few previous studies investigated some of the audit committee characteristics such as: independence (Chan & Li, 2008; Erickson *et al.*, 2005; Hsu, 2007; Ilona, 2008; Nuryanah & Islam, 2011), size (Abdullah, 2010; Al-Matari *et al.*, 2012), meetings (Hsu, 2007) and experience (Hsu, 2007; Ilona, 2008). However, there is a paucity of research, if any, that none of the studies have examined the effect of the relationship between the audit committee and internal auditors on firm performance.

1.2 Justification for Doing this Study in Saudi Arabia

This study focused on Saudi Arabia as an emerging market for several interesting reasons. Firstly, most of the previous studies on corporate governance and firm performance issues have beenlimited to those of developed economies or large emerging economies. It seemsthat small economies such as those of the Arab countries in general and Saudi Arabia in particular are very much understudied in the literature.Currently, there is a lack of studies that investigate the composition of the board of directors, authoritiesand

responsibilities, sub-committees, the legal system in Saudi Arabia and their impact on company practices (Flagi, 2009). Therefore, in this study,the researcher tried to fill this gap by looking at the internal corporate governance (board of directors and audit committees characteristics) and its impact on firm performance.

Secondly, the Saudi Stock Market (SSM) faced an extraordinary crash at the beginning of 2006, which ledthe CMA to suspend the trading of two firms, Bishahand Anaam International Holding Group. These events created a serious question about the effectiveness of different monitoring devices that were presumed to protect investor interests in Saudi Arabia (Al-Abbas, 2009).

Thirdly,the Corporate GovernanceRegulation was issued by CapitalMarket Authority (CMA) in November 2006, in response to critics of the management of Saudi corporation after the 2006 crash. However, corporate governance in Saudi Arabia is still a nascent concept andthe Capital Market Authority (CMA) is still in the process of educating the markets concerning the benefits of applying good corporate governance (World Bank, 2009). In addition, these reports stated that many of the laws and institutions are still relatively new and untested, awareness of the importance of good corporate governance is low and implementation by companies is in its early stages. As a result, the search for mechanisms to enhance corporate governance and improve firm performance has mostly focused on the structure of the board of directors and audit committees.

Furthermore, there is limited number of research publications in respect of corporate governance in SaudiArabia (Al-Abbas, 2009; Alghamdi, 2012; Al-Hussain, 2009; Alsaeed, 2006; Falgi, 2009). While these studies have examined corporate governance from the perceptions of the roles and responsibilities of the boards of directors, the role of audit committees and the effect of corporate governance mechanisms on earnings management, none of them cover the corporate board practices in Saudi Arabia, and, to the best of the researcher's knowledge, so far no study thathas investigated the relationship between the board of directors, audit committee characteristics and their effects on firm performance. Therefore, this study will hopefully reduce the dearth of literature on corporate governance in emerging countries, and,more specifically, in Saudi Arabia.

Lastly, Saudi Arabia is the largest economy in the Middle-East and an important country to the world. It is a member of many worldwide organizations including the United Nations (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 the Organization of the Petroleum Exporting Countries (OPEC). Recently, after the global financial meltdown, Saudi Arabia has become a member of G20, being one of the top twenty economies in the world.

Therefore, this study was an attempt to investigate the relationship between the board of directors, audit committee characteristics and their effects on the performance of public listed companies in Saudi Arabia.

1.3Problem Statement

The performance of the companies listedon the Saudi Stock Markethave fluctuated over time. While some companies have experienced good performance, others have performed badly. For example, in 2010, 20 percent of the listed companies experienced negative performance,as measured by Return on Assets (ROA) and 25 percent negative performance as measured by Return on Earnings (ROE). Poor company performance is believed to be caused by many factors. According to Peng, Buck, and Filatotchev (2003), firm strategy and its implementation are among the factors that may affect company performance. In addition, it is also suggested thatcorporate governance is amongother factorsthat can contribute significantlyto firm performance (Alsaeed, 2006).

The theoretical foundation of the relationship between corporate governance and firm performance in this study was provided by the agency and institutional theory. The core of the agency theory is to resolve conflicts resulting from the separation ofownership and management control of corporate resources (Fama & Jensen,1983; Jensen, 1986).The existence of such conflicts of interest between owners and managers may affect the quality of earnings, and, consequently,firm performance.Therefore, to control conflicts of interests andreduce agency costs, various internal and external tools, known as corporate governance,have been suggested. For example, the board of directors is established as a solution forsuch conflicts.A study byMenon and Williams (1994) describedthe audit committee as one mechanism that could be used by the board of directors to reduce the conflicts of interest between the managers and stockholders to the barest minimum.Anotherstudy byDeZoort *et al.* (2002) described an effective audit

committee as a body of members well equipped with the authority and resources to guard the interests of the stakeholders.

On the other hand, the institutional theory implies that companies might adopt practices orregulations as a result of coercion from a legislator who imposes some practices by force inorder to improve organizational effectiveness.In addition, Kalbers and Fogarty (1998)pointed out thatmany organizational structures, such as board of directors and audit committees, are merely symbolic and may be formed to conform to social pressure without having any actual impact on financial reporting quality and firm performance.

The issue relating to the performance of Saudi listed companies, as well as in other developing countries, have been widely argued as being attributed to the lack of corporate governance,which can be explained by various reasons. One of the main reasons is the lack of coordination and cooperation between the audit committee and internal auditors. This association is the activity and mechanism through which the corporate governance will be fruitful in enhancing the performance.

Due to the role of the audit committee as a mechanism of corporate governance, Bradbury (1990) and Dezoort (1997) claimed that the audit committee has the capability to ensure that processed financial report is credible by monitoring and facilitating communication between the management, and auditors (external and internal).The study by Beasley *et al.* (2000) also found that audit committees that are lacking resources (accessibility to internal and external auditors) are more likely to have fraud in the company.

A comprehensive review of the literature pertaining to the performance implications of corporate governance shows that many studies have examined the relationship between corporate governance (board characteristics) and firm performance (Abdurrouf, 2011;Bhagat& Black, 2002; Bonn, Yoshikawa,& Phan, 2004; Brown & Caylor, 2004; Haniffa & Hudaib, 2006;Ibrahim&Abdul Samad, 2011; Kamardin, 2009; Klein, 1998; Kota& Tomar, 2010; Vafeas & Theodorou, 1998; Yasser, Entebang & Mansor, 2011; Zubaidah *et al.*, 2009). However, little attention has been devoted to investigate the association between audit committee characteristics (as a governance mechanism) and firm performance (Al-Matari *et al.*, 2012;Kota& Tomar, 2010).A study by Chan and Li (2008) also stated that further studies on the impact of audit committee composition on firm value are needed.

Moreover,although a few previous studies investigated certain audit committee characteristics, such as independence (Chan & Li, 2008; Erickson *et al.*, 2005; Hsu, 2007; Ilona, 2008; Nuryanah & Islam, 2011), size (Abdullah, 2010; Al-Matari *et al.*, 2012), meetings (Hsu, 2007) and experience (Hsu, 2007; Ilona, 2008), there is a paucity of research, if any,of studies that examined the effect of the relationship between the audit committee and internal auditors on firm performance.

The low performance of Saudi listed companies can be partially attributed to the fact that the audit committee members and chairman of the board were not shareholders. Being shareholders will give them an incentives to monitor the management activities, which, in turn, will lead to enhanced performance. However, the literature (Haniffa & Hudaib,2006;Vafeas & Theodorou, 1998; Zubaidah*et al.*, 2009) has focused on the relation

between shares ownership by directors (at the board level) and firm performance. To date, this relationship at the audit committee level and board chairman has not been given the necessary attention.

Remarkably, most of the recently published research regarding corporate governance and firm performance has focused primarily on U.S. companies and other developed countries, withless attention being devoted to companies in emerging markets (Chugh, Meador, & Kumar, 2011). Hence, there has been a call for more research relating to corporate governance in developing countries that have a unique business environment.

1.4 Research Questions

The main research questions that were investigated in this research wereas follows:

1. Are the characteristics of the board of directors associated with firm performance in Saudi Arabia?
2. Are audit committee characteristics associated with firm performance in Saudi Arabia?

The specific research questionswere as follows:

1) Is the proportion of non-executive directors associated with firm performance in Saudi Arabia?

2) Is CEO duality associated with firm performance in Saudi Arabia?

3) Is board size associated with firm performance in Saudi Arabia?

4) Is the chairman's shareholding associatedwith firm performance in Saudi Arabia?

5) Is the independence of the audit committee members associated with firm performance in Saudi Arabia?

6) Is the frequency of audit committee meetings associated with firm performance in Saudi Arabia?

7) Is audit committees' shareholdings associated with firm performance in Saudi Arabia?

8) Is the frequency of meetings between the audit committee and the internal auditor associated with firm performance in Saudi Arabia?

9) Is the extent of AC reviews of IA proposals associated with firm performance in Saudi Arabia?

10) Is the extent of AC reviews of the results of internal audit activities associated with firm performance in Saudi Arabia?

1.5 Research Objectives

This study attempted to achieve the following main objectives:

1.To examine the association between board of directors characteristics and the performance of listed companies on Saudi Stock Market.

2.To examine the association between audit committee characteristics and the performance of listed companies on Saudi Stock Market.

The specific objectives were as follows:

1) To examine the association between the proportion of non-executive directors and firm performancein Saudi Arabia.

2) To examine the association between CEO duality and firm performancein Saudi Arabia.

3) To examine the association between board size and firm performancein Saudi Arabia.

4) To examine the association between the chairman's shareholdings and firm performancein Saudi Arabia.

5) To examine the associationbetween the independence of the audit committee members and firm performancein Saudi Arabia.

6) To examine the association between the frequency of audit committee meetings and firm performancein Saudi Arabia.

7) To examine the association between audit committee shareholdings and firm performancein Saudi Arabia.

8) To examine the association between the frequency of meetings between the audit committee and the internal auditor and firm performancein Saudi Arabia.

9) To examine the association between the extent of AC reviews of IA proposals and firm performancein Saudi Arabia.

10) To examine the association between the extents of AC reviews of the results of internal audit activities and firm performancein Saudi Arabia.

1.6 Significance of the Study

A large number ofstudies concerning corporate governance and firm performance have been conductedusing data from the U.S. and UK; however, studies based on data from Middle Eastern countries, arerelatively limited in comparison with those in developing and Asian countries(Al-Ghamdi,2012). Moreover, to thebest of the researcher's knowledge, Saudi Arabia has not yet been the focus of any study regardingthe role of monitoring mechanisms and firm performance.Thus, a differentperspective could be obtained from developing countries, such as Saudi Arabia, which innumerous respects are different, and might enhance the concept of corporate governanceand firm performance.

Therefore, the current study could provide interesting,new primary evidence from a country that has a different business environment andregulations and is considered to be representative of Middle Eastern and Arabic countries.

The significance of the study can be seen from both theoretical and practical perspectives. From a theoretical perspective, although earlier studies recognized that audit committees and internal auditors serve as important determinants of better performance, the relationship between these corporate governance actors has not been thoroughly explored. Therefore, this study focused on the relationship between audit committees and internal auditors (agency role) in ensuring better firm performance.

Moreover, previous studies (Haniffa and Hudaib, 2006; Ilona, 2008; Omar, 2003;Zubaidah, Nurmala, & Kamaruzaman, 2009) examined the impact of shareholding by the board of directors at the board level on firm performance. However, the researcher is not able to obtain any study that has examined these associations at the audit committee level and the

key individual or "focal point" level (board chairman). Therefore, this study added to this literature by determining the impact of shares ownership at the audit committee level and the key individual level (board chairman) on firm performance.

Given that the control variables (firm size and debt) were insignificant and in order to determine the sensitivity of this study for using them as moderators and make this study more significant in terms of its contribution to knowledge, the moderating role of firm size and debt in the relationship between internal corporate governance and firm performance were examined.

This study consideredthe measurement of CEO duality based on the separation of the positionof the Chairman and CEO, as required by the Saudi Code (CMA, 2006), as well as on the presence of independence from family relationship (Kamardin, 2009).

To the practitioners, the expected findings of the study would be useful for the companies, the policy makers and regulators in Saudi Arabia (for example, CMA, Saudi Organization of Certified Public Accountants) in supplying information concerning the effectiveness of the board of directors and the audit committees, and their effect on firm performance in order to enhance corporate governance practices in Saudi Arabia.

1.7 Scope of the Study

There were some aspects that had to be considered regarding the scope of this study. This study did not involve non-listed companies and financial companies because they have

different practices and regulations from other companies. Also, this study was limited to the data after the Corporate Governance Codefor the Saudi Stock Market became mandatory in 2009. Therefore, this study only used 2010data for the companies listed in Saudi Arabia.

The corporate governance variables that wereused in this study were limited to the board and audit committee characteristicssince they are considered to be at the core of monitoring mechanisms. In terms of firm performance, this study focused on two measures of firm performance, namely return on assets (ROA) as an accounting measure and Tobin's Q ratio(TQ) as a market measure.

1.8 Definitions of Terms

For the purposes of this study, the following terms were utilized:

Corporate governance: The Cadbury Committee (1992) defined corporate governance as the system by which companies are directed and controlled. Jensen and Meckling (1976) defined good corporate governance as the key principles of accountability, fairness, transparency as well as responsibility in managing a firm.

Audit committees: Rickard (1993) described the composition of audit committees including a group of senior staff, with the chief executive officer or his deputy being the chairperson. The committee performs the role of protecting the responsibilities of the internal audit not to be dependence. Furthermore, the committee makes sure that management performance and accountability are constantly improving through the employed actions of both the internal and external audit.

Audit Committee Effectiveness: As suggested by DeZoort *et al.* (2002), audit committee effectiveness has been described as a committee of qualified members equipped with the authority and resources to ensure reliable financial reports, ensure internal controls and risk management, and to ensure that capable auditors are appointed in order to safeguard the interests of the stakeholders.

Board composition: Board composition refers to the number of non-executive directors to the total number of directors.

Non-executive director: Non-executive director refers to a member of the Board of Directors who does not have a full-time management position at the company, or who does notreceive a monthly or yearly salary.

Stakeholders: Stakeholders refer to any person who has an interest in the company, such as shareholders, employees, creditors, customers, suppliers, or community.

CEO duality:CEO duality refers to a CEO who is also the Chair of the board of directors.

1.9 Organization of the Study

This thesis consists of six chapters.In the introduction chapter, the background of the study is given.It also explains the statement of the problem, provides research questions,

states the objectives of the study, discusses the significance of the study, scope of the study, the definitions of terms are also given, and, finally, the organization of the chapters.

ChapterTwo provides a concise view of the background of Saudi Arabia, monitoring bodies,andregulations and laws in Saudi Arabia related to the study, and the previous research on corporate governance.

Chapter Threepresents a discussion of the underpinning theories which are agency theory and institutional theory, firm performance, and previousstudies on the board and audit committee,and the audit committee's relations with the internal auditor.

Chapter Fourdiscusses the research framework and methodology employed in the study. In addition, the development of the hypotheses were presented, as well as the research design, sample and data collection, research instrument, operational definition and measurement of the variables, and method of data analysis.

Chapter Five presents the analysis of the response rate, the descriptive analysis of the variables, the correlation matrix of the variables, the assumptions of multivariate analysis,the tests of the research hypotheses through inferential analyses and further tests.

Finally, Chapter Six reports the discussion of the findings of the main results presented in the previous chapter, implications of the study, limitations of the study and suggests future research and concludes the findings.

CHAPTER TWO

CORPORATE GOVERNANCE IN SAUDI ARABIA

2.0 Introduction

This chapter aims to present an overview ofCorporate Governance in Saudi Arabia. Thischapterhas six sections. Section 2.1 presents a background of Saudi Arabia while Section 2.2sheds light on monitoring bodies in Saudi Arabia. Section 2.3 reveals the regulations and laws in Saudi Arabia. Section 2.4 offers previous research on corporate governance in Saudi Arabia and finallySection 2.5 provides a brief summary of the chapter.

2.1 Background of Saudi Arabia

An examination of the business environment in Saudi Arabia entails the presentation of a general background of Saudi political, economical and legal systems. Accordingly, this section provides an overview of Saudi Arabia and the primary aspects of its environment.

2.1.1 The Politics of Saudi Arabia

The Saudi Arabian state establishment can be traced back to 1932 when the then monarch, King Abdul Aziz (1880-1953) founded the country. Following extensive efforts to unite the various areas of the Arabian Peninsula under a united flag, the country has become among the most significant one in the Middle East. Saudi Arabialies in the South West of Asia and it has an approximate area of 2,100,000 square km. (868,730 square miles) and its population is in 24 millions (World Bank, 2009).

Saudi Arabian system of governance is the monarchy that is confined to the male descendants of King Abdulaziz. It has a centralized system with the King as the head of the Council of Ministers; a council that managers both internal and external affairs of the Kingdom and organizes and coordinates the many government branches (The Basic Law of Governance, 1992).

Additionally, Saudi Arabia's basic powers namely executive, legislative and judicial are appropriated to the King. According to the Basic Law of Governance, the Saudi constitution has its basis on the Holy Quran and the legislation is under the purview of Islamic Law (Ministry of Foreign Affairs, 2007). Specifically, Chapter 8 of the Basic Law of Governance stipulates that governance in Saudi Arabia is based on fairness, consultation, and equality, under the purview of Islamic legislation.

Saudi Arabia holds a pivotal position in the Islamic countries as it houses the holiest Muslim sites of Makkah to which over one billion Muslims pray towards, and Medina, Prophet Muhammad's (p.b.u.h.) city of migration and burial. Moreover, it is considered as the land of prophecy and the Islamic cradle. Every year, approximately 2.5 million Muslims perform the rights of Hajj in this holy land.

Islam has a unique influence on Saudi way of life and this can be traced back to the Kingdom's establishment when Mohammed Ibn Saud (the political leader) entered into apact with Sheikh Mohammed Ibn Abdulwahhab (a religious leader) to establish the first Saudi State in 1744 which occupied majority of the Arabian peninsula, headed by the House of Al-Saud (from which the country's name was taken from) through Islamic

legislation (Al-Rumaihi, 1997). Moreover, Saudi Arabia is a member of the Gulf Cooperation Council (GCC), the League of Arab States (LAS), the Organization of the Islamic Conference (OIC) and the United Nations (UN).

2.1.2 The Economics of Saudi Arabia

Saudi Arabia is considered as a developing nation with an oil export-based economy; oil export is the primary source of national income at 90-95% of the total income and 35-40% of GDP. Saudi Arabia holds a quarter of the proven oil reserves of the world and continues to be the largest producer of oil for the coming years (Ministry of Economy & Planning, 2007). It is also the current dominant producer of oil contributing 32% of OPEC output in 2004 (OPEC, 2005) (refer to Figure 2.1).

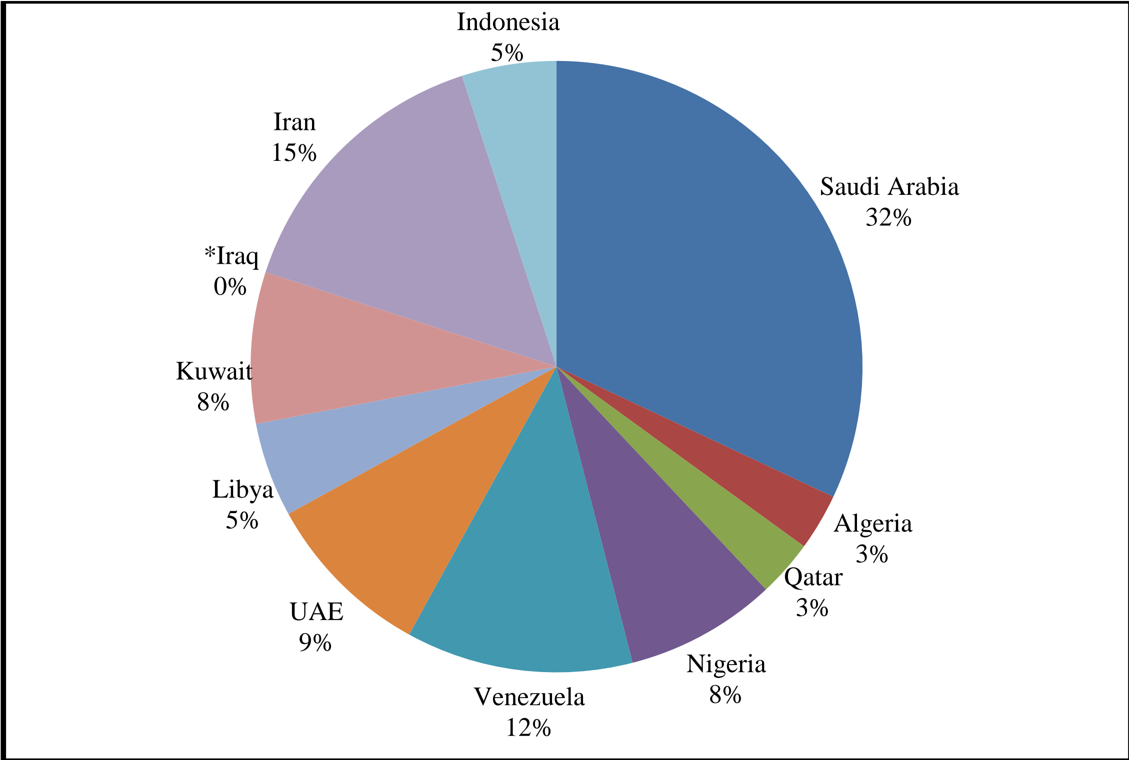

Figure 2.1

Outputs of OPEC Countries in October 2004
Source: OPEC (2005)

Note: The Figure shows the oil production of OPEC's countries in October 2004.
* Iraqi production was stopping in that time because of the war.

Figure 2.2 shows the foreign direct investment inflows from 1990to 2011. It also indicates that the foreign direct investment inflows were very low from 1990 to 2004. From the mid of 2004, the foreign direct investment inflows increased rapidly to nearly USD145000 (billion) in the mid of 2008 before dropping to USD60000 (billion) in the late of 2011. The decline of the foreign direct investment inflows into the country reflects, partially, the decreasing level of the confidence of the foreign investors that can be partially attributed to the lack of corporate governance practices that protect the rights of investors.The study of Kim (2010) shows that corporate governance encourages investmentand stock market development, which is associated withimproved macroeconomic growth. The level of corporate governance is crucial in attracting investors because they send the right signal to both domestic and foreign investor in respect of the potential risk of their investment. Corporate governance is also important for foreign investors who may be moving into a new environment and who need to be sure of what the laws says as well as be confident in the effectiveness of the legal system especially in protecting their right, including their property right. Good corporate governance practices are regarded as important in reducing risk for investors, attracting investment capital and improving the performance of companies (Heenetigala & Armstrong, 2011).

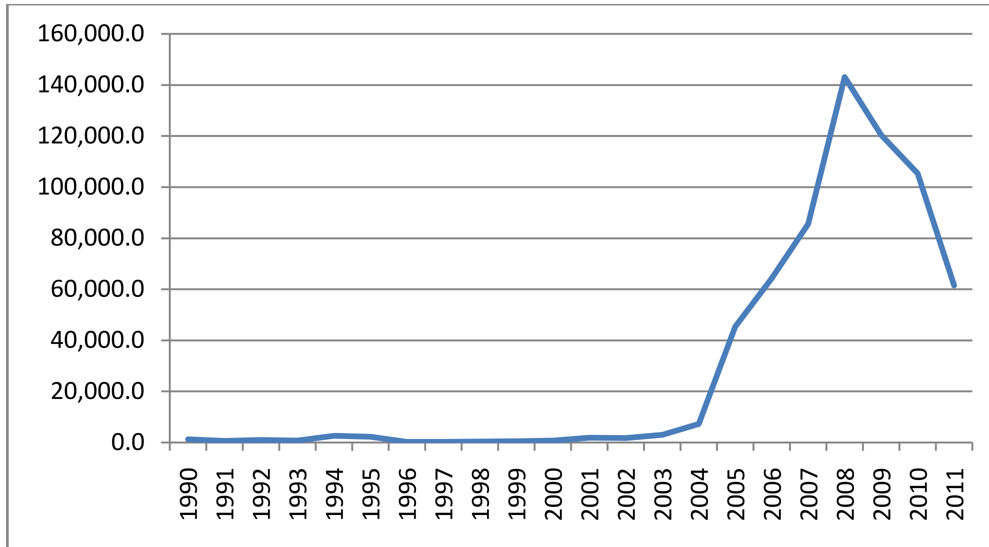

Figure 2.2
The Foreign Direct Investment Inflows between 1990 and 2011

Despite the fact that Saudi Arabia is a huge country (almost equal in size to UK, France and Germany put together), it owns insufficient natural resources like rivers and lakes as 80% of the land area is desert. Prior to 1938, (discovery of oil), life was simple and Saudi Arabia was considered among the poorest nations in the world. But by the 1970s the exchange rate has been particularly high following the considerable increase in the prices of oil. The government initiated five-year plans that targeted the development of systems of education and healthcare and enhancing infrastructure; initiatives that would've been impossible without oil. Despite the fact that the Saudi stock market is considered as an emerging one based on age and relative size, it took first rank among developing countries judging from market capitalization in 2005. Emerging markets and their rankings are listed in Table 2.1.

Table 2.1
Emerging Markets

Rank	Country	Market	Price to Earnings Ratio

		Capitalisation USD million	2004	2005*
1	Saudi Arabia	649.117	24	35
2	Korea	543.95	13	11
3	Russia	458.229	15	18
4	Brazil	446.208	12	10
5	India	393.985	15	17
6	Taiwan	346.984	12	14
7	South Africa	285.105	14	14
8	Mexico	235.973	15	13
9	China	161.912	12	14
10	Malaysia	141.167	15	11

*Estimated
Source: Bakheet Financial Advisors and DataStream (2005).

According to Al-Ghamdi's (2012) recent study, Saudi Arabia has been recently witnessing several reforms with the inclusion of political systems, social life and business; for instance, following intensive negotiations and adopting of regulations and legal system in 2005, Saudi Arabia became a member of the WTO (Ministry of Commerce & Industry, 2006). Additionally, among these reforms is the establishment of the Saudi Arabian General Investment Authority in 2000 to improve the investment environment, eliminate obstacles, and address shortcomings in an attempt to attract both local as well as foreign investors (Falgi, 2009).

The Saudi business environment has recently witnessed increasing development in the form of enhanced regulations (i.e. the Saudi Stock Exchange) and accounting and auditing regulations all act to reinforce the economy of the country. Despite the above, some claim that these reforms are slow-acting and they lag behind the dynamic changes

taking place in the international business environment (Saudi Journal of Accountancy, 2009).

2.1.3The Legal System of Saudi Arabia

The legal system of a country plays a key role in influencing its regulations and practices. In Saudi Arabia, the constitution has its basis on the Holy Quran and the guidelines are laid down based on the traditions of Prophet Mohammed (Sunnah) and other sources related with Islamic law (Shariah) which is considered as the Code of Conduct/Religious Law. In light of its legal system and its adherence to Islamic regulations, Saudi Arabia is considered an Islamic state (Al-Harkan, 2005).

As previously mentioned, Saudi Arabia has a pivotal position among Arabic and Islamic nations as it houses both the holy Muslim sites of Makkah and Madinah (Falgi, 2009). Saudi aspects of life are impacted by Islam with the inclusion of its constitution and social behavior. Therefore, Islam also has an influence over business life and operations while stressing on superior ethical standards, strong belief and human equality. Upon adopting specific standards of accounting and auditing standards or practices of corporate governance, it aims to change them to suit Saudi environment in accordance to Islamic law (Al-Harkan, 2005).

With regards to social behavior, Saudi Arabia can be described as a tribal society directed by Arabic traditions which considerably influences local and national events.

Islam also influences the legitimate Saudi framework upon which the constitution stems from. Owing to the historical relationship of Saudi Arabia with the U.S. and Britain, the business environment in the country is significantly influenced by the latter countries' legislations in light of accounting practices; e.g. law systems of companies, accounting standards, auditing standards and standards of auditor independence (Al-Angari, 2004). Despite the fact that the regulations within Saudi Arabia have national standards, they've been adopted from the U.S. and the U.K.

Saudi banks and financial companies are covered by international accounting standards but the companies listed on the Saudi Stock Market are covered by the national accounting standards (IFRSs, 2011). King Saud University played a part in developing accounting standards through the provision of symposiums concerning accounting development methods in an attempt to reach suitable recommendations for the resolution of obstacles that could prevent the development of accounting standards. It also laid down an Academic Board for accountancy development, exchange of ideas and academic productions, consultations and for research.

The Saudi legal system concerning the business environment comprises of a combination of American, British and other countries' rules and regulations derived from their legislations and structured in an Islamic framework (Al-Ghamdi, 2012). These adopted rules and regulations are made according to Islamic regulations to suit the characteristics of Saudi environment.

2.2Monitoring Bodies in Saudi Arabia

The regulation, supervision and monitoring of Saudi companies are conducted by four main bodies namely, the Ministry of Commerce and Industry, the Capital Market Authority, the Saudi Stock Exchange (Tadawul), and the Saudi Organization for Chartered Public Accountants. Each of them is discussed in brief in the proceeding sections.

2.2.1 The Ministry of Commerce and Industry (MCI)

The Ministry of Commerce and Industry in Saudi Arabia, once referred to as the Ministry of Commerce prior to its integration with the Ministry of Industry, acts as the main body that monitors Saudi companies. It regulates, supervises and registers some of the most significant responsibilities of the Ministry of Commerce and Industry to make sure that Saudi firms adhere to the national regulations. In addition, the Ministry has an indirect supervisory role to several other monitoring institutions including the Saudi Capital Market Authority, the Saudi Stock Exchange, and the Saudi Organization for the Certified Public Accountants.

2.2.2 The Capital Market Authority (CMA)

Saudi Arabia established the Capital Market Authority in 2004 and made it directly answerable to the Prime Minister. It unofficial establishment can be traced back to 1950s after which its successful performance led to the government's founding of basic regulations in the eighties (CMA, 2006). It was official established in 2004 when it acquired full independence with a direct link to the Prime Minister. The CMA role is to

regulate and develop Saudi firms through the provision of effective rules and regulations that increases investment and improves standards of transparency and disclosure. It also aims to protect investors and dealers from illegal market activities (CMA, 2006).

The CMA's legal and financial aspects and administrative autonomy entails its management by a board that comprises of five members that are appointed by the Prime Minister. The members of the board are prevented from engaging in commercial activities or have special interests in any profitable works. Corporate governance practice is among the most important regulations that the board issues – initiating as a recommended regulation and becoming a compulsory regulation recently (in 2010).

The CMA is responsible for issuing regulations and instructions and making sure that they are properly implemented. The CMA's duties can be listed as follows;

1) Developing and regulating the Saudi Stock Market (Tadawul) and enhancing suitable standards and transactions.

2) Creating higher security by the provision of investors and public protection against unfair and erroneous practices including fraud and manipulation, and others that violate Saudi Law.

3) Maximizing the market efficiency and the transparency of securities transactions.

4) Minimizing the transaction risks through the development of appropriate measures and standards.

5) Monitoring the commitment of Saudi listed firms to information disclosure.

6) Monitoring the entire activities and the transactions conducted by the Saudi Market.

7) Enhancing and monitoring the securities issuance and the under-trading transactions.

On the basis of the above, it is evident that the CMA plays a key role in the development and regulation of Saudi Stock Exchange through the issuance of the required regulations and instructions that allow enhanced performance of firms. In addition, it provides investors' protection and creates stable and secure Saudi market. Nevertheless, majority of investors criticize the role of CMA particularly following the financial crisis which affected the Saudi market which questioned the power of CMA to protect investors and prevent illegal activities.

2.2.3 The Saudi Stock Exchange (Tadawul)

Tadawul, an Arabic term, denotes the stock exchange in the Saudi market. The Saudi Stock Exchange or Tadawul is required for the completion of a considerable rate of growth in the Saudi economy and its well-establishment and organization is needed for it to conduct its primary role. Currently, Tadawul is a self-regulated authority governed by a board comprising nine members selected by the CMA and appointed by the Prime Ministry. The board members represent different government organizations including the Ministry of Finance, the Ministry of Commerce and Industry and the Saudi Arabian Monetary Agency in addition to two members from listed companies and four from licensed brokerage companies (Tadawul, 2009).

The Saudi listed firms began operations in the middle of the 1930s with the Arab Automobile Company making the first cock company on the list (Tadawul, 2009). The Saudi economy's significant growth in 1975 reflected increase in price of oil and Saudization (through shares purchase from foreign investors) of a specific portion of foreign banks' capital – this led to an increase in large companies and joint stock banks. During that time, despite the discernible improvement, the Saudi Market stayed informal and not organized. In the 80s, the Saudi Government introduced trading regulations along with the relevant systems. An attempt to regulate the market was made in 1984 through the formation of a committee including the Ministry of Commerce and the Saudi Arabian Monetary Agency. The committee was responsible for the regulation and control of market activities until the CMA was established in 2004 and took over the committee's responsibilities.

In the past few years, the country experienced rapid privatization owing the Saudi government's plan to privatize as many vital economic sectors as possible which resulted in many private and family companies going public. Saudi listed companies therefore showed significant increase from 81 firms in 2005 to 144 in 2010 (Tadawaul, 2009). To date, there are 144 listed companies in various industries in the Saudi market reflecting different ownership percentages.

Foreign investors have increasingly become attracted to the Saudi market through its stable and secure aspect. The Saudi Stock Market is the only entity authorized to carry

out securities trading in the Kingdom. Hence, the Stock Market has various duties and objectives which are listed below;

1. To maximize and guarantee fair and efficient market activities.
2. To guarantee integrity, quality and fairness in the market.
3. To reinforce investors' efforts of education and awareness.
4. To create and improve service excellence for customers such as brokers, issuers, investors, vendors among others.
5. To enhanced the capabilities and competencies of the Exchange.
6. To issue and lay down professional standards for brokers and agents.

Table 2.2

Share Market Indicators for the Last 10 Years

End of period	Number of Companies	Number of Shares Traded	Value of Shares Traded	Market Value Shares	Number of Transactions	General Index
2001	64	692	83.602	275	605.035	2.430.11
2002	68	1,736	133.787	281	1.033.669	2.518.08
2003	70	5.566	596.51	590	3.763.403	4.437.58
2004	73	10.298	1.773.858	1.149	13.319.523	8.206.23
2005	77	12.281	4.138.695	2.438	46.607.951	16.712.64
2006	86	68.515*	5.261.851	1.226	96.095.920	7.933.29
2007	111	57.829	2.557.712	1.946	65.665.500	11.038.66
2008	117	58.727	1.962.945	925	52.135.929	4.802.99
2009	144	56,685	1.264.012	1.196	36,458,326	6.121.76

Source: Saudi Arabian Monetary Agency (2010)

2.2.4 The Saudi Organization for Certified Public Accountants (SOCPA)

The Saudi Organization for Certified Public Accountants (SOCPA) is described as a professional body established in 1991 by the Ministry of Commerce. Its management is placed in the hands of its members who are responsible for the promotion and enhancement of the accounting and auditing profession's practices and for matters that support the development of profession and status (SOCPA, 2007). It plays a key role in the development of accounting and auditing profession in various ways.

1. It reviews and develops standards of accounting and auditing.
2. It monitors the certified public accountants' performance to guarantee adherence to the CPA regulations and standards.
3. It prepares and lays down SOCPA fellowship examination rules and manages CPE courses.
4. It undertakes research concerning accounting and auditing professions and other subjects associated with them.
5. It holds and manages accounting conferences and helps obtain professional expertise and academics.
6. It encourages accounting researchers to examine accounting and auditing profession through incentives.
7. It publishes accounting and auditing standards and up-to-date topics through journals and books.

2.3 Regulations and Laws in Saudi Arabia

The obligations of Saudi firms are limited to the regulations regarding their business and those which may be relevant to corporate governance like the Companies Act (1965), the Capital Market Law (2004), and the Corporate Governance Code (2006) that is CMA-issued. The present section covers the main aspects of corporate governance in Saudi firms with regards to the relevant regulations.

2.3.1 Company Law (1965) and Company Structure

The Company Law (1965) is the most significant regulation and the initial organized effort for the regulation of Saudi firms. It is adopted from the British Companies Law and is issued by Royal Decree in 1965 as a general system for the entire Saudi firms to adhere to instructions and rules. Despite the modification of law to keep abreast of dynamic development in Saudi firms, several still considers the law as being outdated and calls for effective laws that meet current requirements (Al-Ghamdi & Alangri, 2005).

Company structure, on the other hand, has a critical role in the determination of the legal shape and organizational system of the firm. Each company in its initial stage has to stipulate simple regulations like the directors' appointment to the boards, termination, and shareholders' rights. The company structure has to adhere to the regulations and rules of the Saudi Company Law.

2.3.2 Accounting and Auditing Standards

In 1986, Saudi Arabia issued its national standards of accounting and auditing that were originally adopted from the standards of the U.S. Despite most of the banking sector and the financial firms' employment of international accounting standards, majority of Saudi listed firms still employ the Saudi National Accounting Standards (IFRSs, 2011). As previously mentioned, the Accounting Standards Committee of the Saudi Organization for Certified Public Accountants (SOCPA) has the responsibility of the development and review of standards of accounting and auditing in the United Kingdom.

SOCPA attempted to integrate the national standards with the international financial standards (IFRSs) in 2006 and this resulted in majority of banks and financial firms' employment of the latter. SOCPA's final report states that continuous efforts are being expended to determine the issues of the integration process and to identify opportunities that would allow the IFRSs implementation. Although no real statement has been made by SOCPA to determine financial hindrances, they are expected to encounter some.

The National Accounting Standards plays a significant role in the Saudi market environment in terms of developing disclosure and treatments of financial transactions. The Standards comprise of 23 standards including disclosure requirements, revenues standard, inventory standard among others. The Standards also help in increasing the external auditors' competence and in improving audit quality. Seventeen standards address auditor competence, independence, audit plan and audit report and other audit-relevant standards.

2.3.3 Shareholders' Rights

The Company Law provides the right of attending the company's AGM to shareholders holding twenty shares or more. The law appropriates the shareholders their share rights including the right to obtain a proportion of the company's distributed profits and to obtain the same upon the dissolution of the company. Additionally, they have the right of participating in company conferences, voting on share disposal decisions, and of investigating the archives of the company.

Specifically, Article 109 of the Company Law stipulates that shareholders holding 5% of the company's capital have the right to obtain the Companies' Settlement Authority to examine the company in case of any doubts concerning the board of directors or the external auditors' behavior.

2.3.4 The Company's Internal Control

Regarding internal control, the Higher Economics Council accepted the recommendations provided by the ministerial committee as created by the Royal Decree No. 3151 in 2001 to determine the listed firms' situation. The committee provided the following recommendations (The Ministry of Commerce and Industry, 2006);

1. To stress the significance of the supporting role of firms' internal controls and the shareholders' understanding of their role in the monitoring of firm performance to achieve objectives.
2. To guarantee sufficient information appearing in the company's financial statements for investor's value of the performance of the company and to

help them make effective decisions concerning the status of the company and investment protection.

2.3.5 The Corporate Governance Code

In Saudi Arabia, corporate governance mechanisms and their significance were overlooked for a long time until 2005 when the Saudi Capital Market Authority stressed on the issues of the firms performance and until the 2006 market crisis showed critical issues and weaknesses in financial reporting (e.g. lack of transparency, disclosure, and accountability (Saudi Journal of Accountancy, 2006).

Consequently, corporate governance has started to receive considerable support from the Saudi government as well as academics. Currently, corporate governance is a top subject in the environment of Saudi businesses and a debate concerning the improvement of the system of governance came to the limelight. Corporate governance mechanisms in Saudi Arabia encapsulates rules and standards concerning shareholders' rights, disclosure, transparency, and composition of the board, which facilitates the regulation of joint stock companies management listed in the Exchange. This guarantees adherence with best practices protecting shareholders and stakeholders' rights.

The main laws that govern the legal framework which influences corporate governance in the Kingdom can be categorized into three; the company law system stemming from

British Companies Law, the Saudi Organization for Certified Accountants and the Saudi Capital Market Authority.

The Capital Market Authority Board established corporate governance in 2006 and made amendments in 2010 in an attempt to regulate and enhance the Saudi capital market and reinforce financial reporting authenticity and transparency. The Code remained a guideline until the beginning of 2010 when it became a mandatory regulation- during this time, Saudi listed companies were informed to disclose the provisions implemented and otherwise in the annual report and the justifications for non-compliance.

There are five primary parts of the code; first, preliminary provisions and explanations/definitions of terms related to regulation (e.g. independent member, non-executive and shareholders); second, Shareholders rights and the General Assembly; third, disclosure and transparency linked with company policy like the report of the board; fourth, the functions and responsibilities of the board of directors; and finally, publication, coming into force and implementation (Code of Corporate Governance, 2006).

Both the board of directors and board committees are considered as the top defense against ineffective management. The present study is an attempt to examine the role of board of directors and committees in facilitating corporate governance mechanisms. The next section provides the board of directors and committee's role as stipulated by the Saudi Code of Corporate Governance (2006).

2.3.5.1 Board of Directors

2.3.5.1.1 Functions of the Board

The Code stipulates that the board of directors should have the following functions; approving the strategic approach and the firm's objectives and supervising the implementation of these strategies which include comprehensive strategy, plans, policies, capital structure, financial objectives, annual budget, firm performance, risks, organizational and functional structure and settling of conflict cases. This guarantees the financial transactions integrity, and reviews the internal control systems of the firm and monitors its overall performance. It also guarantees the employment of regulations with the inclusion of complete disclosure and corporate governance.

2.3.5.1.2 Responsibilities of the Board

The board of directors is essentially the representative of shareholders and thus, the responsibility for the firm is placed on the board of directors. The main responsibilities of the board of directors is laid down by the Code of Corporate Governance but the company system also plays a role in defining board responsibilities to shareholders and other relevant shareholders. The board of directors is generally responsible for ensuring the financial reporting integrity and the performance of the company.

2.3.5.1.3 BoardFormation

The following criteria have to be satisfied for the formation of board of directors;

1. The board of directors is mandated to have not less than three members and not more than eleven members.

2. Non-executive members should constitute at least one-third of the total members.

3. The Chairman of the board of directors should not be conjoined with any executive position including the position of the Chief Executive Officer (CEO).

4. Independent members should constitute one-third of the board members.

5. Members of the board of directors cannot simultaneously be a member of the board of directors of over five joint stock companies.

The Code also provides some articles concerning the termination of the members of the board. Despite the above extensive stipulations, the Code only concentrates on the importance of the board meetings and overlooks the specifications of the number of annual meetings.

2.3.5.2 Board Committees

An appropriate number of committees should be created according to the requirements of and the circumstances in the company in order to assist the board of directors in performing its responsibilities effectively. The Code of Corporate Governance mandated the creation of an audit committee, and its members' nomination and remuneration in 2006. The committees should satisfy the criteria explained in detail in the following sections.

2.3.5.2.1 Audit Committee

Based on the Code, the board of directors has to create an audit committee which consists of at least three non-executive members with at least one of them, a financial and accounting expert. This committee is responsible for supervising and reviewing the firm's internal and external audit procedure, control system, accounting policy, the financial reporting integrity, disclosure, monitoring management, recommendation of auditor selection and to handle the management-external auditor conflicts.

The audit committee was the sole committee delegated with some responsibilities by the board of directors some years ago. This is because committees like remuneration and nomination committees and executive committees were non-existent (Al-Moataz, 2003). This indicated the audit committees' full responsibility of many functions which adversely impacted its performance of them. Consequently, a committee was created by SOCPA in 2003, to evaluate audit committees in Saudi listed companies in an attempt to develop the accounting and auditing profession. They listed the following main findings; (Falgi, 2009)

1. Ambiguous tasks and field of action of audit committees.
2. Some board members and committee members' unawareness of the purpose of the audit committee.
3. Ambiguous concept of the independence of audit committee members.
4. Insufficient professional and academic qualifications of some members of the committee.

5. Insufficient control mechanisms to monitor the practices of the committee. As a result, the SOCPA's committee generated a project based on organizing the audit committees' performance in listed companies.

Acknowledging the importance of audit committees as a primary mechanism to maximize confidence in financial statements, the Minister of Commerce passed a resolution in January 1994 (Saudi Ministry of Commerce, 1994), which mandated public companies to create audit committees. The resolution concerning the audit committee establishment in Saudi Arabia consists of guidelines for the member selection. These include;

1. The member has to be a shareholder of at least 20 shares and there should be odd number of members that is not less than three.
2. The member cannot be a member of the executive board of directors and he/she cannot handle technical, managerial or consultancy work.
3. The member should be good at financial and accounting practices and standards, and have suitable field qualifications.
4. The member cannot have an interest, direct or otherwise, in the company's transactions and contracts.

The general assembly of the company's shareholders has the ultimate responsibility to select the audit committee's members. The audit committee is responsible for nominating the external auditor to conduct the external audit and to receive auditor's reports. The audit committee has to nominate a total of five audit firms from a list of

licensed firms to conduct audit work in Saudi Arabia. These audit firms are then requested to forward proposals and based on these proposals, the audit committee gets to suggest one or more suitable firms.

The director then forwards this recommendation to the general assembly which is ultimately responsible for the appointment of the external auditor and the determination of the audit fee and the tenure of office. According to the resolution's requirement, if only a single audit firm is appointed, then the audit committee can recommence the nomination process three years following the audit firm commenced audit. On the otherhand, when one more than one is appointed, the nomination process can be recommenced five years following the audit firm commenced audit (Saudi Ministry of Commerce, 1994).

In the context of Saudi banks, the scenario is much more complicated because of the presence of two regulatory bodies exercising control; the Ministry of Commerce and the Saudi Arabian Monetary Agency (Al-Moatz, 2003). SAMA or the Saudi Arabian Monetary Agency issued rules for Saudi Arabian banks for the organization of audit committees (Saudi Arabian Monetary Agency, 1994).

According to the audit committee rules laid down by the Saudi Arabian Monetary Agency (1994), the board of directors has to appoint one of its members as the audit committee chairman for a minimum of three years and such a member should be separate from the executive and the management, for effectiveness. Additionally, the audit committee chairman is responsible for the determination of the committee's

effectiveness and success as he basically sets its tone, agenda and style. As such, the selection of such a chairman should satisfy the criteria enumerated below;

1. He should not be the board of directors' chairman.
2. He should not be associated with other board members or have any financial connection to them.
3. He should not be related with the bank's senior management.

The number of audit committee members should be between three and five and majority of them are required to be in each committee meaning. Audit committee members may comprise of qualified members from the board, ex-board members and outsiders but it should be composed mostly of outsiders who are do not occupy the following positions; board members, senior managers, officers, employees, major customers or agents of the bank or bank affiliates. With regards to the frequency of audit committee meetings, this is gauged through its size and nature of the bank as well as the scope of its activities. A committee having normal activities should have at least four meetings annually including their meeting with the board of directors. On the other hand, the frequency of meetings of audit committees with external auditors is based on its needs and requests. The meetings with external auditors should not be less than four meetings in a year (Saudi Arabian Monetary Agency, 1994).

It is evident from the previously discussed rules that the audit committees membership requirements and other responsibilities stipulated by SAMA are different from those provided by the Ministry of Commerce (1994) which did not provide the establishment

of the committees in detail. It is notable that Al-Twaijry, Brierly & Gwilliam (2002) conducted interviews with academics, external and internal auditors in 1998, in their investigation of the audit committees' role in Saudi Arabian corporate sector. The interviewees voiced their concerning regarding the terms of reference of audit committees and the work scope adopted. The audit committee members' independence and expertise were examined. The interviewees urged for a clear requirement for the Ministry of Commerce to issue additional regulations to enhance audit committee effectiveness in Saudi firms. The audit committee members were however did not contribute to the interviews.

The Internal Audit Committee (IAC), one of the SOCPA committees, conducted a review of the SMC best practices and recommendations in 2002 in an attempt to improve audit committee effectiveness in terms of the current developments in some countries, particularly in the U.S. (Saudi Organization of Certified Public Accountants, 2003). By March 11, 2003, the committee managed to announce its first draft of the new best practices and recommendations aimed at improving the audit committees' effectiveness in public firms.

Contrary to the SMC best practices and recommendations of audit committees, the newly drafted best practices and recommendations are characterized by clarity and comprehensiveness. The main best practices and recommendations of the draft include;

1. Public companies are all mandated to set-up their audit committees.

2. The audit committee should comprise of at least four members and all members should be independent directors.
3. The audit committee should have at least four meetings annually.
4. The chairman of the audit committee should not be a member of the board of directors.
5. The audit committee should have at least one member who is an expert or who has at least a bachelor degree in accounting/finance.
6. The audit committee is mandated to have a formal charter.

The IAC forwarded the first draft to academicians, external auditors, internal auditors and other relevant parties for their feedback on the new best practices and recommendations. Up to this day, no changes have been made on the first draft and it is still ambiguous whether or not the practices and recommendations therein will be taken up by the SSEC or SMC.

The Capital Market Authority recently issued Resolution Number (1-36-2008) dated 12/11/1429H which corresponded to 10/11/2008G, mandating Article 14 (creation of audit committee) of the corporate governance regulations on all the companies listed on the Stock Exchange from 2009. The requirements include;

a. The board of directors shall make a committee called the 'audit committee' with members not less than three, including a finance/accounting specialist. Audit committee members should not be executive board members.
b. Upon the recommendation of the board of directors, the General Assembly of Shareholders, shall lay down rules for the appointment of the audit committee

members, and proceed to stipulate the term of their office and the procedure to be followed.

c. The audit committee's duties and responsibilities include;

1. To supervise the internal audit department of the company and to make sure that it is effectively carrying out its activities and duties as laid down by the board of directors.
2. To conduct a review of the internal audit procedure and prepare a written report regarding the audit and provides recommendations to it.
3. To conduct a review of the internal audit reports and proceed to implement corrective measures with regards to the recommendations provided.
4. To provide a recommendation to the board of directors regarding the appointment, dismissal and the remuneration of external auditors. Upon such recommendation, they should retain makes sure independence is upheld.
5. To provide supervision of the external auditors' activities and approve any activity that goes beyond the audit work scope appropriated to them while they perform their duties.
6. Together with the external auditor, provide a review of the audit plan and feedback regarding the plan.
7. To conduct a review of the comments of the external auditors in the financial statements and carry out follow-up on the actions to be taken.
8. To go through the interim and annual financial statements before it is presented to the board of directors and to provide feedback and recommendations with regards to them.

9. To go through the accounting policies currently in force and to provide suggestions to the board of directors regarding them.

To sum up, the audit committee framework in Saudi Arabia combines the statute and codes of best practice, and the guidelines owing to the lack of listing rules provided by the SSEC in light of the establishment of the audit committees and their structure.

2.3.5.2.2 Nomination and Remuneration Committee

Despite the lack of mandatory stipulation to set up the nomination and remuneration committee, several Saudi listed companies voluntarily set one up. It was only in 2010, when Saudi listed companies were mandated to set up such a committee and make it responsible for the following responsibilities; to provide recommendations to the board regarding the appointment of members and to review and make sure that the requirements of suitable membership skills including qualification, experience, and independence are fulfilled. It is also responsible to lay down clear policies concerning indemnities and board members as well as top executives remunerations.

The nomination and remuneration committee could play a key role in the development of the board of directors' structure and improve its performance in Saudi listed companies by laying down effective polices in the future. But the Saudi legislator has largely overlooked the legal formation of such a committee including its independence which may result in adverse impact on its role in the development and enhancement of board structure.

2.4 Previous Research on Corporate Governance in Saudi Arabia

There is a notable lack of research publications dedicated to the corporate governance in Saudi Arabia indicating that it is not a very interesting topic to researchers. The existing researches have attempted to examine the corporate governance through perceptions of the roles and responsibilities of board of directors, audit committee and the effect of corporate governance mechanisms upon earnings management. However, not a single research addressed the corporate board practices in Saudi Arabia and to the best of the researcher's knowledge, no study has examined the board of directors-audit committee characteristics relationship and its impact on firm performance. Thus, the present study attempts to reduce the gap present in literature concerning corporate governance in emerging countries in general, and in Saudi Arabia in particular.

The present sub-section sheds a light on the findings of the existing research concerning corporate governance in Saudi Arabia. Among these studies is the study conducted by Al-Twaijry et al. (2002) which investigated the role of Saudi firms audit committee and found them to suffer many shortcomings; insufficient terms of reference and limitation in work scope, lack of independence, adverse working relationships with both external and internal auditors, and lack of expertise. They also found an expectation gap between expectations from work expected from the audit committee and their actual work. It appeared that audit committees in Saudi joint stock firms have insufficient authority to control boards of directors, and to improve the protection of shareholders through the external and internal auditors. They noted that audit committees are quite new to the

corporate sector which primarily progressed within its specific commercial and cultural framework and is slow and apprehensive to incorporate Western ideas of corporate governance and accountability.

A related study by Al-Moataz (2003) also examined the audit committees' role in Saudi firms and investigated them in light of best practices based on the academic and professional literature. The main findings revealed great concern over the following; audit committee's attitude towards their responsibilities, their lack of non-executive directors and sufficient professional qualifications of members.

Along the same line, Al-Harkan (2005) noted the perceptions of four stakeholder groups which were financial managers and internal auditors, academics, external auditors and government officials, concerning corporate governance in the Kingdom. His findings showed that majority of large Saudi companies particularly in the field of banking, communication and industry do employ corporate governance mechanisms and find it beneficial. This also held true for the firm's adoption of two main recommendations provided by the Cadbury Report (1992) which states that a board of directors should comprise of not less than three non-executive directors with two of which should be independent, and the separation of the chairman of the board's position with that of the CEO. The findings revealed that the primary factors impacting the process of non-executive directors' appointment include relevant business skills and experience, and professional qualifications. As for the factors inhibiting the practice of good corporate governance, the study pinpointed two main factors which are, the lack of systems and

procedures, and the lack of stress on values and key principles. The study recommended the need for superior disclosure and transparency in Saudi firms.

In a related study, Al-Ajlan (2005) looked into the boards of directors' roles and responsibilities in the context of Saudi banks. He made use of interviews and surveys of banks' directors for data collection and data indicated that board of directors play a key role in Saudi banks strategic planning. The findings showed that in relation to strategic planning, the Saudi banks' board of directors seemed to be able to achieve the roles of setting up plans, directing top management, accepting the strategy, explaining the main goals and the discussing with top management regarding their submitted strategy. On the other hand, with regards to the role of board of directors in monitoring and controlling top management, the findings showed inconsistent views from the participants, particularly on the issue of whether or not the board of directors in Saudi banks were fulfilling their role as a monitoring and controlling mechanisms of top management performance. The Saudi banks shareholders play a key role in monitoring and controlling the banks because most had positions or representatives on the board.

In addition, Asehaly's (2006) study examined the earnings management of publicly traded Saudi companies and revealed differing behavior in different sectors. The study attempted to shed a light on the continuing debate of whether or not the corporate governance in developing countries is effective in the context of the corporate governance mechanisms-earnings management relationship in Saudi Arabia.

The study by Al-Abbas (2009) examines the association between corporate governance mechanisms and earningsmanagement in the Saudi business environment, utilizing a sample of Saudi joint stock companies for 2005, 2006and 2007.The results of the study provide no evidence that corporate governance factors mitigate against earningsmanagement in the Saudi environment. However, auditing firm's size negatively relates to abnormal accruals, whichindicates that auditing firm's size is an important factor with regard to the extent of earnings management. Theresults highlight the need to enhance the legitimacy of corporate governance in Saudi corporations. In addition, itprovides insights into the audit quality role to mitigate against earnings management which, in turn, ought to be considered by audit committees in their decisions of selecting audit firms.

Falgi (2009) investigated corporate governance in Saudi Arabia by examining theperceptions of different stakeholder groups. The study examined the understanding ofcorporate governance, the current practice, the corporate governance framework and theimpact of the social, cultural and economic aspects on the situation on corporate governance in Saudi Arabia. The study used semi-structured interviews and aquestionnaire survey with wide groups of stakeholders and an accountability perspectiveis adopted to interpret the results. The findings suggest that corporate governance inSaudi Arabia is in its early stages and is characterised by a lack of accountability, a weaklegal framework and poor protection of shareholders. The influence of the social, culturaland economic factors is evident and boards of directors are dominated by majorshareholders; thus good corporate governance practices have many challenges.

Alghamdi (2012)examined the relationship between earnings management and internal/external corporate governance characteristics, mainly board of directors, audit committees, audit quality factors, and ownership structure. The expectation of beneficial external and internal corporate governance practices constraining opportunistic earnings management activities was, to a large extent, found to be inaccurate in Saudi Arabia. All internal corporate governance variables apart from outside director, board size and board meetings examined in this research have no significant effect on earnings management.

2.5 Chapter Summary

This chapter aimed to provide a concise view of the background of Saudi Arabia's, legal system, monitoring bodies in Saudi Arabia and important regulations and laws in Saudi Arabia related to research and the previous research on corporate governance in Saudi Arabia. The following chapter discusses the underpinning theories and literature in relation to internal corporate governance and firm performance.

CHAPTER THREE

LITERATURE REVIEW

3.0 Introduction

This chapter aims to present an overview of the literature that relates to the topic under investigation namely,internal corporate governance (board of directors, audit committee effectiveness) and firm performance and explains underpinning theories related to internal corporate governance mechanisms and firm performance. This chapter is organised as follows: Section 3.1 presents a review of literature on firm performance and Section 3.2 provides literature review on internal corporategovernance. Section 3.3on the other hand,illustrates underpinning theories. A summary of this chapter provides in section 3.4.

3.1 Underpinning Theories

3.1.1 Agency Theory

The theoretical background of this study was based on agency theory and institutional theory. According to agency theory, agency relationship is a contract under which "one or more persons (principal) who is the economic resources owner engage another person (agent)who is charged withusing and controlling these resources to perform some service on their behalf, which involves delegating some decision-making authority to the agent" (Jensen & Meckling, 1976). However, this theory assumes that management (as agent) cannot be trusted to take the best action for the public and shareholders (as principal)

because the agents will act for their own interests. To achieve the alignment between the principal's interest and agent's interest and limit agency costs, various internal and external corporate governance mechanisms have been suggested (Haniffa & Huduib, 2006).

The core of the agency theories is to resolve conflicts resulting from the separation of ownership and management control of corporate resources (Fama & Jensen, 1983; Jensen, 1986). Agents normally have more information than principals and this information asymmetry adversely affect the principal's ability to monitor whether their interest are being properly served by the agents (Adams, 1994).

Jensen and Meckling (1976) interpreted managerial discretion as a result of the informational asymmetry that leads to agency problems and increases agency costs. The separation of the activities of ownership and management and the presence of informational asymmetry may cause conflicts of interests. The manager's self-interest could lead to the misuse of firm resources, for instance, through investing in risky and imprudent projects at the expense of the stakeholders who provide capital (Jensen & Meckling, 1976; Shleifer & Vishny, 1986). Therefore, to control conflicts of interests and reduce agency costs, various internal and external tools (known as corporate governance) have been suggested. For example, a board of directors is established as a solution for such conflicts. The board of directors is considered as the strongest internal monitor of the top management because the board has the power to hire, fire, and compensate the top management (Fama & Jensen, 1983).

A strong corporate governance structure would eliminate or at least reduce the conflicts of interests between the shareholders and management. The efficiency of corporate governance structures is most likely to be enhanced if the role of the board of directors as a tool of control is explicitly emphasized. Accordingly, the agency role of board of directors and audit committee are to reduce agency conflict through monitoring top management, monitoring the internal control system, and ensuring the quality of financial reports which will then lead to better firm performance. (Fama & Jensen, 1983).

3.1.2 Institutional Theory

According to the postulation of the institutional theory, organizational structures in an environment indicate conformity and social accountability (Meyer & Rowan, 1977). Stated differently, internal operating processes along with the observable structures lead to the achievement of the actual organizational work. Consequently, organizations characterized by suitable structures steer clear of deep investigations in to their operating core by outside parties (Meyer & Rowan, 1977).

There are rules and regulations that govern organizations to guarantee their legitimacy and survival and to enable them to access resources (DiMaggio & Powell, 1983). But these rules and regulations do not guarantee that the firm will continue to operate in an efficient manner (Meyer & Rowan, 1977).

According to DiMaggio and Powell (1983), based on the institutional theory, institutional pressures would drive organizations to benchmark similar characteristics from other

organizations in the same environment, in an effort to organize themselves. In other words, a process of isomorphism to could occur in three ways; coercive isomorphism, mimetic isomorphism, and normative isomorphism. Coercive isomorphism arises when organizations modify their institutional practices owing to stakeholders' pressure (Meyer & Rowan, 1977) whereas mimetic isomorphism entails organizations attempting to imitate or improve institutional practices of other peer organizations like competitive advantage in light of legitimacy (DiMaggio & Powell, 1983). Finally, normative isomorphism is stems from the pressure of group norms to employ specific institutional practices (DiMaggio & Powell, 1983; Clark, 2004). Here, professional expectation adheres to accounting standard acts as a form of normative isomorphism for the organizations driven by accounting standards.

In the institutional theory, corporate governance is considered as changes in the organizational processes over time and the way governance structures carry out ritualistic roles that legitimizes the interactions between the actors in the corporate governance situation (Cohen, Gaynor, Kirshnamoorthy, & Wright, 2007). It consists of pressures employed to comply with the corporate governance regulations laid down by regulators or stock exchanges. This results in some organizations implementing corporate governance recommendations including a more independent board and an audit committee.

The objective behind corporate governance is to ensure that a firm is linked to the environment through the elucidation and definition of its goals that accommodate the environmental expectations (Judge, Griffiths, Lutkepohl, & Lee, 1985). As such, based on

the institutional theory, corporate governance should involve defining the organizational aims of the firm in light of its existing value system.

The theory contends that historical, social and political issues relevant to highlighting the organizational changes should be handled in order to adopt/reject the new system/regulation (Cohen et al., 2007). Hence, corporate governance, as a novel system, will succeed to the level where there exists a general congruence between the new rules and the present company routines (Yazdifar, 2003).

According to Stedham & Beekun (2000), the institutional theory postulates that the board of directors has two main roles namely, linkage and administration. In the former, the board of directors establishes a relationship between the firm and the external environment while in the latter the board of directors oversees top management performance with particular focus on the CEO.

Moreover, institutional pressure drives organizations to employ similar processes in an attempt to manage in the same manner with organizations in the same environment (DiMaggio & Powell, 1983). This characteristic of organizations can be considered by other organizations as legitimate and socially acceptable structures and management practices, despite of their real effectiveness (Saudagaran, 1997).

On a similar note, Fogarty (1996) contended that the institutional theory is invaluable in highlighting the differences between what organizations actually achieve and what their structures imply to the external environment indicating that the theory is useful for studies

that are conducted to compare the best practices of audit committees with their actual performance.

In sum, an organization's attempt to employ a new legitimate and successful system benchmarked from other organizations is considered as mimetic isomorphism. Accordingly, corporate governance practices may be standardized over time (Braiotta & Zhou, 2006; DiMaggio & Powell, 1983) as organizations are inclined to adopt new regulations or best practices or benchmark other organizations to support their legitimacy (Cohen et al., 2007). Mimetic change occurs when organizations feel that specific attributes of corporate governance add to the governance structure in successful organizations and thus, they benchmark such organizations' accounting treatments and choices. This will in turn maximize adherence with accounting standards and corporate governance mechanisms as time passes (Hoque, 2006).

According to Stedham & Beekun (2000), institutional theory and agency theory work in complement with corporate governance effectiveness and thus, using both structures as a framework may assist in in-depth understanding of corporate governance and board activities.

In sum, organizations are driven by various rules and regulations for their legitimacy, access to resources and their survival (DiMaggio & Powell, 1983). Nevertheless, these rules and regulations are not guarantees to their continued efficient operations (Meyer & Rowan, 1977). Furthermore, Kalbers & Fogarty (1998) stated that many organizational structures including board of directors and audit committees are just symbols and may be

set up to conform to social pressures without influencing quality of financial reporting and performance of the firm.

3.2 Literature Review on Firm Performance

According to Iswatia and Anshoria (2007),performance is the function of the ability of an organization to gain and manage the resources in several different ways to develop competitive advantage. There are typically three broad categories of performance including: financial performance, operational performance and organizational effectiveness (Thomas, 2007). The principal paths to improve financial performance for financial institutions are to improve operational efficiency as well as improving customer service (Duncan & Elliott, 2004). The way firm is managed and the efficacy of the firm's governance structure are assumed to reflect corporate performance (Haniffa & Hudaib, 2006). Similarly, firm's value is supposed to increase and there will be an improvement in shareholders' wealth if the board performs its duties effectively (Abdullah, 2004). This is because the performance of firm is a consequence of past actions of directors and other factors which influence the choice of subsequent directors (Beiner, Drobetz, Schmid & Zimmerman, 2004).

There are two main performance measurements that could be used to measure a company's performance i.e. market based and accounting based performance (Demsetz & Villalonga, 2001). The difference between the two measurements is significant i.e. market based performance measurement is forward looking whilst accounting based performance measurement is backward looking. The other difference is that market based performance

measurement is an estimate of what management would accomplished and accounting based performance measurement is an estimate of what management had accomplished (Lee, 2009). Further to that, market based performance measurement is computed by analysts, fund managers or even the shareholders by applying certain applicable methods whereas accounting based performance measurement is measured by accountants based on professional standards laid by the profession[1]. In Saudi Arabia, the accounting standards are issued by the accounting standards committee of the Saudi organization for certified public accountants (SOCPA) under the International Financial Reporting Standards.

According to Hamid (2008), from 1968 to 1978, several researchers randomly had used accounting performance measurement in their study. Further to that, Hamid (2008) also indicated that from 1978 to 1990, there were more researchers that had used both accounting and market based performance measurement in their studies. Thereafter, a significant number of researchers had used multiple performance measurement in their studies.

Both performance measurements have its own strength in measuring a firm's performance. Accounting performance measurement uses accounting information taken from the annual report or financial statements as it measures performance based on historical data. In addition to that, accounting performance measurements are widely used to provide a more standardized way in making comparison between companies and also between financial periods (Hamid, 2008).

[1]Accounting performance measurement is thus not affected by psychological factor.

Market based performance measurements are considered as forward looking measurement and are more widely used in measuring the value of a firm on a particular time thus seems to be more relevant to others. According to McMullen (1996), market based performance measurements have an advantage over the accounting based performance measurement as it is less vulnerable to differential accounting techniques, procedures and evaluation of the ability of a firm to generate economic earnings in the future. Bhagat and Bolton (2008) opined that market based performance measurements are greatly influenced by investors' expectation. They argued that if investors expect performance to be affected by corporate governance, there would not be a significant relationship between the long term stocks returns and the governance even though significant relationship exists between performance and governance.

As a result, a combination of both performance measurements could be used to provide a more comprehensive insight and understanding of the relationship between selected variables and performance (Baliga, Moyer & Rao, 1996; Bhagat & Black, 2002; Daily & Dalton, 1993; Jong, Gispert, Kabir & Renneboog, 2002; Jong, Gispert, Kabir & Renneboog, 2003; Mokhtar *et al.*, 2009; Sunday, 2008). Some of the most common accounting performance measurements and market based performance measurements are discussed next.

3.2.1Accounting Performance Measurement

Accounting performance measurements are crucial in assisting companies to gauge its performance in its business environment, thus helping managers to effectively plan,

control and achieve the goals of the company (Erhardt, Werbel, & Shrader, 2003). Therefore, the financial performance of a business entity is crucial and requires proper measurement. As it seems today, there are various standards governing how financial could be measured according to the type ofthe business or industry. Below is just some of the accounting performance measurements used in evaluating a firm's performance:

1) Return on Assets (ROA)

ROA is used to indicate how profitable a company's assets are when it comes to revenue generating. Companies that require large initial investments will generally have lower ROA (Hamid, 2008).ROA is calculated as a net income divided by total assets of the company (Abdullah, 2004; Hsu, 2007; Ilona, 2008; Lin & Jen, 2011; Noor Afza, 2010; Krivogorsy, 2006).

According to Haniffa and Huduib (2006), when ROA is higher it shows that assets of the companies are used effectively to meet economic interests of the shareholders. ROA varies widely among companies and is a measure of asset-use efficiency. It can be used as an important indicator to show the difference between businesses' or company's profitability and the rate of return set as a benchmark (that is, risk adjusted weighted average cost of capital). It also measures the operating and financial performance (Klapper & Love, 2002). ROA is useful for evaluating the overall efficiency in generating net income from operations using firm's assets. Moreover, they argued that since it is possible to be efficient and be positioned poorly in the utilization of capital, ROA could also serve as an indicative of management's effectiveness in deploying capital (Miller, Boehlje & Dobbins, 2001).

2) Return on Equity (ROE)

ROE is an indicator of the rate of return on equity that provides useful information about the performance of debt in the capital structure which helps managers to know to what extent financial leverage is working either for, or against their firm's business (Miller *et al.*, 2001). ROE is also one of the most common indicators used to measure a company's performance and its management. ROE is computed as net income divided by average shareholders' equity (Abdullah, 2004; Ahmadu, Aminu & Taker, 2005; Chen, Cheung, Stouraitis & Wong, 2005; Limpaphaym & Connelly, 2006; Omar, 2003).

The average stockholders' equity is derived by averaging out the beginning and the ending shareholders' equity for the period under observation, i.e. Average Shareholders' Equity = (Beginning shareholders' equity + Ending shareholders' equity) / 2. In general, the higher or increasing ROE would be a favorable indicator for investors.

3) Earnings Per Share (EPS)

EPS is one of the most common methods used in stock market-based ratios or market performance indicator. EPS is a compulsory ratio used at the London Stock Exchange, an indicator of how important the ratio is. In essence, EPS measures the overall returns that were generated for each of shares purchased. EPS is computed as earnings attributable to ordinary shareholdersdivided by number of ordinary issued (Abdullah, 2004; Mokhtar *et al.*, 2009).

For the purpose of this study, the two measures of firm performance that will be used are Return on assets (ROA) and Tobin's Q (TQ). This could give a better indication since

both indicators have been used by different groups in evaluating firm performance. This is consistent with the recommendation of some of studies (Mokhtar *et al.*, 2009; Hamid, 2008). They state that a combination of both accounting and market performance measurements could add robustness to the study as the two different performance measurements have their own distinct and unique strengths.

3.2.2 Market Performance Measurement

According to Rashid (2008), the value of firm can be defined as the amount of utility or benefits of a firm by the shareholders. Below are some of the measures on how a firm is being valued using a market based performance measurement;

1) Value Ratio

According to Black (2001), the value of a firm could be measured using the value ratio. It can be derived by dividing the actual market capitalization by potential market capitalization. The actual market capitalization is derived from the price of the shares, whilst potential market capitalization is based from the actual resources of the firm.

2) Tobin's Q

Tobin's Q was developed by James Tobin, a Sterling Professor of Economics at Yale University in 1968. Tobin's Q is a ratio of the market value of equity and debt of a company to the replacement cost of its assets (Agrawal & Knoeber, 1996).Due to the limitation of the available data, this study calculates Tobin's Q as theresult of the market value of equity plus the book value of the debt dividedby the book value of the total assets, as calculated by Aljifri and Moustafa (2007), Baek, Kang and Park(2004),

Bauer, Günster and Otten (2004) and Weir *et al.* (2002). The use of Tobin's Q has an advantage of avoiding difficulty associated with the estimation of either rates of return or marginal cost thus making 'Q' to be a better measure of both the market value and replacement cost of a firm (Lindenberg & Ross, 1981).

3) Price Earnings Ratio (PE ratio)

One of the performance measurement used in numerous studies is the price earnings ratio or better known as PE ratio. It is derived from the current market price of a particular share over the earnings per share. According to Morin and Jarell (2001) and Copeland, Weston and Shastri (2005), the variable can be taken as company's future potential and represents the investment and dividend policy of a firm.

3.3 Literature Review on Internal Corporate Governance

Corporate governance is the set of mechanisms or procedures that control an organization in achieving its goals for maximize to the long-term benefits of shareholders. Good corporate governance is vital to protect not only the interests of shareholders, but also those of others, such as customers, suppliers, employees, and the government in ensuring that firms are accountable for their actions (Vinten, 1998).

According to Klapper and Love (2004), firms with better governance seem to have less need to rely on the legal system to resolve governance conflicts. Moreover, they argued that firms can partially compensate for ineffective laws and enforcement by establishing

good corporate governance and providing credible investor protection, which may improve their performance and valuation.

Although many attempts have been made to define corporate governance, there is noconsensus regarding its meaning since it involves numerous factors which can differ fromregion to region, such as objectives and the mechanisms of implementation. One of the mostpopular and implicit definitions of corporate governance is that introduced by AdrianCadbury, who was a pioneer in raising the awareness and presenting the debate on corporategovernance reforms, in the Cadbury Report, "Corporate governance is the system by whichcompanies are directed and controlled" (Cadbury Committee, 1992). Moreover, MacAvoyand Millstein (2003) define corporate governance as a set of structures specifying authorityand responsibility for the conduct of an organisation and its management. Parkinson (1994)defines corporate governance as the process of supervision and control aimed at ensuring thata firm's managers act for the benefit of shareholders.

The concept of internal corporate governance can be attributed to Berle and Means in 1932who debated the separation of corporate control and ownership(Colarossi, Giorgino, Steri, & Viuiani, 2008). Jensen and Meckling (1976) highlight that managers (the agent) act on behalf of theshareholders (the principal), who are the real owners of the company. However, based onthe agency theory, the issues related to the separation of ownership and management might boostexecutives to collude against owners in order to increase their own personal wealth (Rahman& Ali, 2006)

Over the last two decades, more attention has been paid to the role of different corporategovernance characteristics as monitoring mechanisms which provide more reassurance,notably for investors and regulators.These include mechanisms such as independent board andsub-committees that are likely to protect the shareholders. For instance, the former SECchairperson (Levitt, 1998) suggests that corporate governance plays a significant role; thus,the SEC should pay more attention to these mechanisms.

The reforms of corporategovernance practice have brought about an increase in the appointment of independent ornon-executive directors on corporate boards and sub-committees. These reforms include anumber of regulations established to enhance the role of corporate governance, mainly thatare related to disclosure. For instance, the Sarbanes–Oxley Act (2002) was a reform of thedisclosure of corporate governance information, which was presented following accountingscandals concerning a number of firms such as Enron, Tyco International, Adelphia, PeregrineSystems and WorldCom. According to Chang and Sun (2009), SOX has had a significanteffect on corporate governance practices. They stress that there has been a negativerelationship between firm performance and board and audit committee independence afterSOX which was not seen in the pre-SOX period. In addition, the Saudi Arabia governmenthas recently issued many reforms regarding corporate governance, such as the mandatoryestablishment of sub-committees, a majority of non-executives on boards and the disclosureof corporate governance implementation.However, these reforms have not yet been examinedby academic researcher (Al-Gamdi, 2012).

In general, the previous academic literature has reached some significant conclusions aboutthe relationship between firm performance and internal corporate governance. Accordingly, this section aims to review the literature that attempts to determinea relationship between internal corporate governance mechanisms and firm performance.

3.3.1 Board of Directors

Board of directors is one of the important elements used in internal corporate governance mechanisms. According to Lefort and Urzúa (2008), board of directors is a central institution in the internal governance of a company which provides a key monitoring function in dealing with agency problems inherent in managing an organization (Hermalin & Weisbach, 2003).

Fama and Jensen (1983) argued that by exercising its power to monitor and control management, the board of directors can reduce agency conflicts based on the perception that managers may have their own preferences and may not always act on behalf of the shareholders and thus, board of directors should monitor them (Limpaphayom & Connelly, 2006).Jensen (1986) also suggested that the main role of the board of directors is to act on behalf of shareholders in supervising and monitoring the action of the management, giving advice and vetoing poor production-investment decisions.

In addition, board of directors as internal corporate governance mechanisms will have direct impact in assuring adequate returns for shareholders (Weir, Laing,& McKnight, 2002). One of board of director's duties is to optimize shareholder value (Coles,

McWilliams,& Sen, 2001). According to Limpaphayom and Connelly (2006), the role of board of directors in overseeing management is needed, which management should be checked and controlled to make sure that the management has done their act under all rules. Board of directors' characteristics such as board size, board composition and CEO duality are argued to play a role in influencing firm's financial performance (Coles *et al.*, 2001;Fama & Jensen, 1983;Weir *et al.*, 2002).

The impact of board of directors on companies' financial performance depends on board effectiveness. The board effectiveness relies on three main issues which are board size, composition and internal structure (De Andres*et al.*, 2005). Abdullah (2004) and Fama and Jensen (1983) argued that board independence and its leadership structure are important characteristics of board that determine its effectiveness. The board characteristics namely board composition, director's duality, board size and shareholdings ownership by the members of the board and by chairmanare reviewed in the following sections.

3.3.1.1 Board Composition

The issues of board composition have been looked into from two perspectives. From the first perspective, it is argued that there should be more non-executive directors on boards while other view suggested that more executive directors on boards are desirable. Shamser and Annuar (1993) described board composition as the ratio of outside directors to total number of directors. Fama (1980) and Fama and Jensen (1983) argued that for board to be effective in monitoring its firm's managers, it depends both on the important role performed by inside and outside directors.

Therefore, it was emphasized that an optimal board be made up of both inside and outside directors. The inside directors have in-depth knowledge of firm specific activities and the firm's competitive environment, while outside directors are more independence with monitoring skills. In addition, as a result of outside directors' expertise, prestige and contacts, they are likely to enhance how monitoring is being managed and render help in personnel matters by providing additional links to the external environment.

Over the years, board composition has been an important characteristic and the subject of a lot of studies, as the presence of outside directors in the board is thought to be vital for the functioning of the board in an unbiased manner. Independent directors provide unbiased judgments, especially on issues of strategy, performance, management of conflicts and standards of conduct. Corporate governance committee reports across the world have laid considerable stress on the role of independent directors. However, the 'Companies Act' of most of the countries across the world does not make any distinction between the different categories of directors in terms of their responsibilities, and all directors are equally and collectively responsible by law for a board's actions and decisions.

The Cadbury Committee Report (1992) concluded that the Board should consist of enough number of high calibers of non-executive directors (NEDs) so as have significant influence in the board's decisions. The Saudi Arabia Code on corporate governance (2006) makes recommendations of having at least one third of the independent directors or NEDs on

board members as a best practice to have balance on the board of directors. This makes the independent directors to be effective in realizing the objective of board decisions.

A study by Jensen and Meckling, (1976), put it that the need for independent non-executive directors on the board is justified by the agency theory which states that managers if given the opportunity would work to realize their own objective at the expense of the shareholders because of ownership separation from control (Jensen & Meckling, 1976). Therefore, with independent non-executive directors on the board, assistance will be given by them to monitor and control the opportunistic behavior of management, as well as evaluating the management more objectively.

There have been empirical studies examining the relationship of non-executive directors with firm performance. The results of these empirical studies have been mixed. For example, Pearce,and Zahra (1992) claimed that there is positive relationship between firm performance and board composition. They studied board composition and its effect on firm performance on some Fortune 500 companies.Their findings clearly state that there is a positive relationship between the presence of outside directors on the board and firm performance. They argue that, by expanding boards and recruiting experienced and professional outside directors, firms would benefit by making use of their expertise and experience.

In another study,Rhoades, Rechner and Sundaramurthy (2000), found that NED has a positive relationship with financial performance of less than 1 per cent variation in financial performance, using ROE, ROA and market value of shares. Their argument of why

previous studies show no relationship between NED and performance may be due to small sample size used.

Similarly, in the study among Belgian companies conducted by Dehaene, Vuyst, and Ooghe (2001), the number of external directors have been found to have a significant positive association with return on equity. This provides evidence that the independence of outside directors from firm management is beneficial to the firm and this is also considered by investors for investment decisions making.

In addition, Dahya and McConnell (2003) in their study in the UK found evidence that investors seemed to perceive appointments of outside CEOs as good news, and the period of announcement of stock returns reflected this.

Moreover,A study of Yasser*et al.* (2011) examined the relationship between board composition and and two firm performance measures (return on equity, ROE, and profit margin, PM). Using a sample of 30 Pakistani listed firms between 2008 and 2009, the results provided evidence of a positively significant relationship between board composition andROE and PM.

Furthermore, A study of Swamy (2011) investigated the relationship between board composition as measured by outside directors and firm performance as measured by ROA and ROE. Using a sample of 83 firms in India from 2008 to 2010, He found that there is a positive relationship between outside directors and firm performance as measured by ROA.

Finally, a study of Abdurrouf (2011) examined the relationship between the board composition and firm performance as measured by ROA and ROE. Using a sample of 93 firms in Bangladesh during the year 2006, He revealed that board independent found to be a positive relationship to firm performance (ROA and ROE).

On the other hand, there have been evidences against agency theory. For example, Agrawal and Knober (1996) carried out study based on 400 large U.S. firms between 1983 and 1987. They found evidence of negative association between outside boards and firm performance as measured by Tobin's *Q*. Bhagat and Black (1999) also found negative result by reporting that firms with majority outside directors perform worse than other firms. The result of the studies showed that independent non-executive directors do not positively influence firm performance. This may mean that the independent non-executive directors do not effectively play their roles in these cases. The independent non-executive directors have firm performance role and also affect the comprehensiveness of financial disclosures by firms. Similarly, Coles *et al.* (2001) reported that the effect of outside directors on firm performance in a panel of 144 firms between 1984 and 1994 is negative.

In another study, Abdullah (2004) used all companies listed on the Main Board of Kuala Lumpur Stock Exchange (now known as Bursa Malaysia) between 1994 and 1996 to examine the impact of board composition on company performance (ROA, ROE, EPS and profit margin). The author's finding reveals that board independence bears no relationship with firm performance.

Furthermore, Erickson*et al.* (2005) used publicly traded Canadian firms over the period 1993 to 1997 to investigate the association between the board composition and firm value with significant ownership concentration. Their results indicated that greater board independence is negatively related to firm value. In addition, they found that poorly performed firms raise the proportion of outside director in the following periods. They argued that the value of firm has risen with the presence of outside directors who are officers of financial institutions.

Finally, Ibrahim and Abdul Samad (2011) examined the relationship between independent board and firm performance as measured by Tobin's Q, ROA and ROE. Using a sample of 290 companies listed in Bursa Malaysia from 1999 to 2005, the study found no significant relationship between the proportion of independent directors and performance based on Tobin's Q.

3.3.1.2 CEO Duality

The separation of the functions of CEO from that of chairperson is considered one of the main monitoring mechanisms by the agency perspective. In a situation where this is not the case, duality exists and the monitors and evaluators of the CEO's performance will still be chaired by the CEO. This possibly gives way to conflict of interest and leads to hinder the independence of the monitoring group (Rechner & Dalton, 1989).

A study by Bhagt and Bolton (2008) examined the association between CEO-Chair separation and firm performance which measured by return on assets (ROA), Tobin's Q and

Industry Performance. By using a sample of 847 companies between 1998 and 2002, they found that CEO-Chair separation is significantly positivelycorrelated with better contemporaneous and subsequent operating performance.

Another study by Yermack (1996), using a sample from the annual Forbes Magazine's ranking of the 500 largest public companies in the USA between 1984 and 1991 found that firms are more valuable i.e. perform better when the CEO and the Chairman of the company are two different persons.

Similarly,Coles *et al.* (2001) used the Stern Steward performance 1000 database. For a sample of 144 firms between 1984 and 1994, they found that firms have higher financial performance when the CEO and chairperson positions are separate.

Moreover, Kyereboah-Coleman, and Biekpe (2005) have examined the relationship between CEO duality and some measures of performance such as ROA, Tobin's Q and sales growth of listed non-financial firms on the Stock Exchange of Ghana. They found that the separation of board chairman from the position of chief executive officer reduces the tension that may arise between managers and board members thus bring about positive performance on the path of firms.

Furthermore, Chen *et al.* (2005) used 412 publicly listed firms in Hong Kong to investigate the possible impact of CEO duality on performance, value and dividend payout in family controlled firms between the periods 1995 to 1998. Three measurements (ROA, ROE and market to book ratio) were used to examine the firm's performance. Findings revealed that

CEO duality is significantly and negatively associated with performance (the market to book ratio). The significant is pronounced even after industry and firm fixed effects have been controlled. It was also concluded that CEO duality and lower firm value are related, which implies that companies with combined structure are associated with lower performance.

Finally, Chaghadari (2011) investigated the relationship between CEO duality and firm performance as measured by ROA and ROE in Malaysia. Based on a randomly selected sample of 30 companies listed on Bursa Malaysia during the year 2007, it is found that CEO duality has a negative relationship with firm performance (ROA and ROE).

On the other hand, Boyd (1995) showedthat CEO duality is positively related to firm performance in low munificence environments, using data from 192 firms in 12 industries. The CEO duality is also positively related to firm performance in highly complex environments. Therefore, CEO duality can help firm performance under the right circumstances. The findings do not support the segregation of the positions of CEO and chairperson.

Similarly, findings by Dehaene *et al.* (2001) provided evidence that in a situation where chairman and chief executive roles are combined there is significant higher return on assets than when they are separated. Hence, a positive association existed between duality and firm performance. They further argued that when the chairman is also active as the CEO in the daily activities of the firm, there will be rise in his investment in order to raise firm's size or to boost his personal status.

Moreover, Harjoto and Jo (2008) used a sample of 2,681 firms with board leadership data in the U.S. during the period 1995 to 2005 to examine the impact of CEO duality on firm performance as measured by ROA, operating profit and Tobin's Q. Their results showed that CEO duality positively influenced firm value and performance.

Furthermore, a study by Ibrahim and Abdul Samad (2011) examined the relationship of corporate governance mechanisms and performance between family and non-family ownership of public-listed firms in Malaysia from 1999 to 2005 as measured by Tobin's Q, ROA and ROE. The findings show that CEO duality in firms with non-family ownership was significantly positively related with ROA and ROE.

However, Abdullah (2004) found that CEO duality did not have any relation to firm performance in his study that aimed to investigate the effect of CEO duality on company performance (ROA, ROE, EPS and profit margin) using all companies listed on the Main Board of Kuala Lumpur Stock Exchange (now known as Bursa Malaysia) between 1994 and 1996.

Moreover, Nazli(2010) examined the relationshipbetween CEO duality andfirm performance as measured by Tobin-Q in Malaysia. Using data from the year 2001 annual reports of 87 non-financial listed companies includedin the composite index, the results reveal that CEO duality wasstatistically insignificant in explainingcorporate performance (Tobin's Q).

3.3.1.3 Board Size

Board size or the number of directors on board is an important factor in the effectiveness of the board. Increase in board size would improve companies' board effectiveness to support the management in reducing agency cost that resulted from poor management and would lead to better financial results (Jensen & Meckling, 1976). According to Kyereboah-Coleman and Biekpe (2005), larger boards are better for corporate performance because they have more capabilities and expertise in assisting the management in decisions making and are harder for a powerful CEO to dominate. This results in improving governance especially in enhancing company's management and financial performance.

According to Dalton and Dalton (2005), larger boards provided access to more resources and networking as well adding benefits in order for CEO and other executives to have larger number of individuals to rely upon as sources of advice and counsel. The boards (Larger) have also provided room to broadly improve board diversity with respect to experience, skill sets, gender and race.

The findings of previous studies have shown mixed results with regard to the relationship between this board characteristic and performance. Most researches show that larger boards function less effectively and are negatively related to firm performance (Berghe & Levrau, 2004). Jensen (1993) also argued that having larger board of directors in the corporation leads to less effective as it presents a hard mission for CEO to control.

Using a sample of 452 U.S. public firms between 1984 and 1991, Yermack (1996) provided evidence of a negative association between board size and firm value. Companies with smaller boards demonstrate favorable values for financial data and provide stronger CEOs incentives compensation. Moreover, he argued that one's board gets too big; it becomes difficult to co-ordinate and process problems.

In a study conducted by De Andres *et al.* (2005), it was found that poor performance is associated with companies that possess oversized boards of directors whether in countries with dominant internal mechanisms of governance or in countries with dominant external mechanisms. They indicated that the underlying rationality on the effect of large board on the performance can result in poorer communication and coordination inside the board. Similarly, they found significant negative relationship between the board size and firm financial performance.

Moreover, Noor Afza and Ahmad (2009) examined the relationship between familycontrolled businesses and corporate governance mechanisms with firm value among Malaysian companies. They used a sample of 896 companiesthat were listed on Bursa Malaysia from 2000 to 2003. The findings reveal that small board size was better than large board size.The results also showedthat non-family businesses with smaller board size outperform non-familybusinesses with larger board size.

Furthermore,O`Connell and Cramer (2010) investigated the association between board size and firm performance (ROA, RET and Tobin-Q) in Ireland. Using a sample of 77

firms listed on the Irish Stock Exchange during the year 2001,theresultsreveal that the board size found to be a significant negative to firm performance.

Finally, Kota and Tomar (2010) examined the impact of board size on firm performance (Tobin-Q) in India. Using asample of 106 mid-sized firms in Indiaduring the period 2005 to2007,thefindingsshow that there wasa negatively significant relationship between board size and firm performance (Tobin-Q).

On the other hand, Hanifa and Hudaib (2006) looked into the relationship between board size and two performance measures i.e. Tobin Q and ROA in Malaysia. Sample of 337 firms listed on Bursa Malaysia from 1996 and 2000 were studied. It was noted that board size is significantly associated with market and accounting performance measures. The study also reveals that whilst board size had a positive correlation with accounting performance, it had a negative correlation with the market performance indicating that the market views big size board of directors as ineffective.

Similarly, Kamardin (2009) examined the association between board size and firm performance which was measured by return on assets (ROA) and Tobin's Q. By using a sample of 520 companies listed on Bursa Malaysia, it was found that board size is significant to Tobin's Q with a positive relationship. However, it was not significantly predictive to ROA.

Other studies such as Beiner*et al.* (2004) found no significant relationship between board size and firm valuation, as measured by Tobin’s Q. Similarly, Bhagat and Black (2002)

also revealed no association between board size and firm performance when using sample of the largest U.S. companies.

Moreover, Nazli (2010) investigated the impact of the board size on firm performance as measured by Tobin-Q in Malaysia. Using data from the year 2001 annual reports of 87 non-financial listed companies includedin the composite index, the results show that board size wasstatistically insignificant in explainingcorporate performance (Tobin's Q).

Finally, Chaghadari (2011) examined the relationship between board size and firm performance as measured by ROA and ROE in Malaysia. Based on a randomly selected sample of 30 companies listed on Bursa Malaysia during the year 2007, it is found that there was no significant relationship between board size and firm performance (ROA and ROE).

3.3.1.4 Chairman of Directors Shareholdings

One essential factor that is likely to lessen conflicts between the manager and shareholder is board members' (both executive and non-executive) shares ownership.Stock ownership is a potential determinant of board characteristics. Thus, higher equity ownership on the part of the directors is likely to motivate them to question managerial policies (Patton & Baker, 1987).

In this case, part of the firm is owned by board members.They develop interest like shareholder and are likely not to embark on detrimental behavior to shareholders. This

implies that managerial shareholdings assist in aligning shareholders' interests with that of managers. This is made possible because as the company's performance increases, the managers benefit through their equity interests in the company (Jensen & Meckling, 1976). For this reason, managerial ownership is claimed to be negatively associated with agency conflicts between managers and shareholders, and positively associated with corporate performance.

Jensen (1993) argued that internal control problems arise because outside directors have little stock ownership. He reports that internal controls would be more effective if directors owned substantial stock. The director compensation plan such as stock options increases the directors' equity holdings. Also, the convergence-of-interests hypothesis suggests that larger ownership is associated with the market valuation of the firm. As the ownership stakes of the directors increase, their personal interests are aligned with those of shareholders. Thus, board ownership helps resolve the agency problems and improves the firm performance (Morck, Shleifer& Vishny, 1988).

On the contrary, the entrenchment hypothesis suggests that market valuation is negatively associated with high ownership stakes. As the ownership of directors increases, they do not have to consider other shareholder interests. Therefore, high board ownership decreases firm performance (Morck *et al.*, 1988). Morck *et al.* (1988) examined the relationship between board ownership and Tobin's Q as a proxy for market valuation of the firm. Tobin's Q is measured by the ratio of the market value of assets to their replacement cost. They find that Tobin's Q first rises as board ownership increases from 0 to 5 percent, then declines as ownership stake rises to 25 percent and finally rises slightly

as board ownership is beyond 25 percent. They explain that the increase of Tobin's Q with ownership indicates the convergence-of-interests between directors and shareholders, while the decline indicates entrenchment of the director teams.

McConnell and Servaes (1990) also investigated the relationship between firm performance which was measured by Tobin's Q and insider ownership (i.e. officers and directors). They find a significant curvilinear relation between Tobin's Q and insider ownership. The results show that Tobin's Q increases, then decreases, as insider ownership stake increases.

Similarly, Steiner (1996) examined how ownership structure and firm diversification affect firm valuation. They also tested whether both effects are important in the same Tobin's Q model. Using data from 481 NYSE firms for 1992, the results showed that director ownership and firm diversification together significantly affect the Tobin's Q. In addition, director ownership explains 1.63 percent of the variance in Tobin's Q.

Previous studies only investigated the impact of ownership by board members (at board level) on financial performance; however, the phenomenon of family ownership and cross-chairmanship among firms is common in some Asian countries (Baydoun, 1999). Therefore, this study examined the impact of the chairman of the board on financial performance. Moreover, the chairman is in the position where he has considerable voting right and he is also the main responsible for the effective performance of the board of directors. Ogbechie, Koufopoulos, and Argyropoulou (2009) suggested that chairman

should be having a command on all the executive and non-executive directors. This may lead him to make decisions that lead to better performance.

The highest ranking officer in a corporation'sboard of directors is the chairman of the board. The chairman is responsible to the management; he develops and ensures effective performance of the board of directors; and he gives leadership role to the board in all aspects while executing board’s work. The chairman serves as advisor to the president, the chief executive officer (CEO), and other officers in all matters relating to the interests and management of the corporation. He consults with the CEO and performs functions in the corporation’s external relationships.

The primary role of the chairman of the board is to make sure that both the board and management understand the responsibilities of the board; understand and respect the limit between the board and management; and also to make sure that the board effectively executes its responsibilities in line with the corporate governance guidelines of the board of directors.

Levy (1980) offered the following list of ten tasks for the chairman, some carry out in collaboration with the CEO:

1. Schedule board and committee meeting;
2. Organize and present board agendas;
3. Review board information flow on management proposals;
4. Assure adequate lead time for the effective study and discussion of the business under consideration;

5. Review on-going board information flow;

6. Propose board committee structure and chairmanships;

7. Assign specific tasks to members of the board;

8. Establish procedures to govern the board's work;

9. Prepare and distribute proxy material to stockholders;

10. Most importantly, in collaboration with his fellow directors, identify guidelines for the conduct of the director and assure that each is making a significant contribution.

A study by Baydoun (1999) examined the association between personal ownership (cross-chairmanship) and auditor selection. By using a sample of 415 local companies listed on the Hong Kong Stock, he found that that there is a significant relationship between auditor selection and cross-chairmanship in Hong Kong companies. He also showed that the composition of the Board does not appear to be significant at the entire Board level but it is more significant at the executive director level (the chairman).

3.3.2 Audit Committee

The audit committee is a sub-committee of the full board. The audit committeeprovides communication between the full board, internal auditor, external auditor, theexecutive officers, and finance directors (Song & Windram, 2004). Jensen and Meckling (1976) presented a rationale for the existence of the audit committee thatagency costs increase when managers take the opportunity to act against shareholders' interests. Contractual relationships between mangers and shareholders reduce agency costs. Nonetheless, these contracts must be subsequently monitored (Jensen & Meckling, 1976; Hadden, 2002). The

formation of an audit committee arises from the need to monitor these contracts (Hadden, 2002; Wild, 1994).

Klein (1998) stated that audit committees meet regularly with internal and external auditors to review financial statements and internal controls. Therefore, an audit committee as a governance mechanism reduces information asymmetry between insiders and outsiders and therefore mitigates agency problems. Dezoot *et al.* (2002) also believed that an effective audit committee has qualified members with authority and resources to protect shareholders by insuring reliance on financial reporting, internal controls, and risk management though its oversight role.

A study of Wild (1996) examinedthe relationship between the formation of an audit committee and the quality of accounting earnings. He evaluated the effectiveness of audit committees by comparing the quality of earnings reports before and after the formation of audit committees. Wild selects a sample of 125 companies forming and not forming audit committees between 1966 and 1980. The results showed that the markets' reaction to earning reports is twenty percent greater after the formation of audit committees.

In 1999, NYSE and NASD announced the formation of BRC to improve the effectiveness of audit committees. BRC issues ten recommendations regarding audit committee structure, audit committee effectiveness, and accountability of the audit committee (BRC, 1999). The main recommendations for audit committees of BRC Report: (1) must be composed exclusively of non-executive directors and independent of management, (2) consist of at least three members, (3) include at least one member with financial expertise, (4) meet at

least quarterly to discuss financial reporting quality with external auditors, and (5) provide up-to-date charters detailing committee responsibilities (BRC, 1999).

In response to the BRC, the SEC required that audit committees include: (I) at least three members, (2) all members to be independent of management, and (3) at least one member with financial expertise (Krishnan, 2005). The SEC also required that companies disclose the audit committee charter and report on the proxy statements. Such disclosures ensure the effectiveness of the audit committee (Lin, Li, &Yang, 2006).

In July of 2002,SOX Act of 2002 was signed into law. The SOXassigned specific responsibilities to the audit committee that it did not have previously. For example, audit committee is directly responsible for the appointment, compensation, retention, and oversight of the auditors' works. Additionally, they resolve financial reporting disagreements between management and auditors. Audit committees also have authority to hire independent counsel and advisors (Klein, 2003).

In connection with SOX, NYSE and NASD proposed the following audit committees' changes: (1) a tighter definition of independence, (2) greater proficiency in reading and interpreting financial statements, (3) compliance with specific provisions within the chapter, and (4) deletion of small business exemption from compliance with various regulations (Hadden, 2002). Therefore, this study reviewed the audit committee monitoring effectiveness as follows:

3.3.2.1 Audit Committee Independence

The main and essential feature of an audit committee's effectiveness is its independence from management (BRC, 1999; Public Oversight Board, 1993). The independence nature implies that it has not been related to the corporation that may interfere with the independence exercises of an audit committee's effectiveness on management and the corporation (BRC, 1999). Independence has been described as the extent to which an audit committee consists of non-executive directors (Gaved, 1997; Smith Report, 2003).

According to the first recommendation made by BRC(1999), it was reported that directors are not expected to be considered independent in the following conditions:1), if the director or a member of his/her immediate family was an employee of the company of its affiliates within the past five (5) years; 2), if the director received compensation for work other than board service; 3), if the director serves as a partner or controlling shareholders or executive of a business with which the company has significant business.

The second recommendation by BRC(1999) is about the modification of requirement of NYSE and NASD in order to give room for listed companies to have audit committees devoid of dependent directors. Many other independent advisory bodies have designed guidelines with proposition to reform both the audit process and the audit committee. For example, it was recommended by Treadway Commission (1987) that: "the audit committee members of all public companies should be composed of solely independent directors".

Moreover, SOX (2002) requires that all members of an audit committee be independent of the firm's management, and that the committee oversee the accounting and financial reporting processes as well as the audit of the financial statements. While Saudi Corporate

Governance Cod (SCGC, 2006) has not specifically defined independence, it has recommended in Para 14 (a) that an executive board members are not eligible for audit committee membership.

Most research that investigated the relationship between audit committee independence and firm performance showed a positive relationship. Erickson *et al.* (2005) tested the relationship between audit committee independence and firm value using Canadian public firms between 1993 and 1997. They found a positive relationship between the independence of the audit committee and firm performance which measured by Tobin's Q. Erickson *et al.*(2005) concluded that independent audit committees can also reduce agency problems.

Similarly, Chan and Li, (2008) investigated the impact of audit committee independence on firm performance which measured by Tobin's Q. From Fortune 200 companies, the results indicate that independence of audit committee (i.e., to have at least 50 per cent of expert-independent directors serve on audit committee) positively impacts on firm value.

Finally, Ilona (2008) examined the association between audit committee independence and firm performance which measured by ROA. By using a sample of 133 companies listed on Bursa Indonesia, she found that audit committee independence is positively associated with firm performance.

In contrast, Klein (1998) suggested that independent audit committees with specific knowledge of the firm's operation are more effective. Firm performance is considered as a proxy for audit committee monitoring effectiveness. Based on a sample of 485 S&P 500

firms for 1992 and 486 for 1993, the results show no association between the proportions of outside directors on audit committees and firm performance. Consequently, independent audit committees do not improve firm performance.

Additionally, Weiss (2005) investigated whether audit committee independence was related to monitoring effectiveness. The monitoring effectiveness includes earning quality, value relevance of earnings and firm performance (ROA).Based on an analysis of 227 firms from 2000 to 2001, and 81 firms in 2003, Weiss did not find a relationship between audit committee independence and monitoring effectiveness.

A study of McMullen and Raghunandan (1996) hypothesized that an independent audit committee is more effective. They study 128 companies which reveal financial reporting problems. They found that companies with financial reporting problems are less likely to have audit committees composed only of independent directors.

Another study by Beasley *et al.* (2000) investigated the relationship between audit committee independence and financial statement fraud. They observed 200 fraudulent financial reports issued by the Securities and Exchange Commission in Accounting and Auditing Enforcement Releases between 1987 and 1997. Beasley *et al.* (2000) found that the fraud companies are likely to have less independent audit committees.

Moreover, Carcelloand Neal (2003) considered that independent audit committees should protect auditors from dismissal following a going-concern opinion. By examining a sample of 374 firms between 1998 and 1999, they found that audit committee independence

decreases the possibility of auditor dismissal following the issuance of a going-concern report.

Furthermore, Abbott, Parker, and Peters (2004) examined whether audit committee independence is less likely to experience financial reporting restatement for a sample of 88 restatement firms and their matched control firms. They found that independent audit committees are negatively related to restatements. This result suggested that audit committee independence decreases the likelihood of restatement.

3.3.2.2 Audit Committee Meetings

The number of audit committee meetings provides one proxy for audit committee meetings (Song & Windram, 2004). BRC (1999) recommends that audit committees of the listed firms meet at least once quarterly. Therefore, the numbers of audit committee meeting is considered an important attribute for their monitoring effectiveness (Lin *et al.*, 2006).

A study by Menon and William (1994) asserted that audit committee monitoring functions include composition and frequency of their meetings. From a sample of 200 over-the-countries (OTC) firms between 1986 and 1987, they find that boards rely on audit committees to monitor management. They also found that larger firms are likely to have more audit committee meetings.

Moreover, McMullen and Raghunandan (1996) tested audit committee monitoring effectiveness. Based on a sample of 128 firms which issue financial fraudulent reports, they

found that companies with financial reporting problems are less likely to have frequent committee meetings.

Furthermore, Hsu (2007) examined the association between audit committee meetings and firm performance which measured by using return on assists (ROA) and Tobin's Q. Based on a sample of new U.S. 226 firms, he found that there is a positive relationship between audit committee meetings and firm performance.Similarly, Vafeas (1999) examined whether board meeting frequency is related to firm performance. For a sample of 307 firms from 1990 to 1994, he found that board meeting is inversely related to firm value. Board meetings increases when share price declines. He concluded that the frequency of the board meeting is an important element of board operations.

A study by Xie, Davidson, and DaDalt (2003) investigated whether audit committee activity prevents earning management. By using a sample of 282 firm-year observations, they find that audit committee activity is negatively associated with earning management. This finding suggests that audit committee activity influences their members to serve as effective monitors.

Another study by Abbott *et al.* (2004) also stated that the frequency of audit committee meetings is negatively associated with the incidence of financial misstatement. Based on 88 misstatements of annual results from 1991 to 1999, they conclude that the frequency of audit committee meetings demonstrates a significant and negative association with the occurrence of misstatement.

3.3.2.3 Audit Committee Shareholdings

In the context of audit committees, the possession of higher equity ownership by committee members has the likelihood of lessen problem associated with the collusion of directors with the management to manipulate earnings to their interest or inflate executive pay which in turn is likely to eventually hinder their interest as well. To align the interests of shareholders and outside directors, who are themselves agents of shareholders, firms routinely grant equity to outside directors.Yermack (2004) findings suggested that director equity awards are made systematically and consistent with the predictions of agency theory. Furthermore, Ferris, Jagannathan, and Pritchard (2003) have provided evidence that outside directors who possess larger equity often safeguard shareholder interests such as lessen fraud litigation in a more effective way.

A study by Vafeas (2005) used data on 252 U.S. firms between 1994 and 2000 to study the relationship between equity ownership by audit committees and financial reporting quality. He found that higher equity ownership by committee members resulted to reduce the danger of these directors colluding with management to manipulate earnings and that is generally consistent with the predictions of agency theory.

Similarly, Yang and Khirshnan (2005) examined the stock ownership by audit committee. Using a sample of 896 firm-year observations for the years 1996 to 2000, they reported that stock ownership by independent audit committee directors is positively associated with earnings management. Beasley (1996) also reported that the likelihood of fraud decreases as stock ownership by outside, including grey, directors (not necessarily audit committee

directors) on the board increases. This may be because stock ownership provides incentives for outside directors to monitor management.

However, the results of study by Wright (1996) have provided evidence that a direct financial interest such as stock ownership by audit committee directors may weaken the independence of directors. A univariate test showed that the negative association of stock ownership of audit committee directors with the level of analyst disclosure ratings is weak. Another study by Shivdasani (1993) revealed that ownership by unaffiliated outside directors reduces the possibility of hostile takeover bids, while ownership by affiliated outside directors (with close relation with managers) has no effect.

3.3.2.4 Audit Committee's Relationship with Internal Auditors

According to the Sarbanes-Oxley Act (2002), a good working relationship with the internal auditor can assist the committee in fulfilling itsresponsibility to the board of directors and shareholders.In addition, the higher the level of interaction of the audit committee with the chief internal auditor, such as more frequent meetings between the chief internal auditor and audit committee, the more likelihood that audit committees will be better informed and more diligent in performing their duties (Hutchinson & Zain, 2009).

Furthermore, Menon and William (1994) suggested two benefits derived by the board from the audit committee monitoring role. These are independence and board efficiency. Independence from management is derived with the report made to the audit committee by

both the internal and external auditors. Secondly, the efficiency of the board can be enhanced when the committee that particularly monitors financial reporting processes and management performance offers additional support to the board (Zahra & Pearce, 1989).

The Oversight duties of audit committees includes reviewing the audit plan of the external and internal audit; reviewing the internal auditor (IA) programs, processes or investigations; and ensuring the adequacy of the scope, functions and resources of the IA function. These are advocated by both regulators and advising bodies, including various stock exchange bodies and corporate governance advising bodies. For example, other corporate governance guidelines throughout the world such as BRC (1999) and SOX (2002) in the U.S.; the Cadbury Committee (1992) and the Smith Committee (2003) in the UK; and the Australian Stock Exchange Corporate Governance Council (2003) in Australia provide various best practice guidelines for audit committees.

Specifically, the BRC (1999) advocated the following five principles of best practice for an audit committee: 1), the audit committee's key role in monitoring the management, and external and internal auditor in the audit process; 2), independent communication and information flow between the audit committee and the internal auditor; 3), independent communication and information flow between the audit committee and outside auditors; 4), candid discussions with the management, internal auditor, and outside directors regarding the implications of issues, judgment and impacting quality, and lastly, diligent and knowledgeable audit committee membership.

In Saudi Arabia, all listed companies must have an audit committee of at least three members and the committee should not be dependent of non-executive directors as required by the Corporate Governance Regulations (2006). There should also be at least one member of the audit committee who specializes in finance and accounting matters. The oversight duties and responsibilities of audit committees, as prescribed by the Corporate Governance Regulations article 14 includes the following: 1), to review the internal control system; 2), to review the in term and annual financial statements; 3), to review the audit plan with the external auditor; 4), to review the audit report; 5), to supervise the internal audit department of the company and recommend the appointment, dismissal and the remuneration of external auditors to the board of directors.

The function of the internal auditor is another internal governance mechanism that assists management in realizing the responsibilities of its financial reporting. While carrying out their oversight duties, the analyses and appraisals of different activities of the organization are done by internal auditors which also make the necessary recommendations to enhance internal controls and efficiency. The formulation of the plan of the internal auditor usually takes place annually. The findings are reported by the head internal auditor who also makes recommendations and post-audit follow-ups. Therefore, internal auditors perform significant functions in overseeing the financial control as well as the reporting environment of an entity.

The function of the internal auditor is related to that of the audit committee in a unique way in the sense that the internal audit is supported by an audit committee in many ways, such as through the review of the sufficiency and scope and function of the internal auditor;

provision of enough resources; and in facilitating communication with management (IIA, 2011). Thus, there is potential for audit committees to raise and improve the independence, effectiveness and the overall status of the internal audit. In short, the support given by the audit committee hasdirect implications for the effectiveness of the internal audit (Scarbrough *et al.*, 1998).

Besides the independence and meetings of audit committees, the extent of the interactions between an audit committee and the IA is another important facet expected to result in better firm performance. Corporate governance guidelines, such as the BRC (1999) and Treadway Commission (1987) emphasized the importance of strong working relations between the audit committee and the IA function in preventing financial reporting problems. As argued by the BRC (1999), for an organization to achieve maximum benefit, open lines of communication should exist between the IA and the audit committee. Further, the BRC (1999) recommended the three hold four (4) audit committee meetings per year.

A study by Gendron, Bedard, and Gosselin (2004), using a case study of three companies, suggested that a key aspect of an audit committee's duties is asking challenging questions and assessing responses provided by managers. As noted by Gendron *et al.* (2004) "meetings in effective audit committees may therefore be conceived of as arenas where attendees establish and secure their reputations of trustworthiness".

Further, the results also indicate that in each meeting, audit committees focus on reviewing matters, such as the accuracy of financial statements, the appropriateness of the wording used in financial reports, effectiveness of internal controls, and the quality of the work

performed by the auditors. No doubt, audit committees interaction with IA is a broad concept and encompasses a variety of activities (Raghunandan, Read & Rama, 2001).

Even though the relationship between the audit committee and internal auditors has a significant effect and is expected to have a significant effect on firm performance, this relationship has been greatly ignored in the literature. Therefore, one of the main objectives of this study is to bridge this gap by examining the effect of this relationship on firm performance.

In this study, the focus is on the following three aspects of the relationship between the audit committee and IA: (1) frequency of meetings between the audit committee and the chief internal auditor; (2) audit committee reviews of IA proposals on their annual audit program plans, then annual budget and coordination with external auditors; and (3) audit committee reviews of the results of IA activities, specifically, reviews of financial reporting, internal control and compliance with laws and regulations. The selection of these activities is motivated by the discussions in the reports of the Treadway Commission (1987); BRC (1999); SCGC (2006) and also in prior studies (such as, Goodwin & Yeo, 2001; Goodwin, 2003; Raghimandan *et al.*, 2001; Scarbrough *et al.*, 1998).

3.3.2.4.1 Frequency of Meetings between the Audit Committee and the Chief Internal Auditor

Many studies (Goodwin & Yeo, 2001; Scarbrough *et al.*, 1998; Treadway Commission, 1987; Verschoor, 1992) have shown that when the audit committee and chief internal

auditors hold regular meetings, there is potential for improvement in the activities of the internal audit. Raghunandan *et al.* (2001) also stated that both the audit committee and the IA function can benefit from regular meetings, as this allows an exchange of relevant information. As a result of frequent meetings, the audit committee will remain informed and knowledgeable, enabling it to assist the chief internal auditor to resolve any problems more efficiently.

Regular meetings give room for quick action to explore and carry out deep interaction concerning how to improve the financial reporting system of the organization. Recently, studies have pointed out the significance of frequent meetings by the audit committee. For example, Beasley *et al.* (2000) observed that audit committees of fraud firms do not meet regularly compared to audit committees of a non-fraud industry benchmark.

In addition, Previous research suggested that the IA role includes systems development and maintenance, reviewing operational efficiency and effectiveness including internal controls (Fadzil, Haron, & Jantan, 2005;Goodwin-Stewart & Kent, 2006; Ho & Hutchinson, 2010), fraud investigations and special projects (Beasley et al., 2000) and assessing compliance with company policies, procedures and statutory requirements (Fadzil et al., 2005).

Moreover, Prior studies (Goodwin, 2003; Raghunandan et al., 2001; Scarbrough et al., 1998) have investigated the effect of audit committee independence on audit committee interactions with the internal audit (AC meetings with IAs). However, to the best of the researcher's knowledge, this is the first study that examines these associations on firm performance.

Therefore, it is believed that when the audit committee has regular meetings with the chief internal auditor, there is a likelihood of an improvement in the efficiency of the internal audit function with the consequence of improved firm performance.

3.3.2.4.2 The Extent of Audit Committee Reviews of IA Programs and Plans

Another major responsibility of audit committees is to review the IA programs and plans and ensure that the scope of the program and the resources allocated toward such programs including the annual budget are acceptable (BRC. 1999). Such reviews of IA programs and plans of IA activities are able to affect the efficiency of the IA function, as audit committee members have the opportunity to check whether the scope of IA activities is wide enough to cover the organizational activities that are exposed to high risk.

The audit committee can also review whether the planned scope of IA activities is comprehensive and appropriate to the organization's needs (Kolins, Cangenii, & Tomasko, 1991). Additionally, audit committees can also ensure that communications between the internal and external auditors are well coordinated so that better quality discussions can take place.

Finally, audit committees may also identify weaknesses in the IA plans, and offer suggestions to improve those plans; including improving budgetary provisions and ensuring that the objectives of the IA plans and budgets are met (Mat Zain, Subramaniam, & Stewart, 2006).

As revealed by Gendron *et al.* (2004) on audit committee activities, audit committee members actively review the programs plans and results of IA activities in terms of the accuracy of financial statements, effectiveness of internal controls, and the coordination of work between external and internal auditors. Their results suggest that a key aspect of the work carried out by audit committee members consists of making the attendees in meetings feel comfortable, asking challenging questions and assessing responses provided by managers and auditors.

Most previous studies (Goodwin, 2003; Raghunandan et al., 2001; Scarbrough et al., 1998) investigated the effect of audit committee independence on audit committee interactions with the internal audit (the extent of AC reviews of IA proposals). To the best of the researcher's knowledge, there is no study that has examined these associations on firm performance.

3.3.2.4.3 The Extent of Audit Committee Reviews of the Result of IA Activities

The audit committee also has a responsibility to review the results and outcomes of the IA program and activities. Upon completion of the IA activities and program, the findings of such reviews should be reported to the audit committee who are then expected to monitor the outcomes of the findings and recommendations made by IA (Braiotta, 1999). For instance, the audit committee should be able to identify whether management acted on the recommendations of IA, and, if not, the reasons for non-compliance is required and whether the IA function can further assist management in such instances. In doing so, the

audit committee can also demonstrate support for the IA's position by ensuring management respond to the needs and recommendations of the IA review.

Clearly, audit committees that are more aware and attentive to the needs of the IA function are more likely to promote IA effectiveness. This means that the closer and more intensive the interaction between the audit committee and the IA, the higher the likelihood that the IA can operate efficiently. A study by Allison (1994) showed that one of the audit committee's major responsibilities is to make certain that the internal auditor has support, not only from the audit committee, but from the whole organization.

Undoubtedly, the IA function that receives strong support and regular feedback from the audit committee is more likely to be more objective and forceful in implementing control improvements. Accordingly, such audit committees will contribute more towards enhancing IA effectiveness. Consequently, an effective IA function is more likely to result in better firm performance.

A study by Mat Zain and Subramaniam (2007) is one of the few studies (Gendron & Bedard, 2006; Turley & Zaman, 2007) that looked at the interaction between the IA and audit committee from a qualitative perspective. This study adopts a qualitative research approach using interview data from 11 head of internal audit functions in large publicly-listed companies in Malaysia. This study investigated the perceptions of internal auditors concerning their interactions with ACs and found that ACs are viewed as an essential and invaluable support to the IAF.

In addition, Prior studies (Goodwin, 2003; Raghunandan et al., 2001; Scarbrough et al., 1998) have investigated the effect of audit committee independence on the extent of AC reviews of the result of IAs. However, the researcher has not been able to find any study that has examined these associations on firm performance.

3.4Theoretical Framework

There are several, often competing but sometimes complementary, theories with regard to internal corporate governance such as agency theory, stakeholder theory, stewardship theory, resource dependence theory and institutional theory. However, this study used both agency theory and institutional theoryin examining the relationship between internal corporate governance (board of directors and audit committee) and firm performance.

The agency view (e.g., Fama & Jensen, 1983; Jensen & Meckling, 1976) holds that the board and audit committee are in place to monitor management, who otherwise may act in their personal best interest and not in the interests of the principal (e.g., shareholders). Thus, the board and audit committee's independent members monitor management to prevent opportunistic behavior by management. This perspective is the predominant view of the role of corporate governance in the academic accounting literature.

The board of directors as an entity holds the responsibility for the entity. It is considered to be an essential role in corporate governance and should be run in such a way as to meet the shareholders' interest. As a result of separating corporate management from ownership, the central role played by board is to protect shareholders' interest. Agency theory posits that

shareholders be safeguard for the fact that management (agents) may deviate from acting towards the interest of the (the principal) corporation's owners (Fama, 1980; Fama and Jensen, 1983; Jensen & Meckling, 1976). To minimize agency costs, the board takes up the oversight roles of monitoring the CEO and other top executives, approving the corporation's strategy, and monitoring the control system.

Fama and Jensen (1983) also argued that the board of directors is needed to minimize agency cost and maximize shareholder interests. Enhancement in board of director, in term of board size, board composition and leadership structure, could improve board effectiveness and its capacity to monitor the management (De Andres *et al.*, 2005; Abdullah, 2004). Theoretically, boards of directors' characteristics are argued to play a role in influencing firm's financial performance (Fama & Jensen, 1983; Coles *et al.*, 2001; Weir *et al.*,2002).

In addition, the board is expected to keep proper accounting records, and to make sure of accuracy in the preparation of financial report of the entity while audit of the annual financial report is mandatory for publicly listed companies. Due to its many roles, the audit committee acts as board's delegate to perform its financial and oversight function. An audit committee has been described as a sub-committee consisting of largely non-executive directors who take up the role of dealing with matters relating to audit, financial reporting and internal control (Spira, 1999). As a mechanism of corporate governance, audit committees can make financial reporting process to be credible given the fact that it can monitor and facilitate communication between management, external auditors and internal auditors (Bradbury, 1990; DeZoort, 1997).

In the same way, the existence of audit committees should have direct effects on reporting quality through the benefits of oversight functions performed by the committee. Although a sub-board committee, the audit committee appears to have emerged as the main committee with the remit on ensuring accountability and integrity in the reporting functions of the organisations. It is to be composed mainly of independent non-executive so that it would be able to bring an unbiased and independent judgement to bear on the activities of the organisation towards protecting the interest of the shareholders. This should ordinarily translate to improvement in reporting quality which is required in order to reduce agency costs.

In contrast to agency theory,an institutional theory implies that companies might adopt practices orregulations as a result of coercion from a legislator who imposes some practices by force inorder to improve organizational effectiveness. On the other hand, companies mayaccommodate themselves on similar organizations in their field whichthey perceive to bemore legitimate or successful (DiMaggio & Powell, 1983). However, there is no predictionthat the adoption of these regulations will improve organizational effectiveness. According to the institutional theory view, board of directors and auditcommittee activities may be only loosely coupled with claims of audit committeeeffectiveness, such that the formal audit committee activities are primarilyceremonial/ritualistic and designed to create legitimacy outside the organization.

The independent variables of this study are board of directors, audit committee characteristics and audit committee's interactions with internal auditor (IA). The board of directors variables are composition, CEO duality, size, shareholdings (at the level of the board) and shareholdings by board chairman. The audit committee variables are independence, meetings, shareholdings, audit committee meetings with internal auditors, the extent of audit committee reviews of IA programs and plans and the extent of audit committee reviews of the result of IA activities. The firm performance is the dependent variable and two measurements, namely ROA and TQ, are considered in this study as proxies for accounting return and market return respectively.Figure 3.1 below shows the research framework of the study.

Independent Variables

Dependent Variable

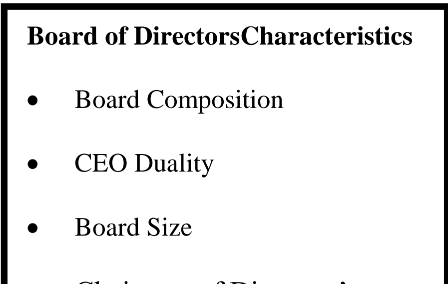

Figure 3.1
Research Framework

3.5 Hypotheses Development

The study integrates both agency theory and institutional theory in developing the hypotheses for the purpose of examining the effect of internal corporate governance mechanisms on firm performance. Agency theory anticipates that boards will enhance firm performance through monitoring management. On the other hand, institutional theory views these mechanisms as practices or regulations as a result of coercion from legislators who impose certain practices in order to improve organizational effectiveness or as result of imitation. In the hypotheses development, the directions of the hypotheses are determined based on empirical evidence from previous studies and the Code of Corporate Governance (2006) in Saudi Arabia.

3.5.1 Board of Directors Characteristics

3.5.1.1 Board Composition

The primary function of the board is to protect the shareholders (Fama & Jensen, 1983) and in order to protect the shareholders, boards composed of majority of non-executive directors are considered desirable by the agency theory. According to Jensen and Meckling (1976), boards dominated by outsiders or NEDs may help to mitigate the agency problem by monitoring and controlling the opportunistic behavior of management. Baysinger and Butler (1985) argued that outside directors provide superior performance benefits to the firm as a result of their independence from firm management which is an important characteristic of board that determines its effectiveness in monitoring management. The

number of non-executive directors on the board is also important as their views carry significant weight on the board's decision-making (Cadbury, 1992).

The results of previous studies that investigated the relationship between board composition and firm performance are inconsistent. Dehaena *et al.* (2001), Omar (2003) and Rhoades*et al.* (2000) found that NED has a positive relationship with financial performance. Similarly, Krivogorsky (2006), Lefort and Urzúa (2008) and Limpaphayom and Connelly (2006)also found positive relationship between board composition (the proportion of independent directors on the board) and firm performance.

On the other hand, Coles *et al.* (2001) demonstrated that there is a negative impact of outside directors on firm performance. Erickson *et al.* (2005) also found a negative relationship between greater board independence and firm value. However, Bhagat and Black (2002) and De Andres *et al.* (2005) found no significant relationship between the composition of the board and the value of the firm.

However, best practice recommendations on corporate governance require boards to be composed of a majority of non-executive directors (ASX Corporate Governance Council 2003; Cadbury 1992; OECD 2004). The Saudi Arabia Code on Corporate Governance (2006) was also incorporated with these recommendations as board composition is considered an important component of board structure in increasing firm performancewhich requires directors to be majority non-executive directors.This situation is furtherenhanced by the requirement of the Saudi code to set up audit

committees consisting all of non-executivedirectors and executiveboard members are not eligible for audit committee membership.

In addition, as a result of outside directors' expertise, prestige and contacts, they are likely to enhance how monitoring is being managed and render help in personnel matters by providing additional links to the external environment. Moreover, non-executive directors might have a positive relationship with firm performance as they commonly have interests directly or indirectly in the companies through shareholdings and poor performance would directly affect them. Thus, it is expected that non-executive directors would lead to better firm performance than executive directors.

Based on the above discussions and in light of the agency theory, the following hypotheses can be empirically tested.

> *H1: There is a positive relationship between the proportion of non-executive directors and firm performance.*
>
> *H1a: There is a positive relationship between the proportion of non-executive directors and ROA.*
>
> *H1b: There is a positive relationship between the proportion of non-executive directors and Tobin's Q.*

3.5.1.2 CEO Duality

A study of Jensen and Meckling (1976) argued that when an individual is holding two top positions, there is a tendency on the path of such individual to adopt personal interests' strategies that could be detrimental to the firm as a whole.

Sharing the same thought, Mallette (1992) argued that in the combined roles, the chairman of the board has to make decisions potentially leading to the conflict of interest. Moreover, in the combined roles, the CEO can set the board's agenda and influence (if not control) the selection of directors for the board. He concluded in his paper that CEO duality can challenge a board's ability to monitor executives.

According to Rechner and Dalton (1991), the separation between the CEO and chairman lead to facilitate more effective monitoring and control of the CEO. Moreover, they argued that firms that fail to do so may have a lower performance than those which split the two top positions. These views have been supported by Jensen (1993) who argued that separating the CEO and chairman positions is important to ensure the board's effectiveness which lead to increase the firm value.

Empirical analyses of the impact of duality on various corporate performance measures have yielded conflicting results. Ahmadu *et al.* (2005), Bhagt andBolton (2008), Coles *et al.* (2001), Feng, Ghoshandand Sirmans (2005), Judge, Naoumova and Koutzevol (2003), Kyereboah - Colemn and Biekpe (2005) andMustafa (2006)found a negatively significant relationship between CEO duality and firm performance. In contrast, Carapeto, Lasfer

andMachera (2005),Schmid and Zimmermann (2007) and Wan and Ong (2005) found no significant difference in the performance of companies with or without role duality.

However, in the Saudi Arabia context, role duality is not common among listed companies because the Cod of Saudi Arabia (2006) requires the separation of the position of CEO and chairmanto ensure proper checks and balances on the top leadership of the company. In addition, combining the positions of CEO and chairman weakens board control and affects board performance negatively (Boyd, 1995). Furthermore, when the CEO is also the chair, the board's effectiveness in performing its governing function will be at stake and the CEO will be able to control board meetings, the selection of agenda items, as well as the selection of board members.

Thus, it is reasonable to test the following hypotheses:

H2: There is a negative relationship between the CEO duality and firm performance.

H2a: There is a negative relationship between the CEO duality and ROA.

H2b: There is a negative relationship between the CEO duality and Tobin's Q.

3.5.1.3 Board Size

The inherent assumption is that a minimum certain number of board membersis required to get the necessary intellect on the board, but if the number crosses the optimummark, various problems relating to coordination and group dynamics come into play, adverselyaffecting firm performance (Chauhan & Day, 2009).Jensen (1993) confirmed

that small board size is more correlated with the quality of monitoring.Lipton and Lorsch (1992) also stated that board might become less effective at monitoring management when its size increases. They recommended that board membership should be between eight and nine persons, and any additional benefits that can be gained from the increased monitoring by additional membership will offset the costs linked with slow decision making.

Many studies (Ahmadu *et al.*, 2005; Chan& Li, 2008; De Andres *et al.*, 2005;Kota & Tomar, 2010; Mustafa, 2006; Noor Afza &Ahmad, 2009; O`Connell & Cramer, 2010)provideempirical evidence which supports the view of the agency theory that a negative relationship exists between boardsize and firm performance. In contrast, Beiner *et al.* (2004), Bhagat and Black (2002) and Limpaphayom and Connelly (2006) found no significant association between board size and firm performance.

The Corporate Governance Code of Saudi Arabia (2006) does not issue any comments on board size.Althougha small boardmay lack the diversity of a large board that would helpcompanies to secure critical resources and contacts (Pearce and Zahra, 1992), a large board cannottake advantage of the cohesivenessand be easy to coordinate. A small board maybe seen to be more effective to improve performance and to limit directors' incentivesto shirk, as the role performance of each member is easier to monitor and decisions canbe made more quickly(Haniffa and Hudaib, 2006).

To re-examine this relationship, the following hypotheses are proposed for empirical testing:

H3: There is a negative association between board size and firm performance.

H_{3a}: There is a negative association between board size and ROA.

H_{3b}: There is a negative association between board size and Tobin's Q.

3.5.1.4 Chairman of Directors' Shareholdings

Fama and Jensen (1983) and Morck *et al.* (1988) asserted that when corporate insiders own low levels of firm equity, they have higher incentives to keep their strategies in line with the preferences of other owners since their bonding to the firm's outcome is high.Managerial shareholdings help align the interests of shareholders and managers since as the company's performance increases, the managers benefit via their equity interests in the company (Jensen & Meckling, 1976). Therefore, managerial ownership is argued to be inversely related to agency conflicts between managers and shareholders, and to be positively related to corporate performance.However, as ownership by corporate insiders reaches a certain point, they would allocate firm resources for their own interest regardless of the effects on outside shareholders (McConnell, 1995).

Studies that investigate the relationship between managerial stock ownership and firm performance show contradicting results. Omar (2003) found that the relationship between shares ownership by board of directors and firm performance is insignificant.Krivogorsy (2006) found that there is no strong relation between the portion of inside directors or level of managerial ownership and profitability in European companies. Zubaidah*et al.* (2009) also showed that the effect of board of directors' ownership on firm performance that measured by value-added efficiency is not established.

However, Haniffa and Hudaib (2006), McConnell and Servaes (1990) and Steiner (1996) argued that shares ownership by board of directors is significantly associated with both market and accounting performance measures. In the study of Hermalin and Weisbach (1991), Tobin's Q was found to be positively related to management ownership up to a stake of 1 percent; for the ownership between 1to5 percent, they found a negative relationship; at the range of ownership from 5 to 20 percent, the relationship become positive again; and for ownership beyond 20 percent it finally turn negative. In their study, Griffith (1999) and Short and Keasey (1999) showed a non-linear association of directors' shareholdings with firm performance.

As discussed above, most prior researches have only examined the impact of shares ownership on various contexts at the board level. To the researcher's knowledge, there is no study that has examined the association between shares ownership at the individual level (the chairman of the board) and firm performance.

Studies on decision making have shown that group leaders and experts may not have appropriate influence on decisions of the groups. For instance, Libby, Trotman,and Zimmer (1987) showed that a group member who has perceived expertise has influential position in decision settings of a group. Daniels, Eadie, McLean, and Ranson(2005) also asserted that anecdotal evidence that group decision may be subjected to free rider effects abound.

A study by Ogbechie*et al.*(2009) suggested that chairman should be having a command on all the executive and non-executive directors. Further, Jensen (1993) indicated that the function of the chairman is to run board meetings and oversee the process of hiring, firing,

evaluating, and compensating the CEO. Minimum rights should be given to the independent chairman to initiate board appointments, board committee assignments, and (jointly with the CEO) the setting of the board’s agenda.

Another study by Baydoun (1999) found that there is a significant relationship between personal ownership (cross-chairmanship) and auditor selection in Hong Kong companies. He also showed that the composition of the board does not appear to be significant at the entire board level but it is more significant at the executive director level (the chairman). Therefore,it is possible that shares owned by chairman affects governance effectiveness differently when compared with shares owned by the remaining members.

Thus, it is reasonable to test the following hypotheses:

> H_4: *There is a positive relationship between chairman's’ shareholdings and firm performance.*
>
> H_{4a}: *There is a positive relationship between chairman's’ shareholdings and ROA.*
>
> H_{4b}: *There is a positive relationship between chairman's’ shareholdings and Tobin’s Q.*

3.5.2 Audit Committee characteristics

3.5.2.1 Audit Committee Independence

The independent audit committees monitor managers better because they have no economic or personal relationship with management (Hsu, 2007). In addition, they are decision experts and good at decision control (Abbott *et al.*, 2004; Beasley, 1996).The independence of audit committees allows internal and external auditors to audit and assess financial information more objectively, and thereby strengthens internal control function. Thus, audit committee independence can reduce financial fraud (Abbott *et al.*, 2004).

The empirical result on the relationship between audit committee independence and firm performance is ambiguous. Chan and Li (2008)found that independence of audit committee (i.e., to have at least 50 per cent of expert-independent directors serve on audit committee) positively impacts the firm performance as measured by (Tobin's Q). Similarly, Ilona, (2008) show that there is a positive relationship between audit committee independence and firm performance as measured by ROA. Moreover, Erickson *et al.* (2005)asserted that independent directors can reduce agency problems. Based on the argument provided by Erickson *et al.* (2005) that directors' independence can reduce agency problem, it can similarly argued that independent audit committee can also reduce the agency problems. In other words, a positive relationship between audit committee independence and firm performance is expected and justified.

Based on above discussion and in the light of the agency theory, the following hypotheses can be empirically tested.

H_5: There is a positive relationship between the independence of the audit committee members and firm performance.

H_{5a}: There is a positive relationship between the independence of the audit committee members and ROA.

H_{5b}: There is a positive relationship between the independence of the audit committee members and Tobin's Q.

3.5.2.2 Audit Committee Meetings

The number of audit committee meetings is considered to be an important attribute for their monitoring effectiveness (Lin *et al.*, 2006).Anderson*et al.* (2004) noted that audit committee monitors theinternal control and provides reliable information to the shareholders. Therefore, audit committee strengthens the internal auditing function and oversees management's assessment ofbusiness risk (Hsu, 2007).

The number of audit committee meetings is considered as a proxy for audit committee activity (Xie*et al.*, 2003). Therefore, the audit committeethat meets more frequently with the internal auditors is better informed about auditing and accounting issues. When an important auditing or accounting issue arises, the audit committee can direct the proper level of internal audit function to address the problem promptly.

Therefore, an audit committee that meets frequently can reduce the possibility of financial fraud (Abbott*et al.*, 2004; Raghunandan, Rama, & Scarbrough, 1998). Inactive audit committees with fewer numbers of meetings are unlikely to supervise management

effectively (Menon & Williams, 1994). Beasley *et al.* (2000) found that fraudulent firms with earning misstatements have fewer audit committee meetings than non-fraud firms. Active audit committee with more meetings has more time to oversee financial reporting process, identify management risk and monitor internal controls. As a result, firm performance increases with audit committee meetings.

More importantly, there have been very few studies that examined the effect of audit committee meeting on firm performance. For example, Hsu (2007) found that there is a positive relationship between audit committee meetings and firm performance.

To re-examine this relationship, the following hypotheses are proposed for empirical testing:

> H_6: *There is a positive relationship between the frequencies of audit committee meeting and firm performance.*
>
> H_{6a}: *There is a positive relationship between the frequencies of audit committee meeting and ROA.*
>
> H_{6b}: *There is a positive relationship between the frequencies of audit committee meeting and Tobin's Q.*

3.5.2. 3 Audit Committee Shareholdings

In the context of audit committee, the possession of higher equity ownership by committee members has the likelihood of lessening the problem associated with the collusion of directors with the management to manipulate earnings to their interest or inflate executive

pay which in turn is likely to eventually hinder their interests as well. On the other hand, there is an increasing concern that audit committees' shareholdings may result in a weakening of their idependence (Millstein, 2002).

This view is supported by the findings of several studies. For example, Mangena and Pike (2005) found a negative association between the proportion of stockholding by audit committee members and interim financial disclosure. In relation to that, a study by Yang and Krishnan (2005) found that stock ownership by both independent and non-independent directors on audit committee is associated with higher levels of quarterly earnings management. From another perspective, Vafeas (2005) argued that higher stock ownership by committee members motivates them to monitor the financial reporting process more effectively and therefore enhances earnings quality. However, Lin *et al.* (2006) did not find a significant relation between stockholdings by audit committee members and the occurrence of earnings restatements.

As discussed earlier, there have been inconsistent findings regarding the effect of audit committee shareholdings on different contexts such as quarterly earnings management, occurrence of earnings restatements and earnings quality. This study aims to investigate the effect of the audit committee shareholdings on firm performance by introducing the following hypotheses:

> *H_7: There is a positive relationship between audit committees' shareholdings and firm performance.*
>
> *H_{7a}: There is a positive relationship between audit committees' shareholdings and ROA.*

H_{7b}: There is a positive relationship between audit committees' shareholdings and Tobin's Q.

3.5.2.4 Frequency of Meetings between the Audit Committee and the Chief Internal Auditor (CAE)

It is believed that when the audit committee has regular meetings with the chief internal auditor, there is a likelihood of an improvement in the efficiency of the internal audit function with the consequence of improved firm performance. Therefore, the aim of this study is to examine the effect of this association on firm performance.

The BRC Report (1999), the Treadway Commission (1987) and the Toronto Stock Exchange Committee on Corporate Governance (TSECCG,1994) reported that there should be direct communication channels between theaudit committee andinternal auditing to appropriately examine and review specific issues.

Meetings between the audit committee and internal auditing on a regular basis provide the audit committee more information and knowledge concerning essential issues relating to accounting and auditing (Mat Zain, 2005). As suggested by the Institute of Internal Auditors (IIA, 2011), it serves as a benchmark for the audit committee to hold meetings with the chief internal auditor more than four times in a year for it to be effective. This view was supported by the findings of Mat Zain (2005). In her study, she found that there is a significant positive relationship between the frequency of meetings between the audit committee and internal auditors and financial statement audit.

Prior studies (Goodwin, 2003; Raghunandan *et al.*, 2001; Scarbrough *et al.*, 1998) investigated the effect of audit committee independence on audit committee interactions with the internal audit (AC meetings with IAs).

Thus, it is reasonable to test the following hypotheses:

> *H_8: There is a positive relationship between the frequency of meetings between the audit committee and internal auditor and firm performance.*
>
> *H_{8a}: There is a positive relationship between the frequency of meetings between the audit committee and the internal auditor and ROA.*
>
> *H_{8b}: There is a positive relationship between the frequency of meetings between the audit committee and the internal auditor and Tobin's Q.*

3.5.2.5 The Extent of Audit Committee Reviews of the Internal Auditor's (IA) Proposals

Another major responsibility of audit committees is to review the IA programs and plans and ensure that the scope of the program and the resources allocated to such programs are includedin an acceptable annual budget (BRC, 1999).The audit committee has the role of making sure that management designs and executes the internal control system effectively. To fulfill this responsibility, the audit committee must review the internal audit program and ensure that its scope is adequate. The BRC Report (1999), the Treadway Commission (1987) and the TSECCG (1994) also noted the audit committee's oversight responsibility to ensure that an effective internal control system is designed and implemented within the company. This requires that the audit committee should review the internal audit proposals

relating to the program, plans, and coordination with external auditors to ensure that its scope is adequate.

The Saudi Arabia Corporate Governance Code (SCGC, 2006) also reported that the oversight role of the audit committee is to go through the procedure of the internal audit and make a necessary report and recommendations in respect of the audit.

A study by Mat Zain (2005) predicted that the greater the extent to which the audit committee reviews the IA plans/programs, budget and IA relationship with external auditors, the greater the expected IA contribution to the financial statement audit. Contrary to expectations, this relationship is found to be non-significant. However, she stated that this difference may be due to the fact that the measurement for this variable is not sensitive enough to capture the appropriate result.

Another study by Gendron *et al.* (2004) stated that audit committees become active when they review the programs plans and results of IA activities in terms of the accuracy of financial statements, effectiveness of internal controls, and the coordination of work between external and internal auditors. Audit committees may also identify weaknesses in the IA plans, and offer suggestions to improve those plans; including improving budgetary provisions and ensuring that the objectives of the IA plans and budgets are met (Mat Zain, 2005).

Most previous studies (Goodwin, 2003; Raghunandan *et al.*, 2001; Scarbrough *et al.*, 1998) investigated the effect of audit committee independence on audit committee interactions

with the internal audit (the extent of AC reviews of IA proposals). Therefore, it can be argued that the greaterthe extent to which audit committee reviews IA plans/programs the morelikely it is to enhance the efficiency of the IA function, and, consequently, improve firm performance.

Accordingly, one of the main objectives of this study is to empirically test the following hypothesized relationship:

> *H_9: There is a positive relationship between the extent of the AC review of the IA proposals and firm performance.*
>
> *H_{9a}: There is a positive relationship between the extent of the AC review of the IA proposals and ROA.*
>
> *H_{9b}: There is a positive relationship between the extent of the AC review of the IA proposals and Tobin's Q.*

3.5.2.6 The Extent of the Review of the Audit Committee of the Results of the IA Activities

The audit committee also has a responsibility to review the results and outcomes of the IA program and activities. Upon completion of the IA activities and program, the findings of such reviews should be reported to the audit committee who are then expected to monitor the outcomes of the findings and recommendations made by the IA (Braiotta, 1999).

Several private sector and regulatory authorities have recommended that the audit committee should always go through the results of financial reporting and internal controls as presented by the internal audits. This is in accordance with the reports of the BRC

(1999), the Treadway Commission (1987) and the TSECCG (1994) in respect of the audit committee's oversight responsibility. In this case, the audit committee assesses the results of the internal audit relating to financial reporting, internal controls and compliance with laws and regulations.

Additionally, the Canadian Securities Administrators Notice (1992) chargedthe audit committee to "review the reports issued by the internal auditor and management's response and subsequent follow-up to any identified weaknesses." The SCGC (2006) also notedthat the audit committee's oversight responsibility is to review the report of the internal audit and see that correct measures are executed in respect of the issues concerning their roles.

Contrary to the prediction of Mat Zain (2005), the results of her study found a negative relationship between audit committee reviews related to financial reporting, internal control and compliance with law and regulation and IA contribution to the financial statement audit. However, she showed that this finding may relate to a lack of sensitivity in the variable measurements.

Based on the aboveargument and other supporting ones, the following hypotheses areproposed to be examined:

> *H_{10}: There is a positive relationship between the extent of the AC review of the results of the internal audit activities and firm performance.*
>
> *H_{10a}: There is a positive relationship between the extent of the AC review of the results of the internal audit activities and ROA.*

H_{10b}: There is a positive relationship between the extent of the AC review of the results of the internal audit activities and Tobin's Q.

3.6 Chapter Summary

This chapter aimed to provide a discussion of the overview of underpinning theories (agency theory and institutional theory). Also in this chapter, literature review in relation to internal corporate governance and firm performance was presented. The following chapter addresses the research framework, methodology adopted in this research and the methods of collecting the primary and secondary data.

Table 3.1
Summary of Previous Research on Board of Directors, Audit Committee and Firm Performance

Author	Location and Sample Used	Independent Variable	Dependent Variable	Result
Vafeas (1999)	UK, 307 firms over the 1990-1994 periods.	Board meetings, measured by the frequency of board meetings.	ROA	Direct evidence on the association between board meeting frequency and market value suggests that boards that meet more frequently are valued less by the market.
Omar (2003)	Malaysia, 202 blockholding companies listed on the Kuala Lumpur Stock Exchange (KLSE)	Board size, number of Non-Executive Directors, Director, ownership and duality.	ROA& ROE	The findings show that except the board size, other variables are mostly insignificant.
Abdullah (2004)	Malaysia, all companies listed on Bursa Malaysia.	Board composition and CEO	ROA, ROE, EPS & profit margin	The results show that board independence and CEO duality did not have any relation to firm performance.
Chen *et al.* (2005)	Korea, 412 publicly listed firms in Hong Kong from 1995-1998.	CEO duality, composition of board and audit committee.	ROA, ROE & market to book ratio	Their results indicate that there is a negative relationship between CEO duality and performance (the market to book ratio). The relationship was significant even after controlling for industry and firm fixed effects.
Kyereboh Coleman and Biekpe (2005)	Ghana 16 listed non-financial firms on the Ghana Stock Exchange.	Board size board composition and CEO duality.	Tobin's Q, ROA & SGR	The study found that board size is positively related to Tobin's Q and ROA, but negatively related to sales growth rate. However, it was found that board the composition and CEO duality have a negative impact on firms' performance in Ghana.

Table 3.1 (Continued)

Author	Location and Sample Used	Independent Variable	Dependent Variable	Result
Ahmadu *et al.* (2005)	Nigerian 93 firms listed in Nigerian stock exchange.	Board size, CEO duality, Outside directors and Ownership concentration.	ROA, ROE, PE, & Tobin Q	Positive effect of large shareholdings on financial performance Significant negative effect CEO duality on financial performance. Their results support the need to maintain a board size of ten persons.
De Andres *et al.* (2005)	USA 450 Non-financial firms from ten countries in Western Europe and North America.	Board size and board composition.	ROE	It was found that (1) there is a negative relationship between firm value and board size (2) no significant relationship between the composition of the board and the value of the firm.
Krivogorsy (2006)	USA 87 companies from nine European countries (foreign U.S. registrants).	Board composition and ownership Concentration.	ROE, ROA& MTB	Strong positive relation between the level of relational-investors ownership (%INST) and profitability ratios, as well as a strong, positive relation between the portion of independent directors on the board and profitability ratios, but no strong relation between the portion of inside directors or level of managerial ownership and profitability in European companies.
Mustafa (2006)	Egypt 85 non-financial Egyptian firms.	Board size, CEO duality and Large shareholders.	ROA, Tobin's Q & M/B	Positive effect of large shareholdings on financial performance however, significant negative effect of board size and CEO duality on financial performance.

Table 3.1 (Continued)

Author	Location and Sample Used	Independent Variable	Dependent Variable	Result
Limpaphaym and Connelly(2006)	Thailand, 24 life insurance firms operating in Thailand.	Board size and board composition.	ROA, ROE and ROI	Board composition has a positive relation to profitability and a negative relation with the risk-taking behavior of life insurance firms. Board size does not have any relation with firm performance.
Haniffa and Hudaib (2006)	Malaysia, 347 companies listed on the Kuala Lumpur Stock Exchange (KLSE)	Board size, directors' shareholdings, board composition	Tobin's Q & ROA	Board size and ownership significantly associated with both market and accounting performance measures.
Hsu (2007)	USA, 226 new U.S. firms.	Board quality, audit committee independence, audit committee financial expertise and audit committee activity	ROA & Tobin's Q	The study found that there is no association between audit committee independence and firm performance. Firm performance increases with audit committee financial expertise. However there is no evidence that there is appositive relationship between audit committee activity and firm performance.
Ilona (2008)	Indonesia, 133companies listed on Bursa Indonesia.	Board quality, board shareholding, board independence, audit committee independence & audit committee financial expertise.	ROA	The results show that only board independence is significantly negative associated with the firm performance.

Table 3.1 (Continued)

Author	Location and Sample Used	Independent Variable	Dependent Variable	Result
Chan and Li (2008)	Fortune 200 companies	Independence of audit Committee, independence of board, board Size and audit committee size.	Tobin's Q	The results indicate that independence of audit committee (i.e., to have at least 50 per cent of expert-independent directors serve on audit committee) positively impacts on firm value. However audit Committee Size and Board Size are both significantly negatively correlated with firm value.
Zubaidah *et al.* (2009)	Malaysia, 75 companies listed on Bursa Malaysia.	Board composition, directors' ownership, CEO duality and board size.	Value-Added efficiency	Boardcomposition and board size have a positive impact on firm performance, while the effects of directors' ownership andCEO duality on the VA efficiency of firm's total resources are not established
Albeera (2009)	Malaysia, 51 companies listed on Bursa Malaysia	Board size, board independence, CEO duality and audit committee size	ROA & OCF	Audit committee size was positively related to ROA, while the proportion of independent directors is negatively related to ROA. The relationship with OCF indicates that board size and audit committee size are positively related.

Table 3.1 (Continued)

Author	Location and Sample Used	Independent Variable	Dependent Variable	Result
Chauhanand Dey (2009)	India, 420 firms (categories of firms operating in the Indian markets)	Board Size and board Independence	accounting-based measures (PBIT), (PAT) and market-based measures (Tobin's Q)	The study foundthat the larger boards are less effective in Indian firms, board independence is insignificant across all categories of firmsin India
Kamardin (2009)	Malaysia, 520 companies listed on Bursa Malaysia.	Non- executive directors, board leadership, multiple directorships, managerial ownership, board meeting and board size.	ROA & Tobin's Q	The results show that non- executive directors, board leadership, multiple directorships and managerial ownership are significantly related to ROA. It was also found that board size, meeting, managerial ownership and managerial- family ownership are related to Tobin's Q.
Abdullah(2010)	Malaysia & Singapore, 30 industrial companies listed on the main stock exchanges in both Malaysia and Singapore.	Board size, CEO duality and audit committee size	ROA & OCF	The study found that board size is negatively related to OCF and ROA in Malaysia but positively related to ROA and OCF in Singapore. However, it was found that CEO duality has a negative impact on firms' performance in Malaysia and Singapore. Audit committee size has a positively impact on ROA and OCF in Malaysia.

Table 3.1 (Continued)

Author	Location and Sample Used	Independent Variable	Dependent Variable	Result
Elghewail(2010)	Malaysia, 137 companies from both construction sector and technology sector that are listed on Bursa Malaysia.	Multiple directorships, board independence, board meeting and director's financial expertise.	ROA	Multiple directorships, board meeting and director's financial expertise have no significant impact on ROA, while board independence has negative impact on ROA.
Kota and Tomar (2010)	India, 106 mid-sized companies from 2005 to 2007.	Non-executive independent directors, CEO duality, board size and audit committee independence.	Tobin-Q	The results revealed a positive significant relationship between CEO duality and firm performance. The study also found that a small board is more effective and enhances the value of the firm. However, the results showed that non-executive independent directors are failing in their monitoring role.
Yasser, Entebang and Mansor (2011)	Pakistan , 30 listed firms between 2008 and 2009.	board composition, board size, CEO duality and audit committee.	ROE& profit margin, PM	The results provided evidence of a positive significant relationship between ROE and PM and three corporate governance mechanisms (board composition, board size and audit committee).
Ibrahim and Abdul Samad (2011)	Malaysia, 290 companies from 1999 to 2005.	Board independent, Board size, CEO duality.	Tobin's Q, ROA & ROE.	The study found no significant relationship between the proportion of independent directors and performance based on Tobin's Q, and ROE. Board size found to be significantly negatively

Table 3.1 (Continued)

Author	Location and Sample Used	Independent Variable	Dependent Variable	Result
				related to Tobin's Q and ROE.
Abdurrouf (2011)	Bangladesh, 93 listed companies in Dhaka Stock Exchanges during the year 2006.	board independence, board size, CEO duality and audit committee.	ROA & ROE	The results provided evidence of a positive significant relationship between ROA and board independent director as well as CEO duality. The results also showed a positive significant relationship between ROE and board independent director as well as chief executive officer duality.

CHAPTER FOUR

RESEARCH METHODOLOGY

4.0 Introduction

This chapter describes the research method utilized to investigate the relationship between board of director's characteristics, audit committee effectiveness and firm performance. This chapter begins witha discussion of the theoretical framework. Next, the hypotheses were developed based on a comprehensive review of the previous relevant literature to be tested in the next chapter.Then, the research methodologyis discussed in detail. A summary of this chapter is provided in the last section of this chapter.

4.1Research Design

A combination of two research methods, namely, the archival and survey research methods, are used in the Saudi Arabian context because the nature of the required data to conduct this study on Saudi listed companies highlights the need of both primary and secondary data as the main data sources. A number of studies suggested that the use of multiple methods in social sciences is an important matter; for example, Rudestam and Newton (2000), and Hussey and Hussey (1997) suggested that it is a perfectly good choice to multi-method for collecting data. Likewise, Denzin (1978) highlighted that adopting various methodologies in the study of the same phenomenon is necessary if the conclusions are the same and leads to increased validity and reliability compared to using a single methodological approach.

The collection of primary data was accomplished through the use of an e-mail survey instrument and secondary data through the annual reports of the year 2010. The annual reports were used to collect the data regarding the board of directors, audit committee characteristics and firm performance variables while the e-mail survey instrument (questionnaire) was sent to the chief internal auditor (CAE) of Saudi listed companies to collect the data regarding the audit committee's interactions with the internal auditors.

4.2 Pre-Testing

Social science researchers emphasize the importance of conducting a pretesting to establish that the proposed questionnaire is theoretically and practically sound, understandable, and clear to the potential respondents. For example, Salant and Dillman (1994) argued that although pre-testing a questionnaire is time-consuming, it is absolutely essential to ensure a quality questionnaire. In addition, Alreck and Settle (1995) stated that even well trained and highly experienced researchers could find some changes that would improve the performance of the questionnaire by conducting a pretesting.

In conducting pretesting, the questionnaire items that are meant to measure audit committee review, internal audit of proposals, and audit committee review of internal audit results were first discussed with two expert academicians to ensure that the items reflected the variables as adopted from the literature. To confirm the findings from the practitioners' perspective, the items were also sent to fifteen Internal Auditors working in Saudi Arabia. The participants were asked to comment on the questionnaire in terms of

clarity and design. Some minor comments, feedback, and suggestions about the items were received in light of which some modifications were implemented and the questionnaire was accordingly finalized to be used for data collection.

4.3 Sample and Data Collection

4.3.1 Sample

This study focused on the listed companies in Saudi Arabiaat the end of the year 2010 andthe banks were excluded from the samplebecause ofthe differences in the regulatory requirements.The total number of companies in Saudi Stock Market (TADWAUL) was 146 companies at the end of the year 2010. The latest sample companies in Saudi Stock Market that provides information on corporate governance attributes after excluding bankswas 135 companies.These 135 companies were allocated to 14 industry sectors namely, Petrochemical Industries, Cement, Retail, Energy and Utilities, Agriculture and Food Industries, Telecommunication and Information Technology, Insurance, Multi-Investment, Industrial Investment, Building and Construction, Real Estate Development, Transport, Media and Publishing and Hotel and Tourism.

4.3.2 Data Collection

The data wasobtained from two sources namely, primary and secondary data. The Primary data was collected by using a questionnaire to the chief internal auditor (CIA) of the listed companies on Saudi Stock Market for the year 2010. Secondary data was collected from the annual reports of the listed companies on SSM for the years 2010. The annual reports of

the year 2010were chosen because they are the latest source of information available at the time the study was conducted.

4.4 Unit of Analysis

The unit of analysis in this study was the Saudi Public Listed Company.

4.5 Research Instrument

The main objective of the questionnaire in this study was to collect the data required to test the hypotheses H_8, $H_9$and H_{10} pertaining to audit committee's relation with internal auditors. The questionnaireswere sent to the directors of IA departments /chief internal auditors to gather their assessment of the extent of the audit committee's interactions. After requiring the respondents to provide general information about themself and their companies, the questionnaireswere concerned with assessing audit committee effectiveness. Appendix B shows an example of the questionnaire that was sent to the chief internal auditor of the Saudi listed companies.

All of the questions and items of the questionnaire were adapted from Mat Zain (2005) except the last item of the question (number seven) was selected from a questionnaire used by Raghunandan *et al.* (2001).Originally, the questionnaire was constructed in English. Because the general language of the target population is Arabic, the questionnaire had to be translated into their language as showed in Appendix C. The purpose of the Arabic version of the questionnaire is to permit for the respondents with little or no knowledge of English to participate in the survey (Al- Lehaidan, 2006).

4.6Operational definition and Measurement of the Variables

4.6.1 Dependent Variables

The firm performance is the dependent variable and two measurements, namely ROA and Tobin's Q ratio, were considered in this study as proxies for accounting measure and market measure respectively. Return on assets (ROA) is a traditional accounting measure and has been widely used in previous studies (e.g., Abdurrouf, 2011; Bhagt & Bolton, 2008; Haniffa & Hudaib, 2006; Ibrahim&Abdul Samad, 2011; Kamardin, 2009; Limpaphaym & Connelly, 2006; Mikkelson, Partch, & Shah, 1997). According to the study by Kamardin (2009), ROA is used in this study to reflect the efficiency of asset utilization by the company (board of directors) in enhancing the shareholders' wealth. ROA is calculated as a net income divided by total assets of the company (Abdullah, 2004; Hsu, 2007; Ilona, 2008; Krivogorsy, 2006; Lin & Jen, 2011; Noor Afza, 2010).

Tobin's Q ratio was used as the market performance measure because it provides anestimate of the intangible assets value such as the market power, goodwill,quality of the management, and growth opportunities (Perfect & Wiles,1994). Therefore, it is used widely in several different versions as a measureof performance in corporate governance empirical research as evidenced byChauhan and Dey (2009), Drobetz, Schillhofer, and Zimmerman (2004), Rashid (2013), Ibrahim and Abdul Samad (2011), Kamardin (2009), Kota and Tomar (2010), and Larcker, Richardson, and Tuna (2004). Due tothe limitation of the available data, this study calculates Tobin's Q as theresult of the market value of equity plus the book value of the debt dividedby the book value of the total assets, as calculated

by Aljifri and Moustafa (2007), Baek, Kang,and Park(2004), Bauer, Günster,and Otten (2004) and Weir *et al.* (2002).

4.6.2 Independent Variables

4.6.2.1 Board Composition

Board composition is the non-executive directors (NEDs) who does not have a full-time management position at the company, or who does not receive monthly or yearly salary (SCGC, 2006). Board Composition (BODCOM) was measured by the proportion of non-executive directors to total number of directors on the board. This variable has been tested in a number of previous studies (Haniffa & Hudaib, 2006; Kamardin, 2009; Omar, 2003; Zubaidah *et al.*, 2009).

4.6.2.2 CEO Duality

CEO duality (DUAL) means that the CEO is also the board chair. In order to test the relationship between CEO duality as independent variable and firm performance measured byROA and TQ as dependent variables, this study followed Bayrakdaroglu, Ersoy, and Citak (2012), Bhagt and Bolton (2008), Coles *et al.* (2001), Mustafa (2006) and Peng, Zhang,and Li (2007) who measured this variableby "0" representing no duality and "1" representing there is a duality.

4.6.2.3 Board Size

Board size (BSIZE) is the total number of directors on the board of each company sample. This will include outside directors, executive directors and non-executive directors.

Following Ahmadu *et al.* (2005),De Andres*et al.*(2005), Kumar and Singh(2013) and Mustafa (2006), this study measured the board size by determining the total number of directors available on the board.

4.6.2.4Chairman of Directors' Shareholdings

Chairman of Directors' shareholdings (COWN) was measured bythe number of shares owned by the Chairman of the board of directors divided by the total shares outstanding..This measure was used by Baydoun (1999).

4.6.2.5 Audit Committee Independence

The measurement of the variable audit committee independence (ACIND) wasbased on that used in previous studies such as Baxter (2007), Carcello and Neal (2000),Cotter and Silvester (2003), Klein (2002a) and Klein (2002b). ACIND was calculated as the proportion of independent directors on the audit committee to total number of directors on the audit committee.

4.6.2.6 Audit Committee Meetings

Audit committee meeting (ACMEET) was measured by the number of audit committee meetings held during the year 2010. Van der Zahn and Tower (2004) and Xie *et al.* (2003) also used the number of audit committee meetings as a measure of audit committee meetings.

4.6.2.7Audit Committees' Shareholdings

Audit committees' shareholdings (ACOWN) were measured by the number of shares owned by audit committee of the company divided by the total shares outstanding.Vafeas (2005) and Yang and Krishnan (2005) also used the proportion of shares owned by audit committee to total shares outstanding as a measure of audit committees' shareholdings.

4.6.2.8Audit Committee Meeting with the Chief Internal Auditor

Based on the previous literature (Goodwin, 2003; Mat Zain, 2005; Raghunandan *et al.*, 2001),audit committee meeting with the chief internal auditor (ACIAM) was measured by the number of meetings between the chief internal auditors with the audit committee members with absence of management during the year 2010.

4.6.2.9Audit Committee Reviews of IA proposals

For Audit Committee Reviews of IA proposals (ACREV1), three questions were asked separately regarding: 1) program/plans; 2) budget and 3) coordination with external auditors. According to (Goodwin, 2003; Mat Zain, 2005; Raghunandan *et al.*, 2001), this variable is measuredby "0" representing no review and "1" representing there is a review of IA proposal for each of the questions.

4.6.2.10Audit Committee Reviews of the Result of IA Activities

Audit committee reviews of the result of IA Activities (ACREV2) represent the extent to which audit committee reviews the results of IA, namely their reviews of: 1) financial

reports; 2) internal control; and 3) compliance with laws 'regulation 4) management responses to internal auditing findings. Based on the previous literature (Goodwin, 2003; Mat Zain, 2005; Raghunandan *et al.*, 2001) and SCGC (2006), four (4) separate questions were asked with the responses being dichotomous, with "0" representing no review and "1" representing audit committee reviews of the results of the IA activities in the following areas: (financial reporting, internal control, compliance with laws/regulation and management responses to internal auditing findings).

4.6.3 Control Variables

4.6.3.1 Firm Size

Generally, firm size has effects on the firm's performance. It is used widely as control variable in the empirical literature of corporate governance such as in Abdur Rouf (2011), Ahmadu *et al.* (2005), Aljifri and Mustafa (2007),De Andres *et al.*(2005), Ghosh and Sirmans (2005), Ibrahim and Abdul Samad(2011), Kota and Tomar (2010), Mustafa (2006), Nuryanah and Islam (2011),and Swamy (2011).However, firm size could have an unclear effect on firm performance. For example, larger firms could be less efficient than smaller firms, because it may encounter moreof the government bureaucracy, more redundancy and biggeragencyproblems (Lehn, Patro,& Zhao, 2003). However, as they are likely to use economies of scale, employ more skilled managers and market power, large firms may turn out to be more efficient (Kumar, 2004).

The use of firm size as a control variable in this study is motivated by the fact that it has been found to be associated with various firm characteristics. Lehn*et al.*(2003) argued

that firm size and growth opportunities are important determinants of the size and structure of boards. They found that board size is directly related to firm size and inversely related to proxies for growth opportunities, whereas insider representation is inversely related to firm size and directly related to proxies for growth opportunities. Coles *et al.* (2001) argued that when the firm is growing, it may seek more board members to help oversee performance of managers or need new directors who have specialized board services to monitor the new growth.

Size of a company can be measured in a number of ways. For example Ahmadu *et al.* (2005), De Andres *et al.* (2005), Ghosh and Sirmans (2005), Ibrahim and Abdul Samad (2011), Mustafa (2006), Nuryanah and Islam (2011)measured firm size by using the book value of the total company assets.

In line withPeng *et al.* (2007), this study measured firm size by using the natural logarithm of the total assets.

4.6.3.2 Leverage

Debt ratio is defined as the sum of long-term and short-term financial debt or the extent of liabilities as a percentage of total assets. It is argued that debt ratio has a varied effect on firm performance.

On the one hand, a positive effect may stem from reducing the free cash flows, exposing the firm more to monitoring by the market. According to Ahmadu *et al.* (2005), large creditors like large stakeholders, also have interest in seeing that markers take performance improving measures. In discussing agency theory, Jensen and Meckling (1976) argued that more highly leveraged companies incur higher monitoring costs, therefore as higher debts levels increase agency cost, managers could offer increased monitoring via more effective boards and its committees. Agency theory would predict that as the extent of leverage increases, the board's effectiveness increases. On the other hand, a negative effect of debt may be caused by either the bankruptcy cost or the debt agency cost (Jensen, 1986).

Leverage waswidely used as a control variable by a number of the empirical studies which examined the relationship between corporate governance and firm performance such as (Ahmadu *et al.*, 2005;Ibrahim and Abdul Samad, 2011; Kyereboah- Coleman & Biekpe, 2005; Nuryanah and Islam, 2011; Mustafa, 2006) and these studies found that the leverage has effect on firm financial performance. Following Alsaeed (2006), Ibrahim and Abdul Samad(2011), Karaca & Ekşi (2012), Nuryanah and Islam (2011),and Mustafa (2006), this study measured firm leverage by dividing the total of liabilities by the total of assets.

Unlike other studies in other contexts, companies in Saudi Arabia are considered to have been recently established and most of them have been in existence for two decades. It is, therefore, expected that the age will not made a big difference. This justifies not including the age as a control variable.

Table 4.1
Summary of Variables Measurement

Name of Variable	Acronym	Measurement
Dependent Variables		
Return on Assets	ROA	Net incomedivided by total assets of the company.
Tobin's Q ratio	TQ	Market value of equity plus the book value of the debt divided by the book value of total assets of the company.
Independent Variables		
Board composition	BODCOM	The proportion of non-executive directors to total number of directors on the board.
CEO duality	DUAL	Dummy variable, taking a value of 1 for firms with CEO as Chair, and 0 otherwise.
Board size	BSIZE	Total number of directors on the board.
Chairman of directors' shareholdings	COWN	The number of shares owned by the Chairman of the board of directors divided bythe total shares outstanding.
Audit committee independence	ACIND	The proportion of independent directors on the audit committee.
Audit committee meetings	ACMEET	The number of audit committee meetings held in the year 2010.
Audit committees' shareholdings	ACOWN	The number of shares owned by audit committee of the company divided bythe total shares outstanding.
Frequency of meetings between chief internal auditor and audit committee.	ACIAM	The number of meetings between the chief internal auditors with the AC members with absence of management in the year 2010.
Audit committee reviews of IA proposals.	ACREV1	Dummy variable (1 = Yes, 0 = No) to report if the AC reviews IA department's proposals related to: (1) programs and plans (2) budget (3) coordination with external auditors.
Audit committee reviews of the result of IA activities	ACREV2	Dummy variable (1 = Yes, 0 = No) to report if the AC reviews IA department's results related to: (1) financial reporting (2) internal control (3) compliance with laws and regulations (4) management responses to internal auditing findings.

Table 4.1 (Continued)

Name of Variable	Acronym	Measurement
Control Variables		
Firm Size	FSIZE	The natural logarithm of the total assets.
Leverage / Debt proportion	DEBT	The percentage of total liabilities to total assets.

4.7Method of Data Analysis

Data analysis was performed by using the Statistical Package for Social Sciences (SPSS) version 18. To achieve the objectives of the study, two main analysis methods were used, namely, the descriptive analysis and inferential analysis.

4.7.1 Descriptive Analysis

This method provides descriptive statistics of mean and standard deviations for all the variables. The rationale for using this approach wasto transform the data into more meaningful and easy to interpret. The output data describes about the dispersion of the data for the selected organizations.

4.7.2 Inferential Analysis

1) Correlation Analysis

Pearson correlation method was employed to determine the strength and directions (positive or negative) of the variables. The variables to be examined with the use of correlation involve corporate governance attributes and firm performance. Positive association means a direct implication of the independent variable on the dependent

variables. That is, the two variables move in the same direction. On the other hand, a negative relationship implies that the two variables move in opposite direction.

2) Multiple Regressions

This is more sophisticated technique and is capable of providing the relationship between groups of independent variables and dependent variables. The test on the significant of the variable is performed at 1 percent and 5 percent confidence level. The relationship is very significant when the value is closer to 1. In addition, it facilitates the hypotheses developed in section 3.3 to be tested. At the same time, it can examine the variance of organizations' performance explained by the independent variables.

The adoption and use of the multiple regressions was based on the following assumption:

i. The independent and dependent variable are linear. The regression coefficient for the independent variables was assumed to be constant.
ii. Constant variance of error terms (Homoscedasticity). The variance of the error terms was constant over the values of independent variables.
iii. Independent of error terms. The error terms were independent and related to other predicted values.
iv. Normality of the error terms. The error terms were normally distributed.

Another aspect of consideration is the degree of multicollinearity. Two (2) methods were used to detect the existence of multicollinearity. The first method was correlation matrix. If the tolerance value is less than 0.2, then there is multicollinearity in the relationship. The next method wasvariance inflation factor (VIF). Based on Hair, Anderson, Tatham, and Black (2010), the common acceptable value of VIF is below 10.

4.8 Model Used

This study used the following two models to examine the relationship between the corporate governance variables (Board of directors and audit committee variables) and firm performance:

Model 1:

$$ROA = \alpha 0 + \beta 1\ BODCOM + \beta 2\ DUAL + \beta 3\ BSIZE + \beta 4 COWN + \beta 5 ACIND + \beta 6 ACME + \beta 7 ACOWN + \beta 8 ACIAM + \beta 9 ACREV1 + \beta 10 ACREV2 + \beta 11 FSIZE + \beta 12\ DEBT + \varepsilon$$

Model 2:

$$TQ = \alpha 0 + \beta 1\ BODCOM + \beta 2\ DUAL + \beta 3\ BSIZE + \beta 4 COWN + \beta 5 ACIND + \beta 6 ACME + \beta 7\ ACOWN + \beta 8 ACIAM + \beta 9\ ACREV1 + \beta 10 ACREV2 + \beta 11 FSIZE + \beta 12\ DEBT + \varepsilon$$

Where:

ROA - Return on assets; proxy for accounting measurement of firm performance.

TQ - Tobin's Q ratio; proxy for market measurement of firm performance.

$\alpha 0$ – Intercept

BODCOM - Board composition.

DUAL - Role duality; chairman of the board is also the chief executive officer.

BSIZE– Board size.

COWN – Shareholdings held by Chairman.

ACIND – Audit committee independence.

ACME – Audit committee meeting.

ACOWN – Shareholdings held by audit committee.

ACIAM – Audit committee meeting with the cheif internal auditor.

ACREV1 – Audit Committee Reviews of IA Programmes and Plans.

ACREV2 – Audit Committee Reviews of the Result of IA Activities and pursue the implementation of the corrective measures.

FSIZE –Firm Size.

DEBT – Leverage.

ε - Error term.

4.9 Chapter Summary

This chapter described the framework of the study which shows the chosen board of directors and audit committee characteristics that might have an influence on firm performance (ROA and TQ) of companies listed on Saudi Stock Exchange. It is hypothesized that these board and audit committee characteristics influence the financial performance of Saudi non-financial companies listed on Saudi Stock

Exchange. In addition, the controlling factors like leverage and firm size were also taken into consideration. Methodology of the study was also described in this chapter. There are two types of data that were used namely,primaryand secondary data. Companies listed on Saudi Stock Exchange for the year 2010 were used as a study population.

CHAPTER FIVE

ANALYSIS AND FINDINGS

5.0 Introduction

The objective of this chapter is to present the results of the data analysis that relates to the topic under investigation: internal corporate governance (Board of directors and audit committee characteristics) and firm performance of companies in Saudi Arabia. There are seven sections in this chapter. Section 5.1 presents the analysis of the response rate. The descriptive analysis of the variables is presented in section 5.2. Section 5.3 discusses the correlation matrix of the variables. The assumptions of multivariate analysis are fulfilled before regression analysis is carried out in section 5.4. Section 5.5 presents the tests of the research hypotheses through inferential analyses. Further tests are carried out to ensure the robustness of the analysis, and the results are discussed in section 5.6. Finally, a summary of the chapter is presented in the last section.

5.1 Responses

This study focuses on companies listed in Saudi Arabia, excluding banks, at the end of 2010. The total number of companies on the Saudi Stock Market (TADWAUL) at that time was 146 companies. The latest sample of companies on the Saudi Stock Market that provides information on corporate governance attributes after excluding the banks was 135 companies.

The data on the relationship between the audit committee and internal audit function was collected though a mail questionnaire survey of the public listed companies in Saudi Arabia during 2010. This method of data collection was considered appropriate because the information sought is not publicly available and the chief internal auditors are in a good position to answer the questions (Goodwin & Yeo, 2001). The questionnaire first determined whether the respondent's company had an internal audit function. For those companies with an internal audit function, further questions were asked relating to the relationship between the audit committee and the internal audit function or otherwise returning the questionnaire. One-hundred and thirty five (135) questionnaires were sent to all the chiefs of the internal departments of public companies listed on the Saudi Stock Market.

The total number of completed questionnaires received after one month from sending, and before the follow-up, reached 60 questionnaires. This represents approximately a 44 percent response rate. The follow-up technique is one of the most effective ways to increase the response rate. It is used to either check if the respondents received the instrument or to remind them to complete and return it accordingly. In recent years, researchers have greatly improved the response rate to data collection in mail surveys by using the follow-up technique (Dillman, 2000; Al-Moataz, 2003). In this study, a follow-up letter was sent to non-respondents and further follow-up procedures in the form of company visits and telephone calls were also carried out. This resulted in a total of 73 usable responses (a response rate of 54.07 percent).

Table 5.1 presents the sample description and response rate of the survey questionnaire concerning the relationship between the audit committee and internal

audit function. A total of 73 responses were received of which 62 were useable responses. Of the 11 non-useable responses, 8 were eliminated due to the fact that companies did not have internal audit departments. Although the overall response rate of this study was 54.07 percent (73),the usable response rate was 45.93 percent (62). A copy of the questionnaire is attached in Appendix B. Other information on firm performance, board of directors and audit committee characteristics was obtained from the annual reports of the respective firms (year-ending 2010). The information about the company's name was required to match with the company's corporate governance information and the financial information.

Table 5.1
Response Rate

Description	Results	Rate
Total questionnaires sent	135	-
Answered questionnaires returned	73	54.07%
Less:		
Companies that fully outsourced or did not have internal audit departments	8	5.93%
Incomplete responses	3	2.22%
Usable response	62	45.93 %

5.2 Company Profile and Descriptive Statistics

Table 5.2 presents a profile of the companies according to the duality variable. Based on the results, only about 13 percent (8) of the firms have their CEOs and board chairman positions combined in one person, whereas 87 percent (54) of Saudi companies separate between the position of the CEO and chairman. This result indicates that the majority of Saudi Stock Market companies are implementing the

best practice of corporate governance in Saudi Arabia, which requires a separation of the CEO and chairman positions.

Table 5.2
Frequency of the Companies according to the Duality Variable

CEO Duality	Frequency	Percentage
Duality	8	12.90%
Separate	54	87.10%
Total	62	100%

Similarly, Table 5.3 illustrates the descriptive statistics of the continuous variables. The descriptive statistics include mean, standard deviation, minimum, and maximum, which were computed using SPSS version 18. Based on the descriptive analysis, as summarized in Table 5.3, the mean value of the proportion of non-executive directors (NEDs) on the board in Saudi companies is 54 percent, suggesting that the boards of Saudi Stock Market companies contain a mix of executive and non-executive directors. The proportion of NEDs in this study is quite low compared to that in the study carried out by Al-Abbas (2009), which was 81 percent.

The study of Fama and Jensen (1983) revealed that this proportion is essentially good for the effectiveness of a board. They argued that the effectiveness of a board depends on the optimal mix of executive and non-executive directors. The result indicates that the majority of directors on the board are non-executive directors. Moreover, this result indicates that Saudi Stock Market companies implement the Code of Corporate Governance with regards to the board of directors comprising a majority of non-executive directors. This result is consistent with the regulations in Saudi Arabia that requires companies to have a majority NEDs on the board.

The result in Table 5.3 also indicates that the mean of board size (BSIZE) is about eight (8) members with a minimum of four (4) members and a maximum of twelve (12) members. The board size of the sample companies in this study is not much different from the study that was conducted in Saudi Arabia by Al-Abbas (2009) of (9) nine members. This result indicates that the number of directors on the boards in the Saudi Stock Market companies complies with the regulation of the corporate governance. This also suggests that Saudi Stock Market companies, on average, choose the optimal number of board members. This is essentially good for firm performance according to researchers, such as Jensen (1993), and Lipton and Lorsch (1992) who argued that small board size leads to better firm performance.

The result on the Chairman of Directors' Shareholdings in Table 5.3 also indicates that the mean proportion of shares held by the Chairman of Directors is 4 percent with a minimum holding of zero and a maximum holding of 29 percent, indicating low shareholdings.

In terms of the independence of the audit committee members, the result shows that the mean proportion of independent audit committee members (ACIND) is 78 percent with a minimum of 25 percent and a maximum of 100 percent. These results indicate that Saudi Stock Market companies are in line with the international Codes of Corporate Governance, such as the Organization for Economic Co-Operationand Development Principles (OECD, 2004), Cadbury Committee (1992) and the Code of Corporate Governance (2006) in Saudi Arabia, which requires the majority of audit committee members to be independent.

Regarding the audit committee meetings, the results in Table 5.3 indicate that the mean for audit committee meetings is about five (5) times a year with a minimum of one (1) and a maximum of twenty-five (25). This shows that Saudi Stock Market companies are consistent with the New York Stock Exchange, which requires that audit committees should meet on a quarterly basis. In addition, the Blue Ribbon Committee (BRC, 1999) recommended that the audit committees should have four meetings a year. However, some companies in Saudi Arabia are not in line with this requirement in that they have less than (4) four audit committee meetings a year. In relation to the Audit Committees' Shareholdings (ACOWN), Table 5.3 shows that the proportion of shares held by the audit committee is quite low with a mean of 24 percent shareholdings; a minimum holding of zero (0) and a maximum holding of 7 percent.

In terms of Audit committee meetings with the CIA (ACIAM), the results of the descriptive statistics in Table 5.3 indicate that the mean number of audit committee meetings with the chief internal auditor (ACIAM) held during the year is about three (3) meetings with a minimum of zero (0) and a maximum of seven (7) meetings. With regards to the audit committee reviews of IA proposals (ACREV1), the results show that the mean of audit committee reviews of the IA program/plans, budget and coordination with external auditors (ACREV1) is 1.37 with a minimum of zero (0) and a maximum of three (3).

For the audit committee reviews of IA Proposals (ACREV1) three (3) questions were asked to gather the extent of audit committee reviews of IA programs/plans, budget and coordination with the external auditor using a dichotomous measure; a value of

one is given for a "yes" answer and zero for a "no" answer, leading to a minimum of zero, indicating that the audit committee does not review any of the IA programs/plans, and a maximum of three indicating that the audit committee reviews all of the IA programs/plans.

In relation to the audit committee reviews of the results of the IA activities (ACREV2), the results in Table 5.3 show that the mean of the audit committee review of the results of the IA activities (i.e. financial reporting, internal control, compliance with laws and regulation reports and management responses to internal auditing findings) (ACREV2) is 2.40 with an actual minimum of zero (0) and an actual maximum of four (4).

For the audit committee reviews of the results of the IA activities (ACREV2), four (4) questions were asked to gather the extent of the audit committee reviews of the results of the IA activities relating to financial reporting, internal control, compliance with laws and regulation reports and management responses to internal auditing findings using a dichotomous measure. A value of one is given for a "yes" answer and zero for a "no" answer. This variable has a minimum of zero (0) indicating that the audit committee does not review any of the results of the IA activities (financial reporting, internal control and compliance with laws and regulation reports) and a maximum of four (4) indicating that the audit committee reviews all the results of the above mentioned IA activities.

With regards to the performance measures, the mean of return on assets (ROA) is 5.78 with a minimum of -6.42 and a maximum of 30.71. The standard deviation is

7.97. This shows that there is a wide variation in the return on assets (ROA) across the companies in the sample. The mean of Tobin's Q ratio (TQ) is 1.31 with a minimum of .36 and a maximum of 4.34. The variation in Tobin's Q ratio (TQ) is small at 0.78.

Table 5.3
Descriptive Statistics of Continuous Variables

Variables	Mean	Std. Deviation	Min	Max
Board Composition (BODCOM)	0.54	.315	0.00	1.00
Board Size (BSIZE)	8.40	1.58	4.00	12.00
Chairman of Directors' Shareholdings (COWN)	0.04	0.07	0.00	0.29
Audit Committee Independence (ACIND)	0.78	0.22	0.25	1.00
Audit Committee Meetings (ACMEET)	4.97	3.26	1.00	25.00
Audit Committees' Shareholdings (ACOWN)	0.00	0.01	0.00	0.07
Meetings between the AC and the CIA (ACIAM)	2.66	1.53	0.00	7.00
Audit Committee Reviews of IA Proposals (ACREV1)	1.37	1.06	0.00	3.00
Audit Committee Reviews of the Result of IA Activities (ACREV2)	2.40	1.08	0.00	4.00
Return on Assets (ROA)	5.78	7.97	-6.42	30.71
Tobin's Q Ratio (Tobin's Q)	1.31	0.78	0.36	4.34

5.3 Correlation Analysis

Pearson correlation analysis was performed in order to obtain an understanding of the relationship among all the variables in the study. Table 5.4 provides a summary of the results from the correlation analysis. The values of the correlation coefficients (r) given in the tables indicate the strength of the associations among variables. In determining the strength of the relationships between each independent variable and the dependent variable, Hair *et al.* (2010) suggested that while the correlation of 0

indicates that there is no relationship, the correlation of ±1.0 indicates the existence of a perfect relationship. In interpreting the correlation between 0 and 1.0, Cohen's (1988) criterion was followed. When the correlation (r) is between ±0.1 and ±0.29, the relationship is said to be small, when r is between ±0.30 and ±0.49, the relationship is described as medium. Finally, the relationship is said to be strong when the correlation is above ±0.50.

In general, all the correlations are less than 0.80 except the correlation between audit committee reviews of IA proposals (ACREV1) and return on assets (ROA), which is high at 0.817. However, the correlation matrix should not be more than 0.80 (Gujarati &Porter, 2009). Therefore, the next step is to look at the Variance Inflation Factor (VIF). A VIF greater than ten (10) indicates a serious multicollinearity problem (Hair *et al.*, 2010). However, as stated in the next section, the values of VIF for all the variables range between 1.163 and 3.156 indicating that the issue of multicollinearity is not present in this study.

Moreover, the results in Table 5.4 show that board composition (BODCOM) revealed a strong positive correlation with the audit committee reviews of IA proposals (ACREV1) and audit committee reviews of the results of IA activities (ACREV2). Board size (BSIZE) is also positively related to audit committee meetings (ACMEET).

Audit committee meetings (ACMEET) is positively related to board size (BSIZE) and audit committee meetings with the CIA (ACIAM). Audit committee meetings with the CIA (ACIAM) is positively correlated to the audit committee reviews of IA

proposals (ACREV1). For audit committee reviews of IA proposals (ACREV1), the correlation is positively related to the audit committee reviews of the result of IA activities (ACREV2). In relation to the firm performance, ROA is positively correlated with board composition (BODCOM), audit committee reviews of IA proposals (ACREV1) and audit committee reviews of the results of the IA Activities (ACREV2).

On the other hand, Tobin's Q ratio (TQ) is positively correlated with board composition (BODCOM), audit committee reviews of IA proposals (ACREV1) and audit committee reviews of the result of the IA activities (ACREV2).

Table 5.4

Results of Pearson Correlation Analysis

	1	2	3	4	5	6	7	8	9	10	11
1) Board Composition (BODCOM)											
2) Board Size (BSIZE)	.148										
3) Chairman of Directors' Shareholdings (COWN)	-.012	.062									
4) Audit Committee Independence (ACIND)	-.046	.002	-.020								
5) Audit Committee Meetings (ACMEET)	.220	.342**	.078	.082							
6) Audit Committees' Shareholdings (ACOWN)	-.136	.054	-.024	.128	-.003						
7) Audit committee meeting with the CIA (ACIAM)	.163	.227	.123	-.073	.646**	.046					
8) Audit Committee Reviews of IA Proposals (ACREV1)	.663**	.232	.150	-.061	.165	-.188	.373**				
9) Audit Committee Reviews of the Result of IA Activities (ACREV2)	.515**	.220	.102	.032	.088	.127	.224	.613**			
10) Return on Assets (ROA)	.771**	.110	.097	-.060	.019	-.158	.193	.817**	.661**		
11) Tobin's Q Ratio (Tobin's Q)	.404**	-.207	.136	.143	-.086	-.080	-.017	.461**	.326**	.656**	

Notes:

**Correlation is significant at the 0.01 level (2- tailed).

*Correlation is significant at the 0.05 level (2- tailed).

5.4 Regression Analysis

Regression analysis is one of the most widely used statistical techniques in various applications of most science disciplines (Hair *et al.*, 2010).Multiple regression analysis is a multivariate statistical technique that can be used to examine the relationship between a set of independent variables and a single dependent variable.

Before undertaking the multiple regression analysis, the data for this study were examined to fulfill various multivariate assumptions to ensure the reliability of the subsequently drawn conclusions. The main assumptions tested prior to conducting the regression analysis were linearity, normality, homoscedasticity and the independence of error terms. Before testing for these assumptions, this study undertook the investigation to detect outliers and check the multicollinearity issue.

Based on the discussion provided in the following sub-section, it was concluded that all the statistical assumptions required for multivariate statistical techniques were satisfied. Satisfaction of these assumptions ensures that the obtained results are valid and reliable. Moreover, these assumption tests and subsequent results of regression analysis are reported in the following sub-sections.

5.4.1 Preparing Data for Multiple Linear Regression Analysis

The ratio between the number of observations to the number of variables included in the study should be at least 5:1 and ideally 20:1, as suggested by Hair *et al.* (2010). As this study had 10 variables and the number of responses collected was 62, it was concluded

that there was an acceptable number of observations to conduct the multiple linear regression analysis.

Before proceeding to carry out the multiple regression analysis, the presence of multicollinearity and outliers were examined, for which it was found that the data have no serious issues relating to the outliers and multicollinearity. In addition, the performed investigations revealed that all the necessary conditions to conduct the regression analysis were satisfied. The procedures used by this study are reported in the following sub-sections.

5.4.1.1 Outlier Detecting

Outliers are defined as the observations that have unique characteristics and differ distinctly from others (Hair *et al*., 2010). They can be detected using univariate, bivariate and multivariate techniques based on the number of variables. Among the commonly used methods to detect outliers is the Mahalanobis Distance Measure. This method, according to Hair *et al.* (2010), measures the distance of each observation from the mean center of all the observations in a multidimensional space. In detecting the outlier observations, the Mahalanobis distance values were examined and compared to the critical values in the Chi-square distribution table.

The results of this study show that the Mahalonobis distance for all the observations ranged between 2.6077 and 55.0768. Referring to the Chi-Square distribution table, the

critical value at 0.001 level of significance and 10 degrees of freedom is 29.5883, which indicates the existence of outlier observations.

In order to identify the outlier observations, a further examination of the SPSS package results saved in the data as Mahalanobis distance was compared to the value of 29.588. As a result of this comparison, only three observations with Mahalanobis distances ranging between 38.3361 and 55.0768 were considered as outliers. Among 62 observations, only three observations were considered as outliers representing a small ratio. Following the suggestion of Coakes and Steed (2003), the outlier observations should be eliminated from the data if their number is big and expected to affect the reliability of the results obtained. Therefore, this study opted to retain the detected outliers for further analysis. In the following sub-section, this study examines the existence of multicollinearity among the variables of the study.

5.4.1.2 Checking the Multicollinearity

Multicollinearity is defined as the extent to which the effect of any variable can be accounted for by other variables (Hair *et al*., 2010). High multicollinearity causes difficulty in the interpretation of the effects of different variables. This study used the tolerance value and Variance Inflation Factor (VIF) to examine the presence of multicollinearity issue among the variables of the study. The tolerance is defined, according to Hair *et al.* (2010), as the variability in a variable that is not accounted for by other variables. Moreover, the VIF indicator is the reciprocal of the tolerance variable.

Table 5.5 shows that the tolerance values for all the variables range between 0.317and 0.860. Moreover, the values of VIF for all the variables range between 1.163 and 3.156. These results indicate that the tolerance values for all the variables of this study are more than 0.1, and, consequently, the VIF are below the threshold value of 10, as suggested by Hair *et al*. (2010).In other words, the tolerance and VIF values of the variables included in this study are within the recommended values. Therefore, it was concluded that the issue of multicollinearity issue is not present in this study.

Table 5.5
Multicollinearity Test

Variables	Tolerance value	VIF
Board Composition (BODCOM)	0.411	2.433
CEO Duality (DUAL)	0.756	1.323
Board Size (BSIZE)	0.757	1.321
Chairman of Directors' Shareholdings (COWN)	0.777	1.287
Audit Committee Independence (ACIND)	0.860	1.163
Audit Committee Meetings (ACMEET)	0.447	2.238
Audit Committees' Shareholdings (ACOWN)	0.825	1.213
Audit committee meeting with the CIA (ACIAM)	0.411	2.430
Audit Committee Reviews of IA Proposals (ACREV1)	0.317	3.156
Audit Committee Reviews of the Result of IA (ACREV2)	0.522	1.916

In general, it can be confidently concluded that this study does not have serious outlier observations and that multicollinearity does not exist.

Prior to conducting the regression analysis, this study devoted the following sub-sections to examine the assumptions of multiple linear regression through the residual analysis (Hair *et al*., 2010). More specifically, the subsequent sections discuss the assumptions of normality, linearity, homoscedasticity, and, finally, the independence of error terms.

5.4.1.3 Testing the Normality of the Error Terms

The normality assumption was examined through the normal probability plots of the residuals for the two dependent variables. The histogram and the normal probability plot (P-P Plots) of the regression standardized residual were the tools based on which the normality was confirmed. As can be seen in Figures 5.1 and 5.2, the data show that the behavior of the data distribution did not deviate substantially from the associated normal curve. Thus, it can be concluded that the data approximately follows normal distribution.

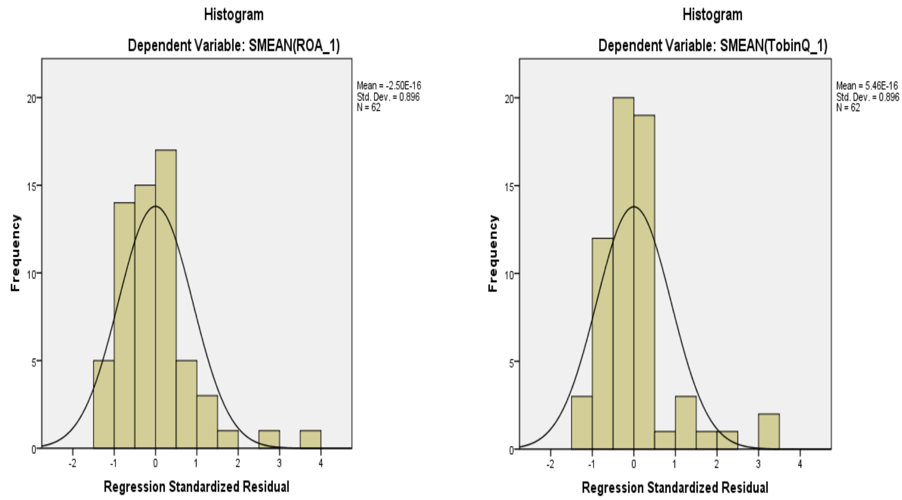

Figure 5.1
Histogram of the Regression Residuals

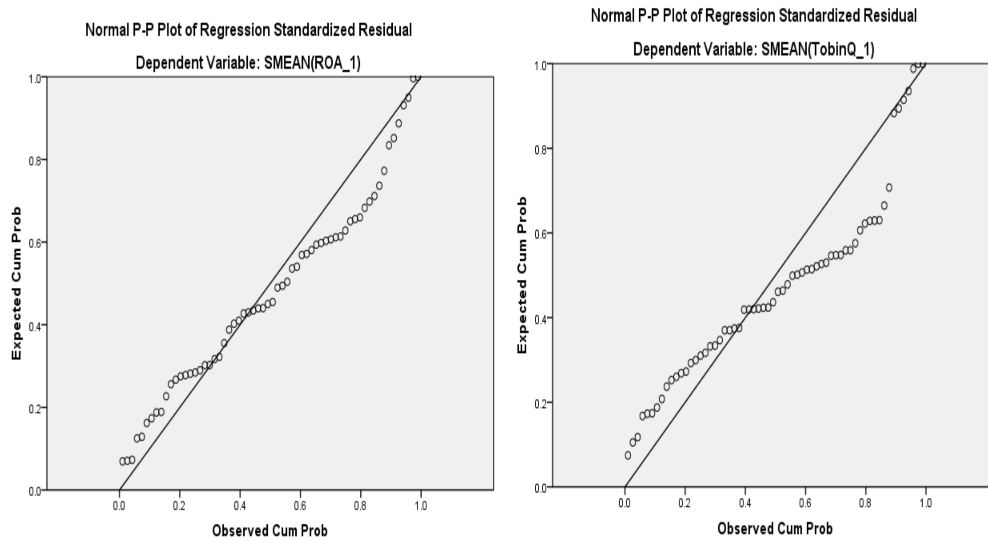

Figure 5.2
Testing Normality using Normal Probability Plot

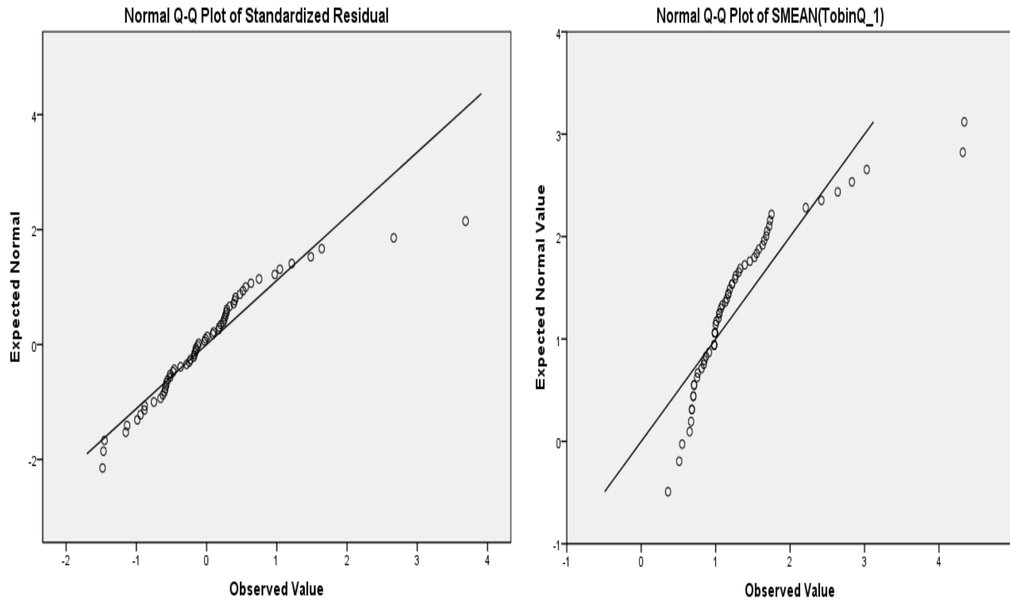

Figure 5.3
Testing Normality using Q-Q Plot

The assumption of normality was also confirmed by examining both the P-P Plot and Q-Q plot for the two dependent variables. The two plots show that the data lie on the straight lines in both graphs indicating that the data are approximately normally distributed.

Additionally, the assumption of normality was also confirmed by employing the Kolmogrov-Smirnov Test. However, the results depicted in Table 5.6 show that the assumption of normality of the error terms is not rejected at the 0.01 level of significance.

Table 5.6
Normality Test of the Residuals

	Kolmogorov-Smirnov		
	Statistic	df	Sig.
Standardized Residual	0.130	62	0.011

Based on the previous discussion, it can be concluded that the normality of the error terms is confirmed. Having confirmed the assumption of normality of the error terms, the process should test the linearity, homoscedasticity and independence of the error terms, as discussed in the following sub-section.

5.4.1.4 Testing the Linearity, Homoscedasticity and the Independence of Errors

This study examined the linearity, homoscedasticity and the independence of the error terms through examining the scatterplot of the residuals for the two dependent variables.

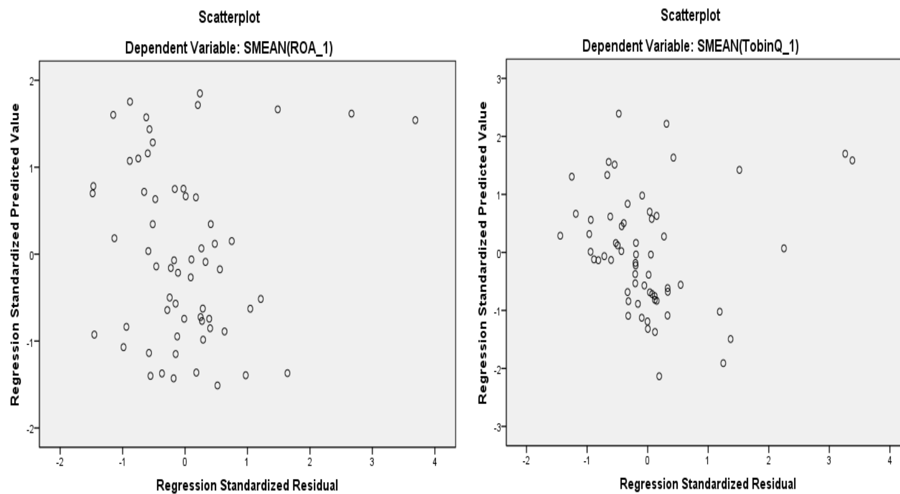

Figure 5.4
Scatterplot of the Residuals

The scatterplot in Figure 5.4 shows that there is no clear relationship between the residual and the predictedvalue. Following the suggestion of Hair *et al*. (2010), since the scatterplot shows no clear relationship between residuals and predicted values, it proves there are no problems of linearity, homoscedasticity or independence of residuals.

5.4.2 Evaluation of the Models

After all the regression assumptions were checked and found to be satisfied, this study ran the regression analysis using SPSS version 18 to examine the predictive power of board of directors, audit committee characteristics and their dimensions on firm performance. The main purpose of the multiple regression analysis was to determine the predictive power of each independent variable on the dependent variable. This part is divided into two sub-sections. The first sub-section examines the relationship between board of directors, audit committee characteristics and firm performance, as measured by ROA. The second sub-section examines the relationship between board of directors, audit committee characteristics and firm performance, as measured by Tobin's Q.

5.4.2.1 Model 1 (Dependent Variable = ROA)

Numerous tests of significance can be applied to the results of multiple regression analysis. The R^2 (R Square) Coefficient is the gauge generally used for evaluating the goodness of a regression equation. R^2 is also referred to as the coefficient of determination that indicates the amount of variance of the dependent variable that is explained by the variables in the model. In this study, R^2 is used to indicate the share of the variance of the dependent variable (firm performance, as measured by ROA) due to

the joint effect of the independent variables (board of directors, audit committee characteristics). If R^2 is equal to 1, it means that there is a perfect linear relationship between the dependent and the independent variables. On the other hand, if R^2 is equal to 0, it means that there is no linear relationship between the dependent and independent variables.

Consequently, the value given under the heading R^2 tells us how much of the variance in the dependent variable (firm performance as measured by ROA) is explained by the model (which includes the variables of the board of directors and audit committee characteristics).

As revealed by the results in Table 5.7, the value of R^2 in this model is 0.824. This means that the model explains 82 per cent of the variance in firm performance, as measured by ROA. This is quite a respectable result. The SPSS also provides an adjusted R^2 value in the output. When a small sample is involved, the R^2 value in the sample tends to be a rather optimistic overestimation of the true value in the population (Tabachnic & Fidell, 2007).

The adjusted coefficient of determination (R^2) indicates that 78.12 percent of the variation in the dependent variable is explained by variations in the independent variables. This means that the variation in firm performance, as measured by ROA, is statistically explained or accounted for by the regression equation. Also, the results in Table 5.7 show that this model is significant since the F-value is significant ($F=19.086$, $p<0.01$). Thus, indicating the validity of the model used.

Beta analysis was used to prove the significance of the regression coefficient. Regression analysis was used to compare the relative influence of the independent variables, which are measured using different units of measurement. For the purpose of testing the hypotheses, standardized beta coefficients were used. Standardized means that these values for each of the different variables have been converted to the same scale so that this study compares them to determine which beta value is the largest (ignoring any negative signs).

The standardized beta coefficients can be compared to one another, thus the larger the beta coefficient, the stronger the impact of that variable on the dependent variable. The regression coefficient shows the variables that contribute to the prediction of the dependent variable in the model.

In this model, the largest beta coefficient is (0.428), which is board composition (BODCOM). This means that this variable makes the strongest unique contribution to explain the dependent variable. Board composition (BODCOM) was also found to be significant at the 0.01 level of significance ($p<0.01$). Therefore, this variable made a significant unique contribution to the prediction of the dependent variable (firm performance, as measured by ROA).

The beta value for audit committee reviews of IA proposals (ACREV1) is slightly less than the beta of board composition ($p<0.01$) ($\beta=0.413$, $t=3.875$, $p<0.05$). Although it made less contribution than that of board composition (BODCOM), it contributed significantly in explaining ROA. Two other variables are arranged according to the

stronger unique contribution, as follows: audit committee reviews of the result of IA (ACREV2) (β=0.216, t=2.602, $p<0.05$) and audit committee meetings (ACMEET) (β=0.184, t=2.046, $p<0.05$). On the other hand, CEO duality (DUAL) (β=0.079, t=1.142, $p>0.05$); board size (BSIZE) (β=0.037, t=0.540, $p>0.05$); chairman of directors' shareholdings (COWN) (β=0.040, t=0.582, $p>0.05$); audit committee independence (ACIND) (β=0.020, t=0.315, $p>0.05$); audit committees' shareholdings (ACOWN) (β=0.038, t=0.575, $p>0.05$) and audit committee meetings with the CIA (ACIAM) (β=0.065, t=0.698, $p>0.05$) are not making a significant unique contribution in predicting the dependent variable (firm performance, as measured by ROA) because the significance values are greater than .05.

In general, the results in Table 5.7 show that four variables are significant predictors of firm performance (as measured by ROA). These variables are the proportion of non-executive directors (BODCOM) (β= 0.428, t= 4.578, $p<0.01$), the extent of AC reviews of IA proposals (ACREV1) (β=0.413, t=3.875, $p<0.01$), the extent of AC reviews of the results of internal audit activities (ACREV2) (β= 0.216, t= 2.602, $p<0.05$), and the frequency of audit committee meetings (ACMEET) (β= -0.184, t= -2.046, $p<0.05$).

However, other variables, such as CEO duality (DUAL), board size (BSIZE), chairman of directors' shareholdings (COWN), audit committee independence (ACIND), audit committees' shareholdings (ACOWN), and audit committee meetings with the CIA (ACIAM) are statistically insignificant to the firm performance of companies (ROA).

Table 5.7

Regression Results of Model 1 (Dependent = ROA)

Variables	Standardized Coefficients Beta	t-value	Sig.
Board Composition (BODCOM)	0.428	4.578	0.000
CEO Duality (DUAL)	0.079	1.142	0.259
Board Size (BSIZE)	-0.037	-0.540	0.592
Chairman of Directors' Shareholdings (COWN)	0.040	0.582	0.563
Audit Committee Independence (ACIND)	0.020	0.315	0.754
Audit Committee Meetings (ACMEET)	-0.184	-2.046	0.046
Audit Committees' Shareholdings (ACOWN)	-0.038	-0.575	0.568
Audit committee meeting with the CIA (ACIAM)	0.065	0.698	0.488
Audit Committee Reviews of IA Proposals (ACREV1)	0.413	3.875	0.000
Audit Committee Reviews of the Result of IA (ACREV2)	0.216	2.602	0.012
Firm size (FSIZE)	-0.050	-0.764	0.449
Debt ratio (DEBT)	0.038	0.532	0.597
R2			0.824
Adjusted R2			0.781
F-value			19.086
F-Significance			0.000
Durbin Watson statistics			2.174

5.4.2.2 Model 2 (Dependent Variable= TQ)

As revealed by the results in Table 5.8, the value of R^2 in this model is 0.424. This means that the model explains 42 per cent of the variance in firm performance, as measured by TQ. The SPSS also provides an adjusted R^2 value in the output. The adjusted coefficient of determination (R^2) indicates that 0.283 percent of the variation in the dependent variable is explained by the variations in the independent variables. This presents that the variation in firm performance, as measured by TQ,isstatistically explained or accounted for by the regression equation. The results in Table 5.8 also show that this model is significant, since the F-value is significant ($F=3.002$, $p<0.01$).

In this model, the largest standardized beta coefficient is (0.487), which is audit committee reviews of IA proposals (ACREV1). This means that this variable makes the strongestunique contribution to explain the dependent variable. Audit committee reviews of IA proposals (ACREV1)also havea significant value of less than .05 ($p<0.05$). Therefore, this variable makesa significant unique contribution to the prediction of the dependent variable (firm performance, as measured by TQ).

The standardized beta value for board size (BSIZE)is slightly less than the beta of audit committee reviews of IA proposals ($\beta=.262$, $t=2.103$, $p<0.05$), indicating less contribution. On the other hand, board composition (BODCOM) ($\beta=0.114$, $t=0.671$, $p>0.05$); CEO duality (DUAL) ($\beta=0.042$, $t=0.340$, $p>0.05$); chairman of directors' shareholdings (COWN) ($\beta=0.104$, $t=0.846$, $p>0.05$); audit committee independence (ACIND) ($p>0.05$) ($\beta=0.175$, $t=1.497$, $p>0.05$); audit committee meetings

(ACMEET)($\beta=0.032$, $t=0.194$, $p>0.05$); audit committees' shareholdings (ACOWN) ($\beta=0.034$, $t=0.283$, $p>0.05$); audit committee meeting with the CIA (ACIAM) ($\beta=0.131$, $t=0.775$, $p>0.05$) and audit committee reviews of the result of IA (ACREV2) ($\beta=0.051$, $t=0.339$, $p>0.05$) do not make a significant unique contribution in predicting the dependent variable (firm performance as measured by TQ) because the significance values are greater than .05

In general, the results in Table 5.8 show that two (2) variables are significant predictors of firm performance (TQ). These variables are board size (BSIZE) ($\beta=.114$, $t=.671$, $p<0.05$) and the extent of AC reviews of IA proposals (ACREV1) ($\beta=.487$, $t=2.528$, $p<0.05$). However, other variables, such as the proportion of non-executive directors (BODCOM), CEO duality (DUAL), chairman of directors' shareholdings (COWN), audit committee independence (ACIND), the frequency of audit committee meetings (ACMEET), audit committees' shareholdings (ACOWN), audit committee meetings with the CIA (ACIAM), and the extent of AC reviews of the results of internal audit activities (ACREV2) are statistically insignificant to the firm performance of companies (TQ).

Table 5.8

Regression Results of Model 2 (Dependent = TQ)

Variables	Standardized Coefficients Beta	t-value	Sig.
Board Composition (BODCOM)	.114	.671	.505
CEO Duality (DUAL)	-.042	-.340	.735
Board Size (BSIZE)	-.262	-2.103	.041
Chairman of Directors' Shareholdings (COWN)	.104	.846	.402
Audit Committee Independence (ACIND)	.175	1.497	.141
Audit Committee Meetings (ACMEET)	-.032	-.194	.847
Audit Committees' Shareholdings (ACOWN)	.034	.283	.778
Audit committee meeting with the CIA (ACIAM)	-.131	-.775	.442
Audit Committee Reviews of IA Proposals (ACREV1)	.487	2.528	.015
Audit Committee Reviews of the Result of IA (ACREV2)	.051	.339	.736
Firm size (FSIZE)	-.174	-1.471	.148
Debt ratio (DEBT)	.071	.553	.583
R2			0.424
Adjusted R2			0.283
F-value			3.002
F-Significance			0.003
Durbin Watson statistics			1.965

5.5 Hypotheses Testing

5.5.1 Relationship between Board of Directors, Audit Committee Characteristics and ROA

Table 5.9 presents the results of multiple regression analysis between the internal corporate governance variables (Board of Directors and Audit Committee Characteristics) and ROA with the corresponding coefficient value and t-value. The results show that the relationship between the proportion of non-executive directors (BODCOM) and ROA is positively significant at the 0.01 level of significance (β= 0.428, t= 4.578, $p<0.01$). CEO duality variable is not significant to ROA with indicators (β=0.079, t=1.142, $p>0.05$). For the board size variable, the relationship between board size and ROA is not significant (β= -0.037, t= -0.540, $p>0.05$).

Chairman's shareholdings variable was not reported to be significant to ROA with indicators (β=0.040, t=0.582, $p>0.05$). The results in Table 5.9 also show that the independence of the audit committee members variable is not significant to ROA with indicators (β=0.020, t=0.315, $p>0.05$). The relationship between the frequency of audit committee meeting (ACMEET) and ROA is negatively significant at the 0.05 level of significance (β= -0.184, t= -2.046, $p<0.05$).

For the audit committees' shareholdings variable, the relationship between audit committees' shareholdings and ROA is not significant with indicators (β= -0.038, t= -0.575, $p>0.05$). The frequency of meetings between the audit committee and internal auditor variable is not significant to ROA with indicators (β=0.065, t=0.698, $p>0.05$). The extent of AC reviews of IA proposals variable (ACREV1) is positively significant

to ROA at the 0.01 level of significance with indicators (β=0.413, t=3.875, p<0.01). The results in Table 5.9 also reveal that the relationship between the extent of AC reviews of the results of internal audit activities (ACREV2) and ROA is positively significant at the 0.05 level of significance (β= 0.216, t= 2.602, p<0.05).

Table 5.9
Summary of the Hypotheses Related to ROA

Variables	Expected signs	Standardized Coefficients Beta	t-value	Decision
Board Composition (BODCOM)	+	0.43**	4.58	Supported
CEO Duality (DUAL)	-	0.08	1.14	Not Supported
Board Size (BSIZE)	-	(-)0.04	(-)0.54	Not Supported
Chairman of Directors' Shareholdings (COWN)	+	0.04	0.58	Not Supported
Audit Committee Independence (ACIND)	+	0.02	0.32	Not Supported
Audit Committee Meetings (ACMEET)	+	(-)0.18*	(-)2.05	Not Supported
Audit Committees' Shareholdings (ACOWN)	+	(-)0.04	(-)0.58	Not Supported
Audit committee meeting with the CIA (ACIAM)	+	0.07	0.70	Not Supported
Audit Committee Reviews of IA Proposals (ACREV1)	+	0.41**	3.88	Supported
Audit Committee Reviews of the Result of IA (ACREV2)	+	0.22*	2.60	Supported

Notes:

**Correlation is significant at the 0.01 level (2- tailed).

*Correlation is significant at the 0.05 level (2- tailed).

5.5.2 Relationship between Board of Directors, Audit Committee Characteristics and TQ

The results of multiple regression analysis between internal corporate governance variables (Board of Directors and Audit Committee Characteristics) and TQ is presented in model 2 Table 5.10 with the corresponding coefficient value and t-value. The results of model 2 indicate that no significant relationship exists between the proportion of non-executive directors (BODCOM) and TQ (β=.114, t=.671, p>0.05). CEO duality (DUAL) variable is not significant to TQ with indicators (β= -.042, t= -.340, p>0.05).

For board size (BSIZE), the results of model 2 indicate that there is a negatively significant relationship between board size and TQ at the 0.05 level of significance (β=.114, t=.671, $p<0.05$). Chairman's' shareholdings variable (COWN) is not significant to TQ with indicators (β= .104, t= .846, $p>0.05$). The results in Table 5.10 also show that the independence of the audit committee members variable (ACIND) is not significant to TQ with indicators (β=.175, t=1.497, $p>0.05$). For audit committee meetings (ACMEET), there was no significant relationship between the frequency of audit committee meetings and TQ (β= -.032, t= -.194, $p>0.05$).

Moreover, the results in Table 5.10 show that the audit committees' shareholdings variable (ACOWN) is not significant to TQ with indicators (β=.034, t=.283, $p>0.05$). The frequency of meetings between audit committee and internal auditor variable (ACIAM) is not significant to TQ with indicators (β= -.131, t= -.775, $p>0.05$). The extent of AC reviews of IA proposals variable (ACREV1) is positively significant to TQ at the 0.05 level of significance with indicators (β=.487, t=2.528, $p<0.05$). For AC reviews of the results of IA (ACREV2), there is no significant relationship between the extent of AC reviews of the results of internal audit activities and TQ (β=.051, t=.339, $p>0.05$).

Table 5.10
Summary of the Hypotheses Related to TQ

Variables	Expected signs	Standardized Coefficients Beta	t-value	Decision
Board Composition (BODCOM)	+	0.11	0.67	Not Supported
CEO Duality (DUAL)	-	(-)0.04	(-)0.34	Not Supported
Board Size (BSIZE)	-	(-)0.26*	(-)2.10	Supported
Chairman of Directors' Shareholdings (COWN)	+	0.10	0.85	Not Supported
Audit Committee Independence (ACIND)	+	0.18	1.50	Not Supported
Audit Committee Meetings (ACMEET)	+	(-)0.03	(-)0.19	Not Supported
Audit Committees' Shareholdings (ACOWN)	+	0.03	0.28	Not Supported
Audit committee meeting with the CIA (ACIAM)	+	(-)0.13	(-)0.78	Not Supported
Audit Committee Reviews of IA Proposals (ACREV1)	+	0.49*	2.523	Supported
Audit Committee Reviews of the Result of IA (ACREV2)	+	0.05	0.34	Not Supported

Notes:

**Correlation is significant at the 0.01 level (2- tailed).

*Correlation is significant at the 0.05 level (2- tailed).

5.5.3 Summary of Hypotheses Testing: Internal Corporate Governance and Firm Performance

Based on the findings from the Pearson correlation analysis and regression analyses conducted in this chapter, Table 5.11 summarizes the findings relating to the hypotheses testing procedures at the 0.01 and 0.05 levels of significance. The analyses show that the effect of internal corporate governance variables on ROA and TQ are somewhat different. For board of director's characteristics, the proportion of non-executive directors and ROA is positively significant. However, there is no significant relationship between the proportion of non-executive directors and TQ.

CEO duality variable is not significant to either measure of firm performance (ROA and TQ). Board size and ROA is not significant. However, there is a negatively significant relationship between board size and TQ. The chairman's shareholdings variable is not

significant to either measure of firm performance (ROA and TQ). For audit committee characteristics, the independence of the audit committee members' variable is not significant to either measure of firm performance (ROA and TQ).

The relationship between the frequency of audit committee meetings and ROA is negatively significant. However, there is no significant relationship between the frequency of audit committee meetings and TQ. The audit committees' shareholdings variable is not significant to either measure of firm performance (ROA and TQ). The frequency of meetings between the audit committee and internal auditor variable is not significant to either measure of firm performance (ROA and TQ).

The extent of AC reviews of IA proposals variable is positively significant to both measures of firm performance (ROA and TQ). The relationship between the extent of AC reviews of the results of internal audit activities and ROA is positively significant. However, there is no significant relationship between the extent of AC reviews of the results of internal audit activities and TQ.

Table 5.11
Summary of the Hypotheses Testing Results

Hy no	Hypothesis statement	Decision
H1	There is a positive relationship between the proportion of non-executive directors and firm performance.	Partially Supported
H2	There is a negative relationship between the CEO duality and firm performance.	Not Supported
H3	There is a negative association between board size and firm performance.	Partially Supported
H4	There is a positive relationship between chairman's' shareholdings and firm performance.	Not Supported
H5	There is a positive relationship between the independence of the audit committee members and firm performance.	Not Supported
H6	There is a positive relationship between the frequencies of audit committee meeting and firm performance.	Not Supported
H7	There is a positive relationship between audit committees' shareholdings and firm performance.	Not Supported
H8	There is a positive relationship between the frequency of meeting between audit committee and internal auditor and firm performance.	Not Supported
H9	There is a positive relationship between the extents of AC reviews of IA proposals and firm performance.	Supported
H10	There is a positive relationship between the extents of AC reviews of the results of internal audit activities and firm performance.	Partially Supported

In conclusion, the results of this study obtained from Pearson correlation and multiple regression analyses reveal that while some hypotheses are supported or partially supported by the empirical results, others are not supported. More specifically, Table 5.11 shows that H9 is supported; H1, H3 and H10 are partially supported; while H2, H4, H5, H6, H7 and H8 are not supported.

5.6 Further Analyses

This study conducted further tests to examine whether the main results were sensitive to different variables and different measurements. First, the variables were splitted into two categories variables, board of director's characteristics and audit committee characteristics to examine their effects on firm performance. Next, different measurements were used to confirm the main findings. In addition, this study conducted further test to examine the moderating role of control variables, firm size and debt, on the relationship between internal corporate governance and firm performance.In this way, the additional tests were conducted to obtain a richer explanation and ensure the robustness of the results in achieving consistent findings.

5.6.1 Board of Directors and Audit Committee Characteristics

Previous research conducted by some researchers like Xie *et al.* (2003) and Hsu (2007) suggested that audit committee characteristics should not be included in the same regressions with board characteristic variables because of the high correlation between the two sets of variables.

5.6.1.1 Board of Directors Characteristics

The relationship between board of director's characteristics and firm performance was analysed by using the following two models:

Model 1:

$$ROA = \alpha 0 + \beta 1\ BODCOM + \beta 2\ DUAL + \beta 3\ BSIZE + \beta 4\ COWN + \beta 5\ FSIZE + \beta 6\ DEBT + \varepsilon$$

Model 2:

$$TQ = \alpha 0 + \beta 1\ BODCOM + \beta 2\ DUAL + \beta 3\ BSIZE + \beta 4\ COWN + \beta 5\ FSIZE + \beta 6\ DEBT + \varepsilon$$

Where:

ROA - Return on assets; proxy for accounting measurement of firm performance.

TQ – Tobin s'Q.

α0 – Intercept

BODCOM - Board composition.

DUAL - Role duality; chairman of the board is also the chief executive officer.

BSIZE - Board size.

COWN - Shareholdings held by Chairman.

FSIZE – The book value of the total assets of company.

DEBT – The percentage of total liabilities to total assets.

ε - Error term.

The results in Table 5.12 show consistency with the main findings in which the insignificant variables (DUAL and COWN) and directions of the relationships remained the same. For board composition (BODCOM), the main models revealed that the

relationship between the proportion of non-executive directors and ROA was found to be positively significant and there was no significant relationship between the proportion of non-executive directors and TQ. However, when the board characteristics variableswere run separately, the proportion of non-executive directors and both of the firm performance measurements (ROA and TQ) was found to be positively significant. In terms of board size, it was found that small board size enhances company performance when it is measured by TQ. Therefore, these findings confirm the main findings for hypothesis H1c that Saudi Stock Market companies with smaller board size tend to have better company performance.

Table 5.12
Regression Results between Board Variables and Firm Performance (ROA and TQ)

Variables	ROA (MODEL 1)		TQ (Model 2)	
	Beta	t-value	Beta	t-value
(Constant)		-1.214		3.452
Board Composition (BODCOM)	.803**	9.304	.434**	3.643
CEO Duality (DUAL)	.147	1.623	.038	.302
Board Size (BSIZE)	-.032	-.366	-.254*	(-)2.074
Chairman of Directors' Shareholdings (COWN)	.146	1.612	.206	1.652
Firm size (FSIZE)	.013	.151	-.136	-1.104
Debt ratio (DEBT)	-.050	-.542	-.062	-.493
R2		.624		.283
Adjusted R2		.583		.204
F-value		15.218		3.610
F-Significance		0.000		.004

5.6.1.2 Audit Committee Characteristics

The relationship between audit committee characteristics and firm performance was analyzed by using the following two models.

Model 1:

$$ROA = \alpha 0 + \beta 1ACIND + \beta 2\ ACME + \beta 3\ ACOWN + \beta 4\ ACIAM + \beta 5ACREV1 + \beta 6ACREV2 + \beta 7\ FSIZE + \beta 8\ DEBT + \varepsilon$$

Model 2:

$$TQ = \alpha 0 + \beta 1ACIND + \beta 2\ ACMEET + \beta 3\ ACOWN + \beta 4\ ACIAM + \beta 5ACREV1 + \beta 6ACREV2 + \beta 7\ FSIZE + \beta 8\ DEBT + \varepsilon$$

Where:

ROA - Return on assets; proxy for accounting measurement of firm performance.

TQ – Tobin s'Q.

$\alpha 0$ – Intercept

ACIND – Audit committee independence.

ACMEET – Audit committee meeting.

ACOWN - Shareholdings held by audit committee.

ACIAM – Audit committee meeting with the cheif internal auditor.

ACREV1 – Audit Committee Reviews of IA Programmes and Plans.

ACREV2 – Audit Committee Reviews of IA Results.

FSIZE – The book value of the total assets of company.

DEBT – The percentage of total liabilities to total assets.

ε - Error term.

The results inTable 5.13are consistent with the main findings in which the insignificant variables (ACIND, ACOWN and ACIAM) and directions of the relationships remained the same. The results also reveal similar effect in which the significant variables (ACREV1 and ACREV2) and directions of the relationships remained the same except audit committee meeting (ACMEET) is not significantly related to ROA.

Table 5.13
Regression Results between AC Variables and Firm Performance (ROA and TQ)

Variables	ROA (MODEL 1)		TQ (Model 2)	
	Beta	t-value	Beta	t-value
(Constant)		-1.688		.989
Audit Committee Independence (ACIND)	-.004	-.053	.193	1.626
Audit Committee Meetings (ACMEET)	-.064	-.689	-.095	-.635
Audit Committees' Shareholdings (ACOWN)	-.047	-.615	.018	.150
Audit committee meeting with the CIA (ACIAM)	-.068	-.675	-.118	-.731
Audit Committee Reviews of IA Proposals (ACREV1)	.682**	6.863	.525**	3.298
Audit Committee Reviews of the Result of IA (ACREV2)	.287**	3.090	.059	.395
Firm size (FSIZE)	-.119	-1.675	-.239*	(-)2.100
Debt ratio (DEBT)	.081	1.094	.119	.999
R2		.746		.348
Adjusted R2		.708		.249
F-value		19.488		3.531
F-Significance		0.000		0.002

5.6.2 Sensitivity of Proxy for Audit Committee Meetings (ACMEET)

Regression analyses were also run to check the sensitivity of using different measurement of audit committee characteristics in the relationship. The results in Table 5.14 showthat by using alternate dichotomous variable of audit committee meetings

(ACMEET) (which is coded 1 if the number of meetings is at least four times per year, 0 otherwise), the analyses revealed that audit committee meetings variable was reported to be not significant to both measures of firm performance (ROA and TQ). The most glaring difference was that the findings showed a negatively significant relationship to ROA but the alternative measure showed aninsignificant relationship to ROA.

Table 5.14
Regression Results between ACMEET (alternative measure) and Firm Performance (ROA and TQ)

Variable	ROA (MODEL 1)		TQ (Model 2)	
	Beta	t-value	Beta	t-value
Audit Committee Meetings (ACMEET)	-.100	-1.090	.076	.468

5.6.3 Sensitivity of Proxy for CEO Duality (DUAL)

The measurement of CEO duality based only on the positions separation between the chairman and CEO as required by the Saudi Corporate Governance Code (CMA, 2006:Art. 12d). However, it was also base on the presence of independence from family relationship and significant shareholders (Kamardin, 2009). Hence, this study repeated the regression model by using this alternative measure.

The results in Table 5.15 show that by using alternate dichotomous variable of CEO duality (DUAL)(which is coded 1 if the CEO is the board chairman and also from the same family, 0 otherwise), the analyses revealed that CEO duality (DUAL) variable was reported to be significant to both measures of firm performance (ROA and TQ).

The most glaring difference was that the findings showed insignificant relationship to ROA and TQ, however, the alternative measure showed significant relationship to both of them (ROA and TQ).

Table 5.15
Regression Results between CEO Duality (alternative measure) and Firm Performance (ROA and TQ)

Variable	ROA (MODEL 1)		TQ (Model 2)	
	Beta	t-value	Beta	t-value
CEO duality (DUAL)	(-).160**	2.021-	.252*	1.762

Notes:

**Correlation is significant at the 0.05 level (2- tailed).

*Correlation is significant at the 0.10 level (2- tailed).

5.6.4Sensitivity for Using the Control Variables (Firm Size and Debt) As Moderators

In order to know the sensitivity of this study for using firm size and debt as moderators and make this study more significant in term of its contribution to knowledge, the moderating role of firm size and debt in the relationship between internal corporate governance and firm performance was examined. Firm size plays a significant role in influencing the board characteristics and firms' growth capabilities (Baek *et al.*, 2004). It is also believed that firm size has a considerable impact on the organizations' corporate governance practices, remuneration policy and capabilities to generate a better growth and market expansion. This is because it represents the complexity of the organizations' operation and requires different boards' characteristics in pursuing more strategic roles for better achievement (Fama & Jensen, 1983). Moreover, larger firms have a greater

capacity to adopt governance measures since they may interact with the international market on a more frequent basis, and are therefore required to keep up with the procedures.

In terms of debt, debt financing provides an alternative or complementary monitoring mechanism to managerial ownership for reducing the agency costs of an organisation, as external financing can induce monitoring by lenders (Agrawal & Knoeber, 1996;Ang, Cole, &, Wuh Lin, 2000).Direct monitoring by these debt covenants and capital market participants also will put the organisations on the alert, as they know that these external parties will subject them to continual scrutiny (Mustapha, 2009). Furthermore, a study by Ang *et al.* (2000) found that agency costs are lower with greater monitoring by banks. In addition, banks also lead organisations to operate more efficiently by better utilising assets and moderating perquisite consumptions in order to improve the organisations' reported financial performance to the banks (Ang *et al.*, 2000). This is agreed by Jensen (1986) who states that the action of managers of organisation with high debts will be monitored by the debt holders and controlled by the debt contracts. Regression analyses related to the moderating effect are presented in the following sub-sections:

5.6.4.1 The Moderating Effect of the Firm Size on the Relationshipbetween Internal Corporate Governance Mechanisms and Firm Performance (ROA)

The results of the hierarchical regression analysis were reported through the following three models as illustrated in Table 5.16.

Model 1: In this model, the fourboard of directors characteristics and the sixaudit committee characteristics were introduced to the model. This model, however, was found to be significant ($F=23.382$, $p<0.001$) with adjusted R^2 as 78.6percent and significant F change at the 0.001 level of significance. The results in Table5.16 show that board composition (BODCOM), audit committee reviews of IA proposals (ACREV1) and audit committee reviews of the result of IA (ACREV2) were found to have significant effect on firm performance(ROA)with the indicators ($\beta= 0.447$, $t= 4.963$, $p<0.01$), ($\beta= 0.398$, $t= 3.837$, $p<0.01$)and ($\beta= 0.213$, $t=2.601$, $p<0.05$) respectively. In addition, an audit committee meetings variable (ACMEET) wasfound to be significant predictor toward ROA only at the 0.10 level of significance.

Model 2: In this model, firm size (FSIZE) was introduced to examine its predictive power toward firm performance (ROA). Even though the model showed a significant result at the 0.01 level, it did not improve the explanatory power of the model since the R^2 change was not significant (R^2 change=0.002, $p>0.1$). Furthermore, this model accounted for 90.7percent of the variance in the model. Four variables in this model were reported to have a significant predictive power toward firm performance (ROA). There variables were namely, board composition (BODCOM), audit committee meetings (ACMEET), audit committee reviews of IA proposals (ACREV1) and audit committee reviews of the result of IA (ACREV2) with indicators ($\beta= 0.436$, $t= 4.747$, $p<0.01$), ($\beta= -0.184$, $t= -2.070$, $p<0.1$), ($\beta= 0.404$, $t= 3.866$, $p<0.01$) and ($\beta= 0.212$, $t= 2.584$, $p<0.05$) respectively.

Model 3: In this model, the interaction terms between firm size (FSIZE) and board of directors, audit committee characteristics were examined to test the moderating effects of this study. This model was reported to be significant at the 0.01 level of significance (F=10.962 p<0.01) accounting for 92.3percent of the dependent variance. However, this model found to be insignificant (R^2 change= 0.029, p>0.05).

The results in Table 5.16 show that only board composition (BODCOM)(β= 0.292, t= 3.431, p<0.1) was reported to be significant predictor of firm performance (ROA) at the 0.1 level of significance.

The results regarding the interaction terms reveal that only one relationship in the model was significantly moderated by firm size (FSIZE). Specifically, the interaction term between firm size (FSIZE) and audit committees' shareholdings (ACOWN) was significant at the 0.1 level of significance (β= - 0.525, t= - 3.609, p<0.1). These results, however, indicatethatfirm size (FSIZE) negatively moderate the relationship between audit committees' shareholdings (ACOWN) and firm performance (ROA).

Table 5.16
The Moderating Effect of Firm Size on the Detailed Model

	Model 1	Model 2	Model 3
Variables	Predictors	Moderators	Interactions
Board Composition (BODCOM)	0.447***	.436***	.436*
CEO Duality (DUAL)	.091	.091	.091
Board Size (BSIZE)	-.053	-.042	-.042
Chairman of Directors' Shareholdings (COWN)	.046	.052	.052

Table 5.16 (Continued)

	Model 1	Model 2	Model 3
Variables	Predictors	Moderators	Interactions
Audit Committee Independence (ACIND)	.014	.012	.012
Audit Committee Meetings (ACMEET)	-.184*	-.184*	-.184
Audit Committees' Shareholdings (ACOWN)	-.042	-.041	-.041
Audit committee meeting with the CIA (ACIAM)	.067	.072	.072
Audit Committee Reviews of IA Proposals (ACREV1)	.398***	.404***	.404
Audit Committee Reviews of the Result of IA (ACREV2)	.213**	.212**	.212
Firm Size (FSIZE)		-.046	-.046
BORCOM x FSIZE			.001
DULT x FSIZE			.015
BSIZE x FSIZE			.679
COWN x FSIZE			1.187
ACIND x FSIZE			-.178
ACMEET x FSIZE			2.428
ACOWN x FSIZE			-.655*
ACIAM x FSIZE			-1.362
ACREV1 x FSIZE			-.765
ACREV2 x FSIZE			-.361
F value	23.382	21.097	10.962
F Sig.	0	0	0
R^2	.906	.907	.923
Adjusted R^2	.786	.784	.774
R^2 change	.821	.002	.029
Significant F change	0	.480	.639

* : p< 0.1; **: p<0.05; ***: p<0.01

Figures5.5and 5.6show that while the effects of other board and audit committee characteristics on firm performance (ROA) were proven not to be significantly moderated, their effects on ROA were found to be worth noting. Specifically, it can be noticed that in the high firm size (FSIZE), CEO duality (DUAL) and large board size (BSIZE) lead to a better firm performance (ROA).

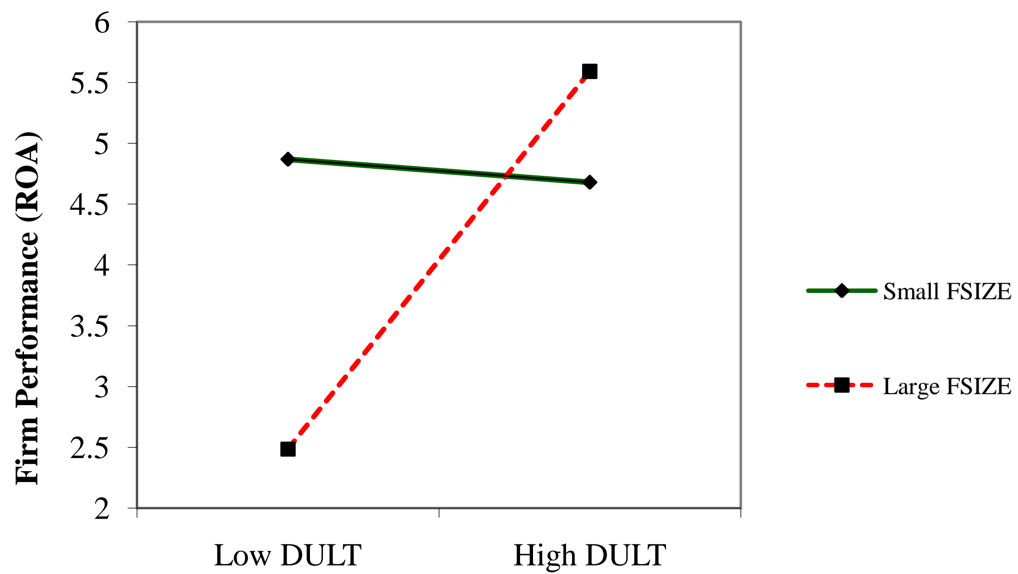

Figure 5.5
The ModeratingEffect of FSIZE on DUAL - ROA Relationship

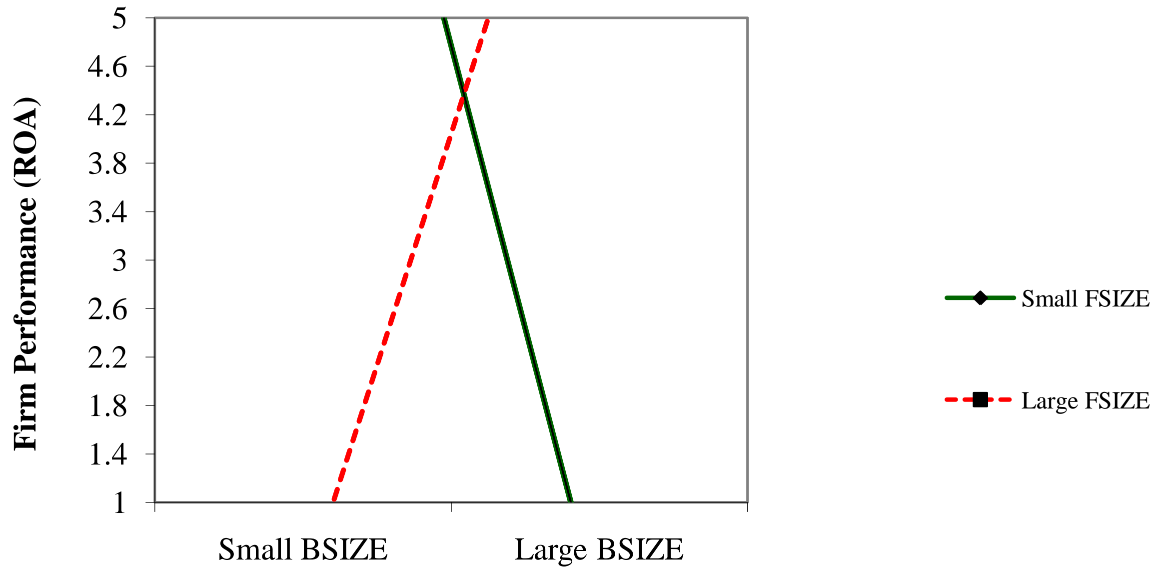

Figure 5.6
The ModeratingEffect of FSIZE on BSIZE - ROA Relationship

5.6.4.2 The Moderating Effect of the Firm Sizeon the Relationship between Internal Corporate Governance Mechanisms and Firm Performance (TQ)

The results of the hierarchical regression analysis were reported through the following three models as illustrated in Table 5.17.

Model 1: In this model, the fourboard of directors characteristics and the sixaudit committee characteristics were introduced to the model. This model, however, was found to be significant ($F=3.351$, $p<0.01$) with adjusted R^2 as 27.8percent and significant F change at the 0.01 level of significance. The results in Table4.16 showed that CEO duality (DUAL) andaudit committee reviews of IA proposals (ACREV1) were found to have significant effect on firm performance(TQ)with the indicators ($\beta= -0.017$, $t= -0.144$, $p<0.05$)and ($\beta= 0.448$, $t=2.352$, $p<0.05$) respectively.

Model 2: In this model, firm size (FSIZE) was introduced to examine its predictive power toward firm performance(TQ). Even though the model showed a significant result at the 0.01 level, it did not improve the explanatory power of the model since the R^2 change was not significant (R^2 change=0.002, $p>0.1$). Furthermore, this model accounted for 42percent of the variance in the model. Two variables in this model were reported significant predictive power toward firm performance(TQ). Two variables were namely, board size (BSIZE) and audit committee reviews of IA proposals (ACREV1) with indicators (β= -0.271, t= -2.204, $p<0.05$) and (β= 0.471, t= 2.491, $p<0.05$) respectively.

Model 3: In this model, the interaction terms between firm size (FSIZE) and board of directors, audit committee characteristics were examined to test the moderating effects of this study. This model was reported to be significant at 0.05 level of significance (F=1.882 $p<0.05$) accounting for 49.7percent of the dependent variance. However, this model found to be insignificant (R^2 change= 0.077, $p>0.1$).

The results in Table 4.16 show that only chairman of directors' shareholdings (COWN) (β= 0.594, t= 3.431, $p<0.05$) was reported to be significant predictor of firm performance (TQ) at the 0.1 level of significance.

The results regarding the interaction terms reveal that only one relationship in the model was significantly moderated by firm size (FSIZE). Specifically, the interaction term between firm size (FSIZE) and board size (BSIZE),chairman of directors' shareholdings (COWN) and audit committee reviews of IA proposals (ACREV1) were significant with

indicators (β= 0.441, t= 4.820, p<0.01), (β= 0.183, t= 2.049, p<0.05) and (β= - 0.525, t= - 3.609, p<0.1) respectively. However, the results indicated that firm size (FSIZE) negatively moderate the relationship between audit committee reviews of IA proposals (ACREV1)and firm performance (TQ).

Table 5.17

The Moderating Effect of Firm Size on the Detailed Model

	Model 1	Model 2	Model 3
Variables	Predictors	Moderators	Interactions
Board Composition (BODCOM)	.168	.128	.650
CEO Duality (DUAL)	-.017**	-.020	.150
Board Size (BSIZE)	-.311	-.271**	.496
Chairman of Directors' Shareholdings (COWN)	.105	.128	.594**
Audit Committee Independence (ACIND)	.167	.159	-.115
Audit Committee Meetings (ACMEET)	-.031	-.033	2.819
Audit Committees' Shareholdings (ACOWN)	.023	.029	-.153
Audit committee meeting with the CIA (ACIAM)	-.135	-.119	-1.421
Audit Committee Reviews of IA Proposals (ACREV1)	.448**	.471**	-.820
Audit Committee Reviews of the Result of IA (ACREV2)	.045	.044	-.376
Firm Size (FSIZE)		-.167	-2.183*
BORCOM x FSIZE			1.429
DULT x FSIZE			.385
BSIZE x FSIZE			2.964*
COWN x FSIZE			3.612**

Table 5.17 (Continued)

	Model 1	Model 2	Model 3
Variables	Predictors	Moderators	Interactions
ACIND x FSIZE			-.504
ACMEET x FSIZE			7.517
ACOWN x FSIZE			-1.110
ACIAM x FSIZE			-3.711
ACREV1 x FSIZE			-3.719*
ACREV2 x FSIZE			-1.150
F value	3.351	3.293	1.882
F Sig.	.002	.002	.042
R2	.396	.420	.497
Adjusted R2	.278	.293	.233
R2 change	.396	.024	.077
Significant F change	.002	.160	.794

* : p< 0.1; **: p<0.05; ***: p<0.01

Referring to the graphs in Figures5.7, 5.8 and 5.9, it can be clearly shown that large board size (BSIZE) and high board of directors shares (COWN) can enhance the firm performance (TQ) in the presence of high firm size (FSIZE) much better than otherwise. On the other hand, audit committee reviews of IA proposals (ACREV1) can enhance the firm performance (TQ) especially when firm size (FSIZE) is low.

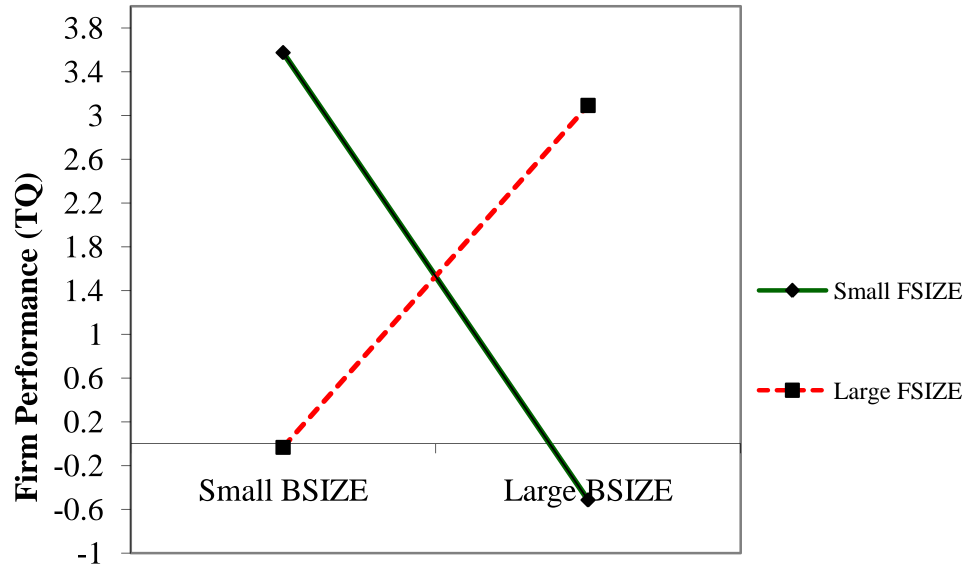

Figure 5.7
The ModeratingEffect of FSIZE on BSIZE -TQ Relationship

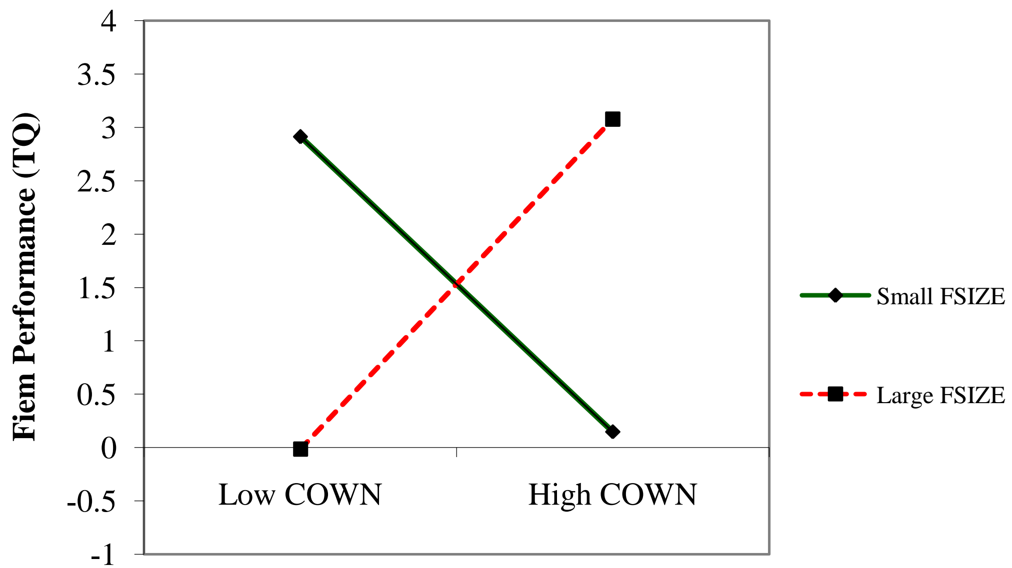

Figure 5.8
The ModeratingEffect of FSIZE on COWN -TQ Relationships

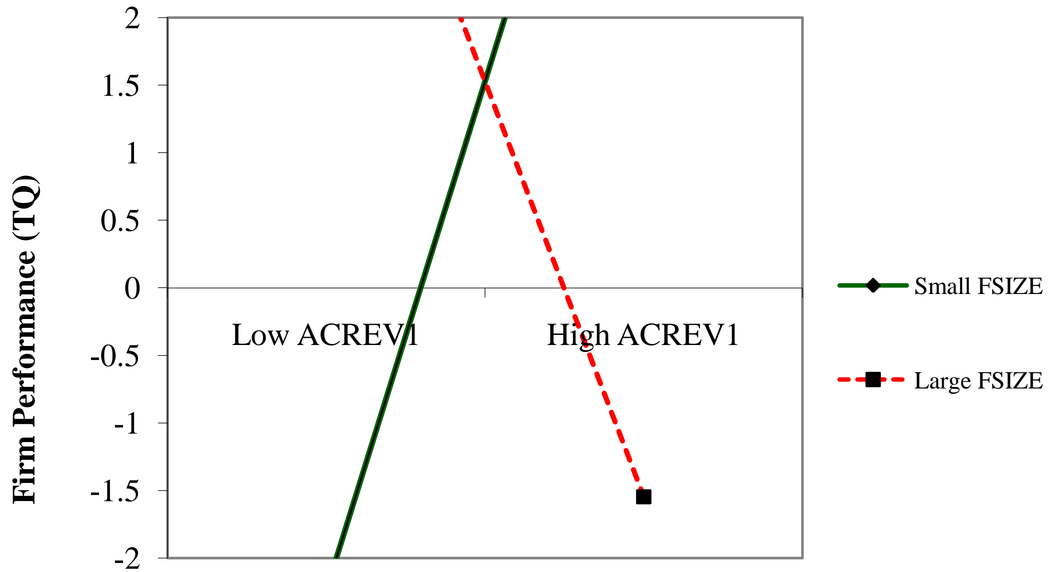

Figure 5.9
The ModeratingEffect of FSIZE on ACREV1-TQ Relationship

Referring to the graphs in Figures5.10, 5.11, 5.12, 5.13, 5.14, 5.15 and 5.16, it clearly showed that large non-executive directors(NEDs), CEO duality (DULT), audit committee meetings (ACMEET)can enhance firm performance (TQ) in the presence of large FSIZE much better than otherwise. On the other hand, high audit committee independence (ACIND), high audit committees' shareholdings (ACOWN), high audit committee meeting with the CIA (ACIAM) and high audit committee reviews of the result of IA (ACREV2) can enhance firm performance (TQ) especially when firm size (FSIZE) is small.

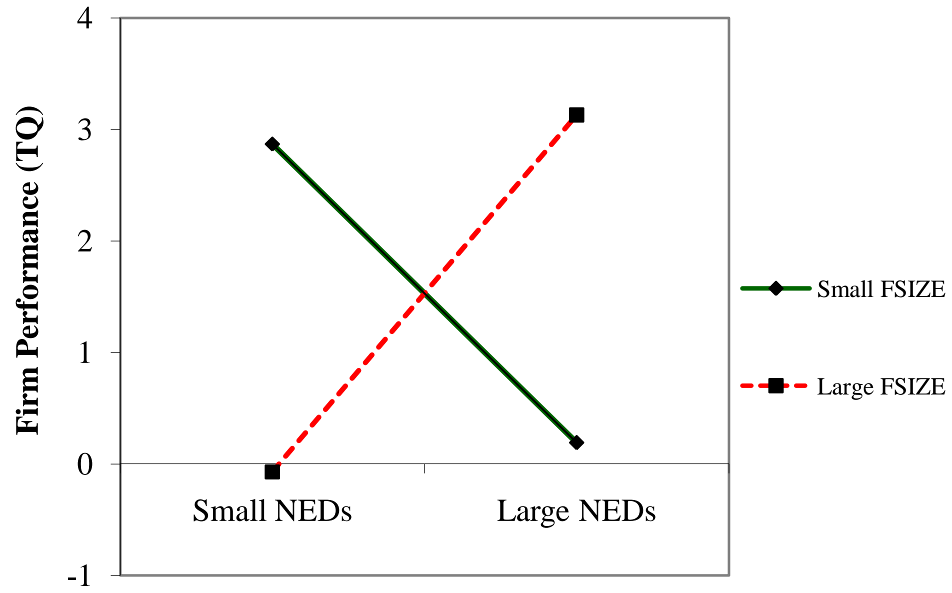

Figure 5.10
The ModeratingEffect of FSIZE on BOCOM(NEDs) –TQ Relationship

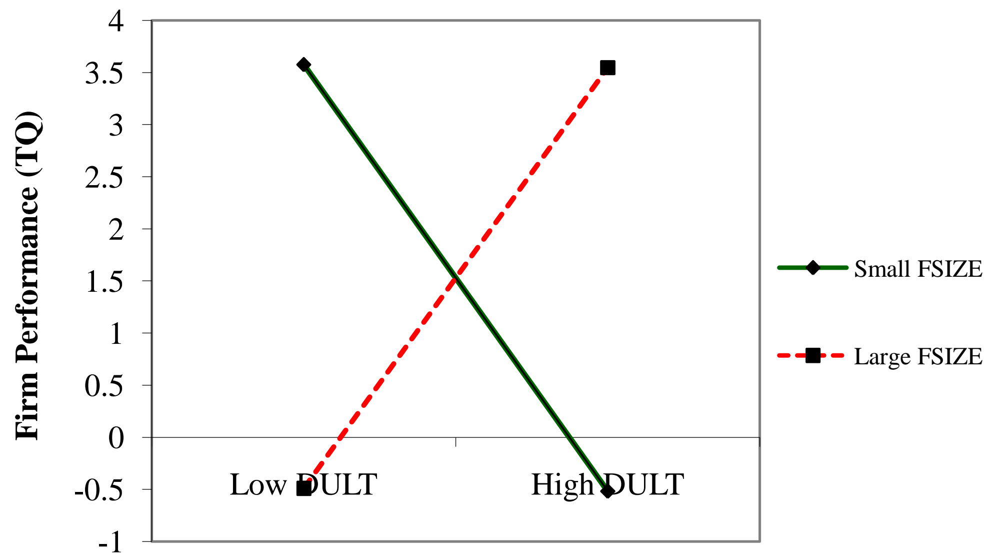

Figure 5.11
The ModeratingEffect of FSIZE on DULT –TQ Relationships

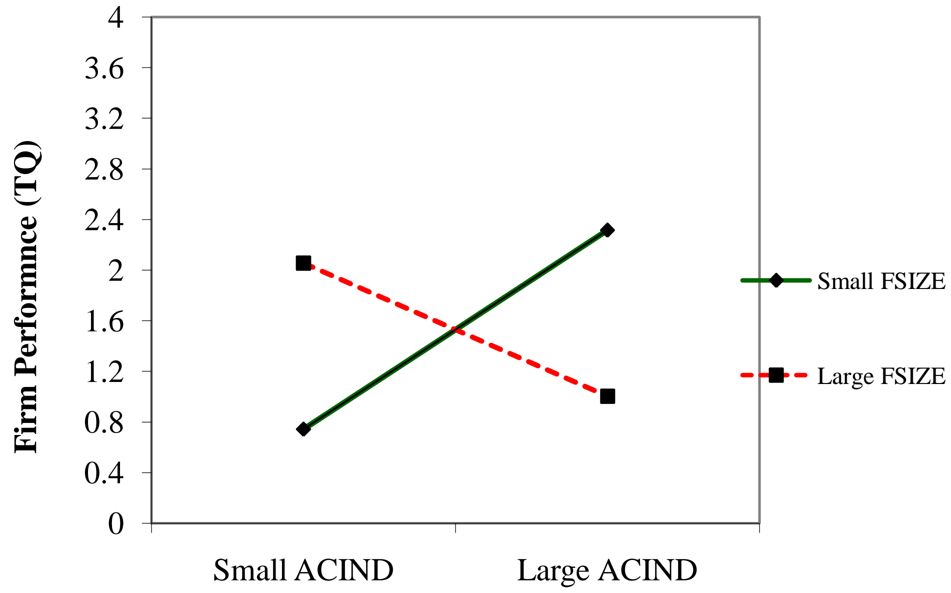

Figure 5.12
The ModeratingEffect of FSIZE on ACIND– TQ Relationship

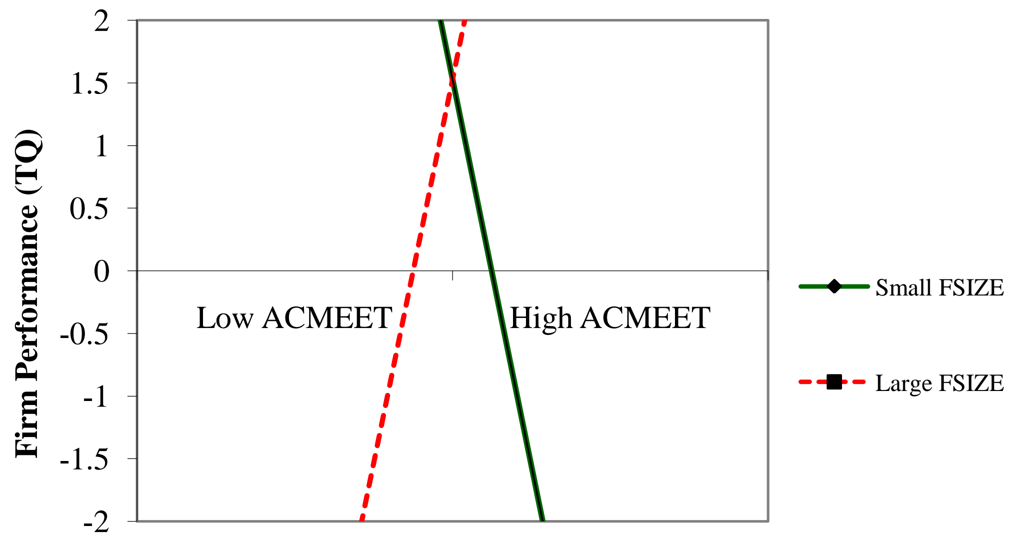

Figure 5.13
The ModeratingEffect of FSIZE on ACMEET–TQ Relationship

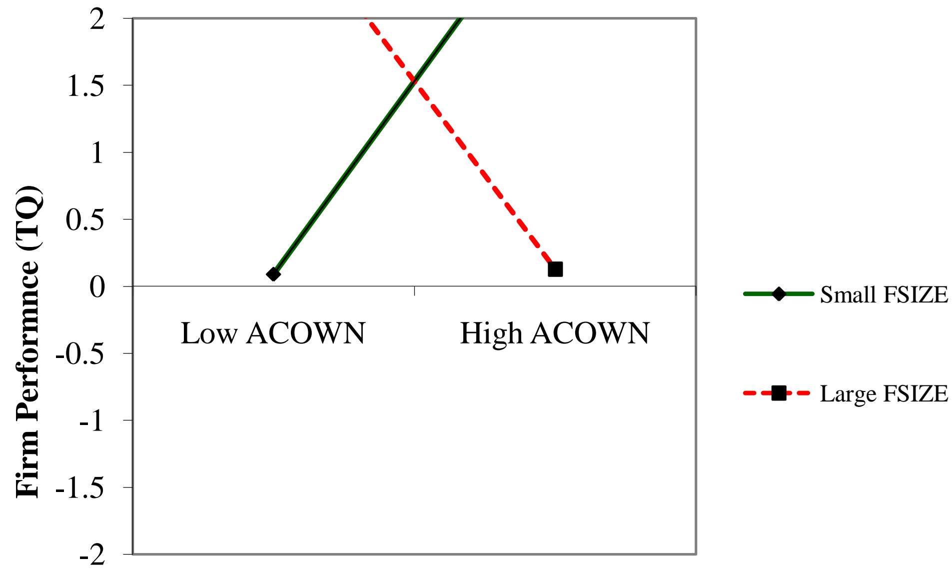

Figure 5.14
The ModeratingEffect of FSIZE on ACOWN–TQ Relationship

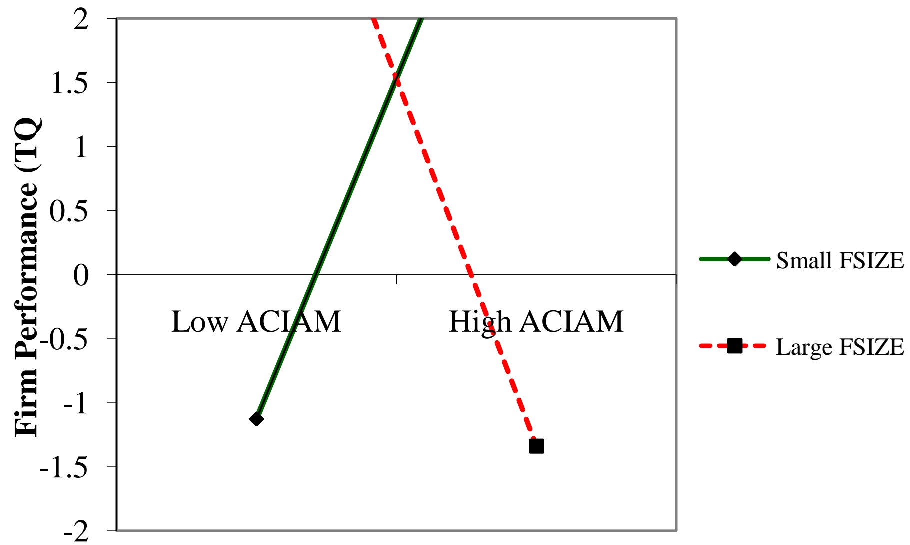

Figure 5.15
The ModeratingEffect of FSIZE on ACIAM –TQ Relationship

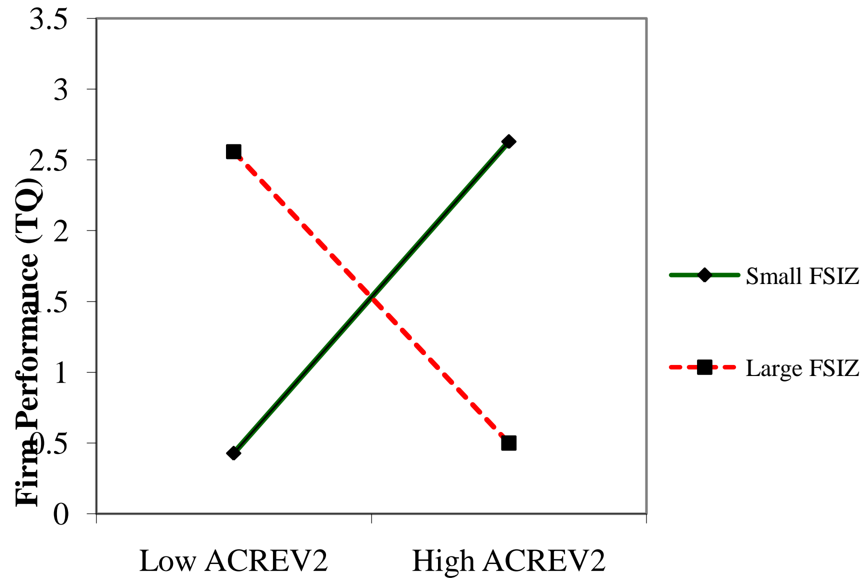

Figure 5.16
The ModeratingEffect of FSIZE on ACREV2 –TQ Relationships

5.6.4.3 The Moderating Effect of the Debt on the Relationships between Internal Corporate Governance Mechanisms and Firm Performance (ROA)

The results of the hierarchical regression analysis were reported through the following three models as illustrated in Table 5.18.

Model 1: In this model, the fourboard of directors characteristics and the sixaudit committee characteristics were introduced to the model. This model, however, was found to be significant (F=23.382, p<0.01) with adjusted R^2 as 78.6percent and significant F change at the 0.001 level of significance. The results in Table5.18 showed that board composition (BODCOM), audit committee meetings (ACMEET), audit committee reviews of IA proposals (ACREV1)andaudit committee reviews of the result of IA (ACREV2) were found to have significant effect on firm performance(ROA)with

the indicators (β= 0.447, t= 4.963, $p<0.01$), (β= -0.184, t= -2.078, $p<0.05$), (β= 0.398, t= 3.837, $p<0.01$)and (β= 0.213, t=2.601, $p<0.05$) respectively.

Model 2: In this model, debt ratio (DEBT) was introduced to examine its predictive power toward firm performance (ROA). Even though the model showed a significant result at the 0.01 level, it did not improve the explanatory power of the model since the R^2 change was not significant (R^2 change=0.001, $p>0.1$). Furthermore, this model accounted for 82.2percent of the variance in the model. Four variables in this model were reported significant predictive power toward firm performance (ROA). There variables were namely, board composition (BODCOM), audit committee meetings (ACMEET), audit committee reviews of IA proposals (ACREV1) and audit committee reviews of the result of IA (ACREV2) with indicators (β= 0.441, t= 4.820, $p<0.01$), (β= -0.183, t= -2.049, $p<0.05$), (β= 0.404, t= 3.833, $p<0.01$) and (β= 0.216, t= 2.610, $p<0.05$) respectively.

Model 3: In this model, the interaction terms between debt ratio (DEBT) and board of directors, audit committee characteristics were examined to test the moderating effects of this study. This model was reported to be significant at the 0.01 level of significance (F=10.400 $p<0.01$) accounting for 84.5percent of the dependent variance. However, this model found to be insignificant (R^2 change= 0.024, $p>0.05$).

The results in Table 5.18 show that non-executive directors (NEDs), audit committee reviews of IA proposals (ACREV1)and audit committee reviews of the result of IA (ACREV2)were reported to be significant predictors of firm performance (TQ) with

indicators (β= 0.307, t= 2.508, p<0.05), (β= 0.307, t= 2.508, p<0.05) and (β= 0.458, t= 2.362, p<0.05) respectively.

The results regarding the interaction terms revealed that there is no relationship in the model was significantly moderated by debt ratio (DEBT).

Table 5.18
The Moderating Effect of DEBT on the Detailed Model

	Model 1	Model 2	Model 3
Variables	Predictors	Moderators	Interactions
Board Composition (BODCOM)	.447***	.441***	.415***
CEO Duality (DUAL)	.091	.082	.057
Board Size (BSIZE)	-.053	-.050	-.029
Chairman of Directors' Shareholdings (COWN)	.046	.035	.041
Audit Committee Independence (ACIND)	.014	.021	.033
Audit Committee Meetings (ACMEET)	-.184**	-.183**	-.262
Audit Committees' Shareholdings (ACOWN)	-.042	-.040	.120
Audit committee meeting with the CIA (ACIAM)	.067	.061	.058
Audit Committee Reviews of IA Proposals (ACREV1)	.398***	.404***	.378**
Audit Committee Reviews of the Result of IA (ACREV2)	.213**	.216**	.248**
Debt Ratio (DEBT)		.032	.089
BORCOM x DEBT			1.429
DULT x DEBT			.385
BSIZE x DEBT			2.964

Table 5.18 (Continued)

	Model 1	Model 2	Model 3
Variables	Predictors	Moderators	Interactions
COWN x DEBT			3.612
ACIND x DEBT			-.504
ACMEET x DEBT			7.517
ACOWN x DEBT			-1.110
ACIAM x DEBT			-3.711
ACREV1 x DEBT			-3.719
ACREV2 x DEBT			-1.150
F value	23.382	20.942	10.400
F Sig.	0	0	0
R2	.821	.822	.845
Adjusted R2	.786	.782	.764
R2 change	.821	.001	.024
Significant F change	0	.656	.797

* : p< 0.1; **: p<0.05; ***: p<0.01

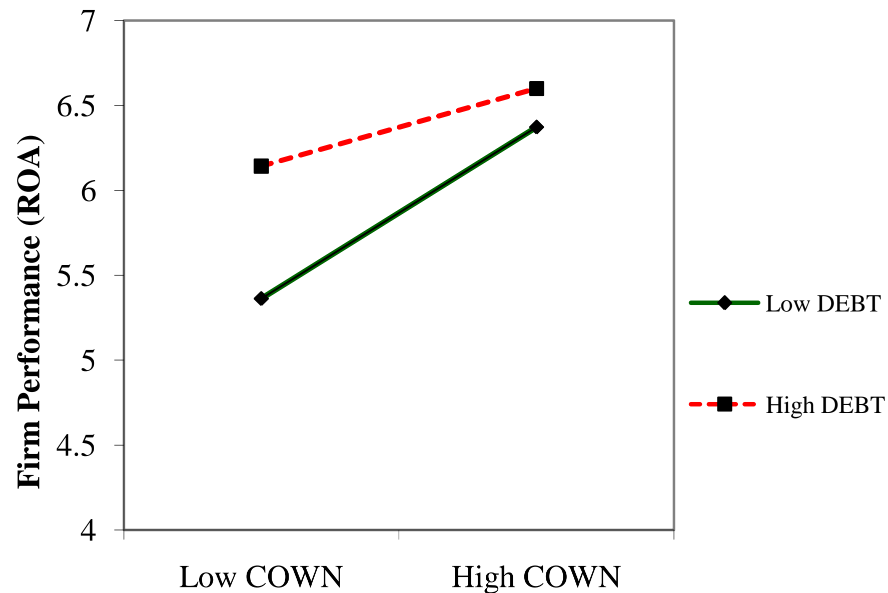

Figure 5.17
The ModeratingEffect of DEBT on COWN – ROA Relationship

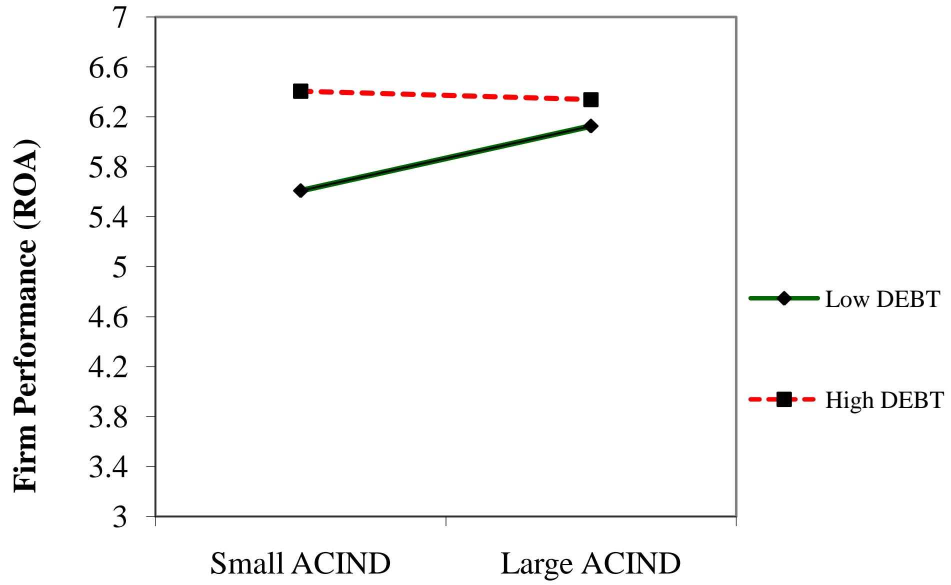

Figure 5.18
The ModeratingEffect of DEBT on ACIND – ROA Relationship

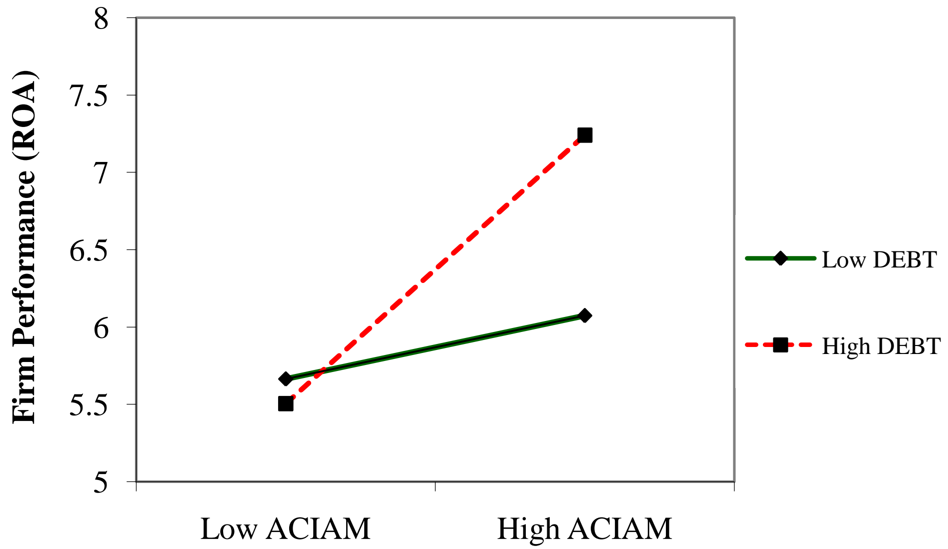

Figure 5.19
The ModeratingEffect of DEBT on ACIAM – ROA Relationship

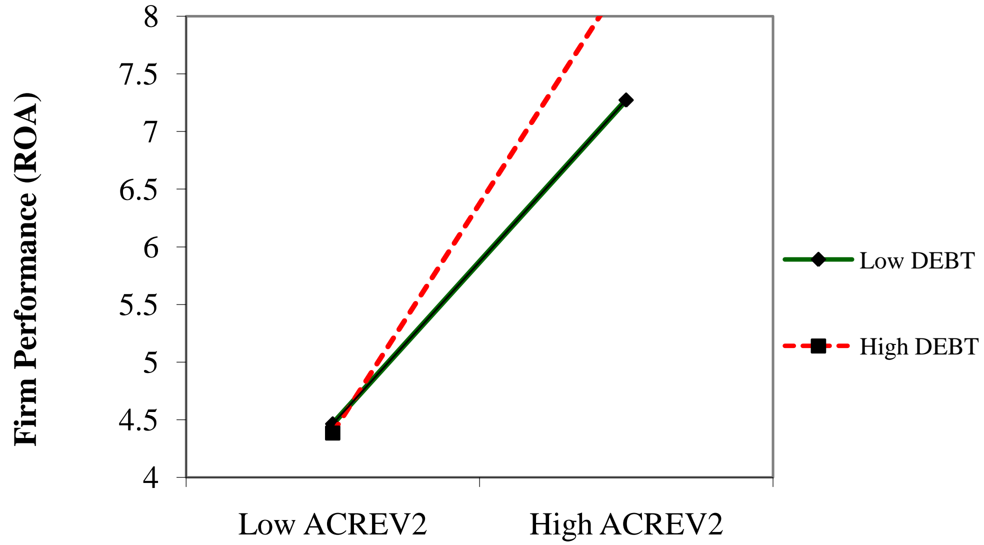

Figure 5.20
The ModeratingEffect of DEBT on ACREV2 – ROA Relationship

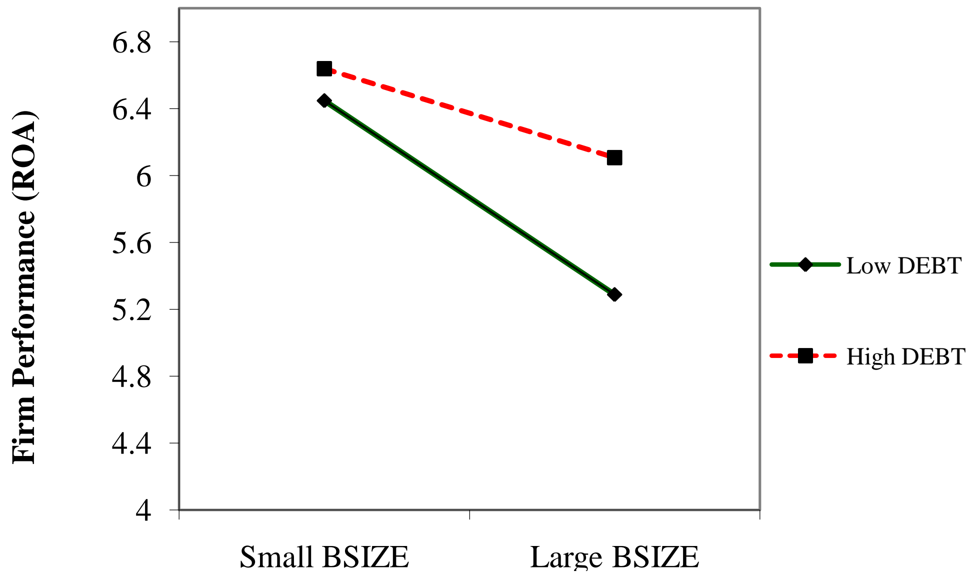

Figure 5.21
The ModeratingEffect of DEBT on BSIZE–ROARelationship

Figures5.17, 5.18, 5.19 and 5.20showed that while the effects of board and audit committee characteristics on firm performance (ROA) were proven not to be significantly moderated by debt ratio (DEBT), their effects on performance were found

to be worth noting. Specifically, it can be noticed that in the high debt ratio (DEBT), audit committee meeting with the CIA (ACIAM) and audit committee reviews of the result of IA (ACREV2) lead to a better performance. On the other hand, it was also illustrated that chairman of directors' shareholdings (COWN) and audit committee independence (ACIND) can enhance firm performance in low debt ratio (DEBT) to a higher level than in the case of high debt ratio (DEBT).

The Figure 5.21 reveals that the smaller board size (BSIZE) a company has, the higher firm performance (ROA) it has. In addition, this role of board size (BSIZE)may be even severe in low debt ratio (DEBT).

5.6.4.4 The Moderating Effect of the Debt on the Relationships between Internal Corporate Governance Mechanisms and Firm Performance (TQ)

The results of the hierarchical regression analysis were reported through the following three models as illustrated in Table 5.19.

Model 1:In this model, the fourboard of directors characteristics and the sixaudit committee characteristics were introduced to the model. This model, however, was found to be significant (F=3.351, $p<0.05$) with adjusted R^2 as 27.8percent and significant F change at the 0.05 level of significance. The results in Table5.19 show that board size (BSIZE) andaudit committee reviews of IA proposals (ACREV1) were found to have significant effect on firm performance(TQ)with the indicators (β= -0.311, t= -2.581, $p<0.05$)and (β= 0.448, t=2.352, $p<0.05$) respectively.

Model 2: In this model, debt ratio was introduced to examine its predictive power toward firm performance (TQ). Even though the model showed a significant result at the 0.05 level, it did not improve the explanatory power of the model since the R^2 change was not significant (R^2 change=0.002, $p>0.1$). Furthermore, this model accounted for 39.8percent of the variance in the model. Two variables in this model were reported significant predictive power toward firm performance (TQ). Two variables were namely, board size (BSIZE) and audit committee reviews of IA proposals (ACREV1)with indicators (β= -0.307, t= -2.508, $p<0.05$) and (β= 0.458, t= 2.362, $p<0.05$) respectively.

Model 3: In this model, the interaction terms between debt ratio (DEBT) and board of directors, audit committee characteristics were examined to test the moderating effects of this study. This model found to be insignificant (R^2 change= 0.041, $p>0.1$).

The results in Table 5.19 show that board size (BSIZE)and audit committee reviews of IA proposals (ACREV1)were reported to be significant predictors of firm performance (TQ) at the 0.05 level of significance(β= -0.307, t= -2.508, $p<0.05$) and (β= 0.458, t= 2.362, $p<0.05$) respectively.

The results regarding the interaction terms revealed that there is no relationship in the model was significantly moderated by debt ratio (DEBT).

Table 5.19

The Moderating Effect of DEBT on the Detailed Model

Variables	Model 1 Predictors	Model 2 Moderators	Model 3 Interactions
Board Composition (BODCOM)	0.168	0.159	0.152
CEO Duality (DUAL)	-0.017	-0.032	-0.07
Board Size (BSIZE)	-.311**	-.307**	-.288**
Chairman of Directors' Shareholdings (COWN)	0.105	0.088	-0.001
Audit Committee Independence (ACIND)	0.167	0.179	0.213
Audit Committee Meetings (ACMEET)	-0.031	-0.03	-0.048
Audit Committees' Shareholdings (ACOWN)	0.023	0.027	0.171
Audit committee meeting with the CIA (ACIAM)	-0.135	-0.145	-0.213
Audit Committee Reviews of IA Proposals (ACREV1)	.448**	.458**	.465**
Audit Committee Reviews of the Result of IA (ACREV2)	0.045	0.05	0.031
Debt Ratio (DEBT)		0.049	0.103
BORCOM x DEBT			0.108
DULT x DEBT			-0.128
BSIZE x DEBT			0.026
COWN x DEBT			0.199
ACIND x DEBT			-0.01
ACMEET x DEBT			-0.091
ACOWN x DEBT			0.18
ACIAM x DEBT			-0.135
ACREV1 x DEBT			-0.052
ACREV2 x DEBT			-0.16
F value	3.351	3.008	1.495

Table 5.19 (Continued)

	Model 1	Model 2	Model 3
Variables	Predictors	Moderators	Interactions
F Sig.	0.002	0.004	0.135
R^2	0.396	0.398	0.44
Adjusted R^2	0.278	0.266	0.146
R^2 change	0.396	0.002	0.041
Significant F change	0.002	0.705	0.978

* : p< 0.1; **: p<0.05; ***: p<0.01

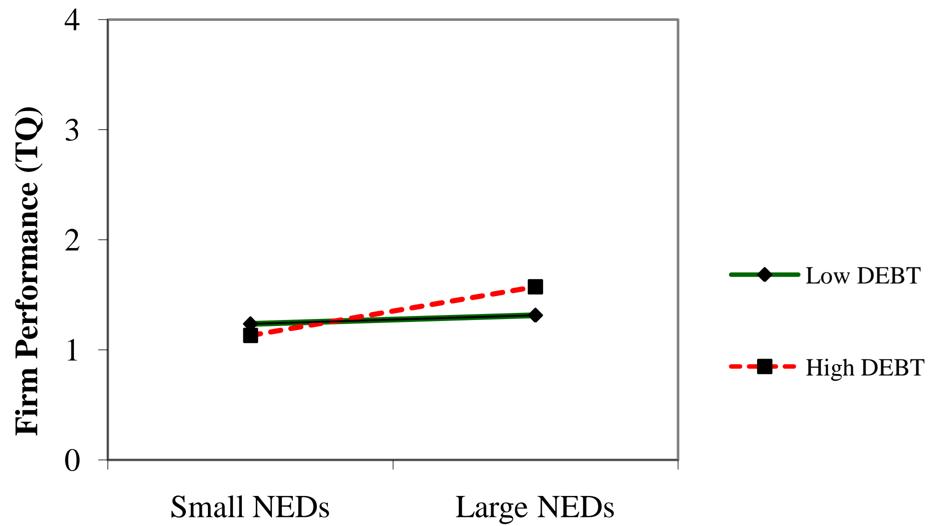

Figure 5.22

The ModeratingEffect of DEBT on BOCOM (NEDs) – TQ Relationship

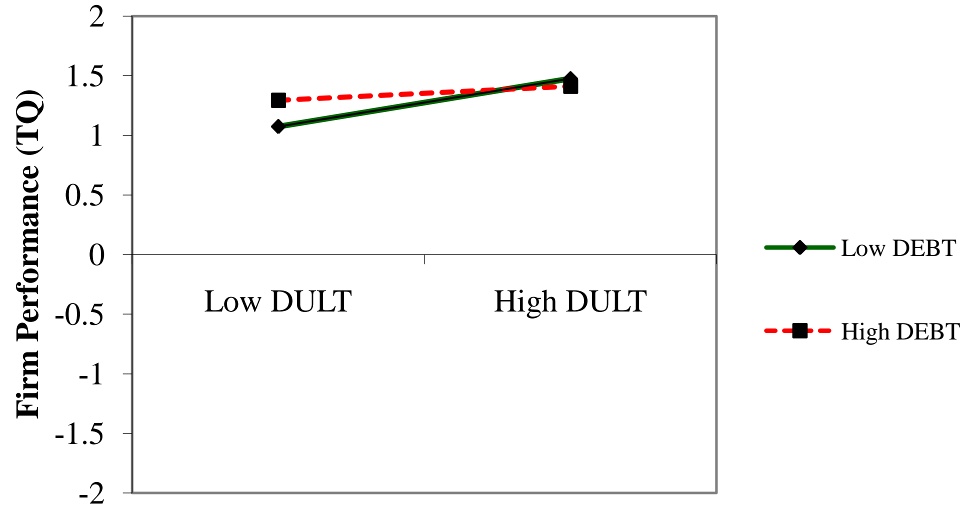

Figure 5.23
The ModeratingEffect of DEBT on DULT–TQ Relationship

Figures5.22 and 5.23show that while the effects of board and audit committee characteristics on firm performance (TQ) were proven not to be significantly moderated by debt ratio (DEBT), their effects on performance were found to be worth noting. Specifically, it can be noticed that in the high debt ratio (DEBT), non-executive directors (NEDs) can lead to a better performance. On the other hand, it was also illustrated that CEO duality (DUAL) can enhance the organizational performance in low debt ratio (DEBT) to a higher level than in the case of high debt ratio (DEBT).

5.7 Chapter Summary

This chapter presentsthe analysis of the response rate, the descriptive analysis of the variables and Pearson correlation analysis. The overall response rate of this study is 54.07 percent (73) but the usable response rate was 45.93percent (62).This result also indicates that the majority of Saudi Stock Market companies were implementing the best practice of corporate governance in Saudi Arabia which requires a separation of CEO

and chairman positions. Next, detecting outliers and checking the multicollinearity issues were investigated and also the assumptionswhich are linearity, normality, homoscedasticity and independence of the error terms were tested prior to conducting the regression analysis. In general, it can be confidently concluded that this study does not have serious outlier observations and the multicollinearity does not exist in the study and the normality of the error terms was confirmed.Following the suggestion of Hair *et al*. (2010), since the scatterplot shows no clear relationship between residuals and predicted values, it proves there are no problems of the linearity, homoscedasticity and the independence of residuals.In conclusion, the results of this study obtained from Pearson correlation and multiple regression analyses reveal that while some hypotheses were supported or partially supported by the empirical results, others were found not to be supported.Finally, further tests werecarried out to ensure the robustness of the analysis.

CHAPTER SIX

DISCUSSION AND CONCLUSION

6.0 Introduction

This chapter discusses the findings of the main results presented in the previous chapter. It consists of six sections. The summary of the study is presented in section 6.1. Section 6.2 discusses the hypotheses in greater detail, as presented by the results in Chapter Four. The implications of this study are offered in Section 6.3. Section 6.4 reports the limitations of the study and suggests future research. Section 6.5 concludes the findings.

6.1 Summary of the Study

The main objective of this study is to investigate the relationship between the internal corporate governance mechanisms that are related to the board of directors, audit committee characteristics and the performance of the Saudi companies listed on the Saudi Stock Exchange (TADAWL), excluding financial companies, at the end of 2010.

This study addresses the problem that arises due to the existence of a conflict of interests between shareholders and management, within the system of the corporate governance structure, and which may affect the quality of company performance in Saudi Arabia. Therefore, to control conflicts of interests and reduce agency costs, various internal and external tools, known as corporate governance, have been

suggested. For example, a board of directors and audit committee are established as a solution for such conflicts.

There are several main reasons behind the investigation of the association between board and audit committees and firm performance. First, high profile corporate collapses in Saudi Arabia and overseas have created considerable concern among investors and regulators about company performance. The Saudi Stock Market faced an extraordinary crash at the beginning of 2006 (the stock price index collapsed and SSM lost 65 percent of its value), which led to the Capital Market Authority (CMA) suspending the trading of two firms. These events created a serious question about the effectiveness of different monitoring devices that were presumed to protect investor interests in Saudi Arabia.

Second, there is still a lack of evidence regarding the impact of audit committee characteristics and effectiveness on firm performance. Many previous studies have examined the relationship between corporate governance (board characteristics) and firm performance (Zubaidah *et al.*, 2009; Bhagat & Black, 2002; Bonn *et al.*, 2004; Brown &Caylor, 2004; Haniffa & Hudaib, 2006; Kamardin, 2009; 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 performance (Hsu, 2007). Chan and Li (2008) also stated that further studies on the impact of audit committee composition on firm value are needed.

Finally, 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; Bhagat & Black, 2002; Brickley *et al.*, 1997; Haniffa & Hudaib, 2006; Hermalin & Weisbach, 1991). These results contribute to the corporate governance debate and show that the designed governance structures improve the performance of firms. However, Elghewail (2010) suggested that such results cannot be adopted blindly without considering the unique business environment existing in the respective country.

Based on the problem of this study and the comprehensive review of the relevant literature conducted in Chapter 1, Chapter 2 and Chapter 3, this study aims to achieve the following main objectives;

1. To examine the association between the board of directors' characteristics, namely, their composition, CEO duality, size and shareholdings by the chairman and firm performance.

2. To investigate the association between audit committee characteristics, namely, their independence, meetings, shareholdings and their interactions with internal auditors and firm performance.

In order to achieve the aforementioned objectives of this study, a comprehensive review of the literature was conducted and reported throughout this study, especially in Chapter 3. The past relevant literature revealed that little attention has been devoted to investigate the association between audit committee characteristics (as a governance mechanism) and firm performance (Hsu, 2007).

Additionally, past studies have considered the capital markets in the developed countries like the US and UK to investigate the association of corporate governance (in particular, the characteristics of board) with firm performance. However, few studies have been conducted in countries with emerging markets that are usually characterized by concentrated stock ownership and significant government ownership in listed firms.

In light of the objectives of the study and the discussions that were provided in Chapter 1, Chapter 2 and Chapter 3, the framework was formulated in Chapter 4. As argued in Chapter 4, this framework was theoretically built on the agency and institution theory in relation to internal corporate governance mechanisms and firm performance.

Chapter 3 discussed the related relevant variables; Chapter 4 discussed the hypotheses development, measurement and the methodology while Chapter 5 showed the statistical results. This study has answered the research questions regarding these issues, which will hopefully contribute to the regulators (e.g. Capital Market Authority, CMA) and the listed companies in Saudi Arabia.

To test the hypotheses of the study, multiple regression was used to analyze the relationship between the corporate governance variables (Board of directors and audit committee variables) and firm performance. The firm performance was measured using two measurements, namely, return on assets (ROA) and Tobin's Q (TQ), which were considered in this study as proxies for market measure and accounting measure, respectively. The effect of ten internal corporate governance

variables, namely, Board Size (BSIZE), the proportion of non-executive directors (BODCOM), CEO duality (DUAL), chairman of directors' shareholdings (COWN), audit committee independence (ACIND), audit committee meetings (ACMEET), audit committee shareholdings (ACOWN), audit committee meetings with internal auditors (ACIAM), the extent of audit committee reviews of IA programs and plans (ACREV1), the extent of audit committee reviews of the result of IA activities (ACREV2), and two control variables, firm size (SZE) and leverage (DEBT) were examined.

A combination of two research methods, namely, the archival and survey research methods is used in the Saudi Arabian context because the nature of the required data to conduct this study on Saudi listed companies highlights the need of both primary and secondary data as the main data sources. The data on the relationship between audit committee and internal audit function were collected though a mail questionnaire survey of the public listed companies in Saudi Arabia during 2010. This method of data collection was considered appropriate because the information sought for is not publicly available and chief internal auditors are in a good position to respond to the questions designed.

The questionnaire first determined whether the respondent's company had an internal audit department. For companies with an internal audit department, further questions were asked regarding the relationship between audit committee and the internal audit function. One-hundred and thirty five (135) questionnaires were sent to all the heads of the internal departments of public companies listed on the Saudi Stock Market. A total of 73 responses were received of which 62 were useable responses. Of the 11

non-useable responses, 8 were eliminated because the companies either fully outsourced or did not have internal audit departments. Although the overall response rate of this study is 54.07 percent (73), the usable response rate is 45.93 percent (62).Other information on firm performance, board of directors and audit committees characteristics was obtained from the annual reports of the respective companies (year-ending 2010).

In achieving the main objective of the study, two sets of general hypotheses were developed for this purpose. The first set was to examine the relationship between board of director variables and firm performance (ROA and TQ). The second set of hypotheses was to capture the relationship between audit committee variables and firm performance (ROA and TQ). The analyses showed that the effect of internal corporate governance variables on ROA and TQ were somewhat different. For board of director's characteristics, the proportion of non-executive directors and ROA is positively significant. However, there was no significant relationship between the proportion of non-executive directors and TQ. CEO duality variable is not significant to both measures of firm performance (ROA and TQ). Board size and ROA is not significant. However, there was a negatively significant relationship between board size and TQ. The chairman's shareholdings variable was not reported as significant for either measure of firm performance (ROA and TQ).

For audit committee characteristics, the independence of the audit committee members' variable was not reported to be significant for either measure of firm performance (ROA and TQ). The relationship between the frequency of audit committee meeting and ROA is negatively significant. However, there was no

significant relationship between the frequency of audit committee meetings and TQ. The audit committees' shareholdings variable was not reported to be significant for either measure of firm performance (ROA and TQ). The frequency of meetings between the audit committee and internal auditor variable was not reported to be significant for either measure of firm performance (ROA and TQ). The extent of AC reviews of the IA proposals variable is positively significant for both measures of firm performance (ROA and TQ). The relationship between the extent of AC reviews of the results of internal audit activities and ROA is positively significant. However, there was no significant relationship between the extent of AC reviews of the results of the internal audit activities and TQ.

The findings of this study are considered to be of value for both academicians and practitioners, as discussed in the following sections. In addition, the limitations faced by the study, as well as future research directions are provided and detailed.

6.2 Discussion of Hypotheses

Based on the results in Section 5.4, the following sections discuss the findings of the two models that are related to the accounting measure (ROA) and the marketing measure (Tobin's Q).

6.2.1 Discussion of First Model (Results Based on Accounting Measure)

Of the variables hypothesized to be associated with ROA, the study found that the proportion of non-executive directors (BODCOM) (β= 0.428, t= 4.578, $p<0.01$), the extent of AC reviews of IA proposals (ACREV1) (β=0.413, t=3.875, $p<0.01$), the

extent of AC reviews of the results of internal audit activities (ACREV2) (β= 0.216, t= 2.602, p<0.05), and the frequencyof audit committee meetings (ACMEET) (β= -0.184, t= -2.046, p<0.05) were significant. However the direction of the audit committee meeting was opposite to what was expected.

Other hypothesized variables, CEO duality, board size, chairman of directors' shareholdings, audit committee independence, audit committees' shareholdings, and audit committee meetings with the CIA were found to be in accordance with the expected directions but insignificant except the direction ofCEO duality, which was opposite to the expectation.

6.2.1.1 Board of Directors' Characteristics

6.2.1.1.1 Board Composition

The study hypothesized a positive relationship between the proportion of non-executive directors (NEDs) and firm performance. The result of the relationship between the proportion of non-executive directors (NEDs) and ROA is significant in a positive direction. Thus, hypothesis 1a is supported. The results also support the premise of the agency theory that boards dominated by NEDs may help to mitigate the agency problem by monitoring and controlling the opportunistic behavior of management.

The results of this study are consistent with those of Dehaena *et al.* (2001), Kamardin (2009), Heenetigala and Armstrong (2011), Mashayekhi and Bazaz (2008), Rhoades *et al.* (2000) and Swamy (2011). However, the results of this study are in contrast to

those of Coles *et al.* (2001), and Erickson *et al.* (2005) who found a negative relationship and also to those of Bhagat and Black (2002), De Andres *et al.* (2005), Haniffa and Hudaib (2006), Klein (1998), and Omar, (2003) who found an insignificant relationship.

The results show that board accountability to shareholders has resulted in increasing the profitability through ROA. Therefore, in Saudi Arabia, board composition is considered an important component of board structure forincreasing firm performance. Additionally, the result supports the regulation of the Code of Corporate Governance (2006) in Saudi Arabia, which recommends that a majority of directors should be non-executive directors.The explanationsuggested for this relationship is that the remuneration of non-executive directors is more closely linked to the financial performance of the shares than that of the executive directors (Heenetigala & Armstrong, 2011).

Furthermore, mostly, non-executive directors have shareholdings in the companies (Klien, 1998; Roberts *et al.*, 2005). Therefore, having an interest in the companies provides an incentive for them to work for high performance. In addition, because some of the non-executive directors are ex-employees of the companies, CEOs or executive directors from other companies (Klien, 1998), they are well-versed about the company's operations, and, hence, can contribute to the management, especially in terms of strategic tasks.

6.2.1.1.2 CEO Duality

Based on the premise of the agency theory and in contrast to the institutionaltheory that expects these mechanisms as practices or regulations as a result of coercion fromlegislators who impose certain practices in order to improve organizational effectiveness or as aresult of imitation, the study hypothesized a negative relationship between CEO duality (DUAL) and firm performance. However, the results show that CEO duality is insignificantly related to ROA. The insignificant effect of this variable means that there is no significant difference in the performance of companies that separate the roles of the CEO and the chairman and those that practice CEO duality. However, an interesting point to note here is that the coefficient is positive while the theoretical model predicts a negative relationship between this variable and the dependent variable (ROA). Thus, hypothesis 2a is not supported and it can be concluded that there is no evidence to support the notion that there is a relationship between CEO duality and ROA.

The results contradict the results of prior research by Ahmadu *et al.* (2005), Bhagt and Bolton (2008), Coles *et al.* (2001), Feng *et al.* (2005), Judge *et al.* (2003), Kyereboah-Colemn and Biekpe (2005) and Mustafa (2006). However, it is similar to that of Abdullah (2004), Carapeto *et al.* (2005), Hsu (2007), Mashayekhi' and Bazaz (2008), Omar (2003), Rechner and Dalton (1991), Schmid and Zimmerman (2007), and Wan and Ong (2005).

One plausible explanation for that might be that the use of financial ratios (ROA) may not be able to capture the board and leadership role in establishing firm value (Abdullah, 2004). Rather, using long-term measures, such as firm growth and share

price, might be able to capture the roles of both board independence and CEO duality. Furthermore, as argued by Judge *et al.* (2003), even with the existence of a formal law that separates the roles of CEO and the chairperson, informal activities may still undermine the law and firm performance. So, even though most of the companies in this study separate the two roles, it may just be a case of form over substance, and, hence, the company fails to reap the actual benefits of such practice.

6.2.1.1.3 Board Size

Board size is considered to be another effective factor in board characteristics that may have aninfluence on the firm performance.According to agency theory, which predicts that a small board size is more effective in monitoring the management, this study hypothesized a negative relationship to accounting performance (ROA). The result shows that board size is insignificantly associated to ROA with a negative direction. Therefore, hypothesis 3a is not supported.

The insignificant relationship between board size and ROA is consistent with the results ofBeiner *et al.* (2004), Bhagat and Black (2002), Gul and Sajid (2012), Ibrahim and Abdul Samad (2011), and Limpaphayom and Connelly (2006). However, the result is in contrast with the findings ofAhmadu *et al.* (2005), Chan and Li (2008), De Andres *et al.* (2005), Mashayekhi and Bazaz (2008), and Mustafa (2006). A possible explanation for this relationship is that CEO domination on board activities and asymmetry information of CEO may limit the board from performing effective monitoring (Kamardin, 2009).

6.2.1.1.4 Chairman of Directors' Shareholdings

The study hypothesized a significant relationship between shares held by the Chairman and ROA based on the notion that board members with appropriate shareholding will have anincentive to provide effective monitoring and oversight of important corporate decisions and so improve firm performance. However, the results show that Chairman of Directors' Shareholdingsareinsignificantly related to ROA. Thus, hypothesis 4a is not supported. This result is consistent with the findings ofZubaidah *et al.* (2009), Agrawal and Knoeber (1996), and Vafeas and Theodorou (1998),whoinvestigated the relationship at the board level.

This result is in conflict with the predictions suggested by the separation of ownership and control. However, it may reflect a trade-off between the alignment of manager-shareholder interests at lower levels of ownership, and entrenchment effects at higher levels of ownership (Vafeas & Theodorou, 1998).A possible explanation for this insignificant relationship is that chairmen in Saudi Arabia may not be motivated by the equity interests in the company and they are more highly rewarded in the form of perquisites and allowances.

6.2.1.2 Audit Committee Characteristics

6.2.1.2.1 Audit Committee Independence

The study hypothesized a positive effect between audit committee independenceand firm performance based on agency theory. Although there is a high proportion of independent audit committees in this study, the results show that audit committee independenceis insignificantly related to ROA. Thus, hypothesis 5a is not supported.

This finding does not support the recommendations of the Saudi Corporate Governance Code(2006) that audit committees should be independent in order to reduce the financial fraud, and, consequently, improve firm performance.

This finding is consistent withHsu (2007) and Klein (1998) who found no relationship between audit committee independence and firm performance, as measured by ROA. Moreover, the study of Abdur Rouf (2011) could not provide a significant relationship between the value of the firm measures (ROA) and audit committee as measured by the existence of the audit committee. Therefore, the independence of the audit committee does not lead to a reduction inagency problems. However, it is in contrast with the study of Swamy (2011), who reported a positive relationship between audit committee independence and firm performance, as measured by ROA.

A possible reason for the insignificant result of audit committee independence is that the mere presence of independent audit committee memberson the board might not be enough for the audit committee to achieve its duties as a monitoring mechanism, which results in better firm value. There should be a large majority of expert-independent audit committee members that serve on the audit committee to enhance firm value.

6.2.1.2.2 Audit Committee Meetings

According to the agency theory, the frequency of the audit committee meetings can help to prevent any wrongdoing by the management and thus reflect better performance. Therefore, this study hypothesized a positive relationship to ROA. The

result for the relationship between audit committee meeting and ROA shows a significant relationship with a negative direction. Thus, hypothesis 6a is not supported. This is consistent with the finding by Song and Windram (2004), who asserted that extra audit committee meetings increase when the stock performance is poor and also the finding by Hsu(2007), who indicated that poorly performing companies are likely to hold more meetings to please investors instead of to enhance firm value. Another possible explanation for the negative significant is that the frequency of audit committee meetings may increase in times of financial distress or in times of controversial decisions that may involve illegal or questionable activities.

However, a further examination (using alternate dichotomous variable of audit committee meetings, which is coded 1 if the number of meetings is at least four per year, 0 otherwise, to replace the number of meetings per year) reveals that the audit committee meetings variable is insignificant to ROA.

6.2.1.2.3 Audit Committees' Shareholdings

The study hypothesized a significant relationship between shares held by the audit committee and ROA based on the notion that audit committee members with appropriate shareholding will have anincentive to provide effective monitoring and oversight of important corporate decisions and so improve firm performance. However, the results show that audit committees' shareholdings are insignificantly related to ROA. Nevertheless, it is interesting to observe that the coefficient is negative, which is contrary to the expectation in the theoretical model. Thus, hypothesis 7a is not supported.

The role of the audit committee is assumed to make board monitoring more effective. However, the results suggest that the effectiveness of the audit committee members is likely to be impaired if the members of the audit committee have appropriate shareholding in the company. This result supports the concern that awarding directors with stock or stock options leads to entrenchment by directors, causing the directors to lose their objectivity and independence (Wright, 1996).

6.2.1.2.4 Audit Committee Meeting with the CIA

Based on the notion that the frequency of meetings between audit committees and internal auditors serves as a benchmark for the audit committee's effectiveness, this study hypothesized a positive relationship to ROA. However, the results show that audit committee meeting with the CIAis insignificantly related to ROA. Thus, hypothesis 8a is not supported.

The non-effectiveness of the audit committee meetings with the chief internal auditor onfirm performance can be attributed to different reasons. One plausible reason is that these meetings lack the coordination and cooperation on the matters relating tothe overall performance. If the audit committee members coordinate with the chief internal auditor, they will be able to detect anywrong practice that may affect firm performance. Another reason is that what matters in the meeting is not the number but rather the content. If these meetings are not well-organized and planned for, they will have no effect on firm performance. One may also attribute the level of knowledge of the audit committee members and how willing they are to cooperate effectively to ensure the prosperity of the firm.

6.2.1.2.5 Audit Committee Reviews of IA Proposals

This study predicted that the higher the extent to which the audit committee reviews the IA plans/programs the higher the likelihood ofenhancingthe efficiency of the IA function, and,consequently,improvingfirm performance. Inconsistentwith this expectation, this relationship isfound to be positively significant to firm performance, as measured by ROA. Therefore, hypothesis 9a is supported.

6.2.1.2.6 Audit Committee Reviews of the Result of IA

This study predicted that the higher the extent to which audit committee reviews IA results the higher the likelihood of enhancing the efficiency of the IA function, and, consequently, improving firm performance. Consistent with this expectation, this relationship is positively significant to firm performance, as measured by ROA. Therefore, hypothesis 10a is supported.

6.2.2 Discussion of Second Model (Results Based on Marketing Measure)

Of the variables hypothesized to be associated with TQ, the study finds that board size (BSIZE) (β= -0.262, t= -2.103, $p<0.05$), the extent of AC reviews of IA proposals (ACREV1) (β=0.487, t=2.528, $p<0.05$)are significant.Other hypothesized variables, the proportion of non-executive directors (BODCOM), CEO Duality (DUAL), Chairman of Directors' Shareholdings (COWN), Audit Committee Independence (ACIND), the frequencyof audit committee meetings (ACMEET), Audit Committees' Shareholdings (ACOWN), Audit committee meeting with the CIA (ACIAM) and the extent of AC reviews of the results of internal audit activities (ACREV2)are found to be as the expected directions but insignificant except the

directions forthe frequencyof audit committee meetings (ACMEET) and Audit committee meetings with the CIA (ACIAM), which were opposite to the expectations.

6.2.2.1 Board of Directors' Characteristics

6.2.2.1.1 Board Composition

Unlike accounting performance and in contrast to the expectations, board composition (measured as the ratio of non-executive directors to the total number of directors) is insignificantly related to marketing performance (TQ). However, it is in the same direction asthe expectation. This finding is in conflict with the predictions of the agency theory, which suggests that non-executive directors act as a check and balance mechanism and that more non-executives on the board will help improve firm performance. However, this insignificant relationship may be attributed to the institutional theory,whichexpects corporate governance mechanisms as practices or regulations, as a result of coercion fromlegislators who impose certain practices in order to improve organizational effectiveness or as aresult of imitation. The result is also consistent with the findings of prior studies by Haniffa and Hudaib (2006), Ibrahim and Abdul Samad (2011), Kota and Tomar (2010), Mohd, Rahman, and Sakthi (2008), and Vafeas and Theodorou (1998).

This result might be attributable to the limited oversight provided by non-executive directors (NEDs). Another possible alternative explanation is that although non-executive directors are presumed to be independent, in fact they may not be effective as monitors (Barako, Hancock, & Izan, 2006). Although thenon-executive directors'

variable (NEDs) is found to be positively significant to ROA, it is found to be insignificant to TQ.

6.2.2.1.2 CEO Duality

In contrast to the expectations of the agency theory, CEO duality (DUAL) is insignificantly effected to marketing performance (TQ). This result is similar to the finding that is related to accounting performance (ROA), however, it is in the negative direction. This result supports the findings of Ehikioya, (2009), Haniffa and Hudaib, (2006), Ibrahim and Abdul Samad (2011), Heenetigala and Armstrong (2011), Lin& Jen (2011), and Hsu (2007). The study of Lipton and Lorsch (1992) suggested that the market believes that the CEO is the most knowledgeable and experienced person in the company and is best suited to serve as chairperson of the board.

6.2.2.1.3 Board Size

The result finds that while there is no relationship between board size and accounting performance (ROA), there is a significant negative relationship with the market performance (TQ) indicating that the market perceives big size board of directors as ineffective. Thus, hypothesis 3b is supported. The negatively significant relationship between board size and marketing performance (TQ) is consistent with the idea that asmall board size is more correlated with the quality of monitoring (Jensen, 1993). This finding is also supported by priorstudies, such as Chauhan and Dey (2009), Ibrahim and Abdul Samad (2011), Kota and Tomar (2010),and Wei Hu, Tam, and Tan (2010).

On the other hand, the result is in contrast with the findings ofEhikioya (2009), and Haniffa and Hudaib (2006) whoconcluded a significant positive relationship between board size and TQ. A possible explanation is that the board of the Saudi listed companies does not have the same characteristics as the board in the above mentioned studies due to a number of factors, such as thedifferences in culture and corporate governance practice, as well as having different political andeconomic aims. Another explanation suggested for this relationship is that board size is only a measure of the factual number of directors, and does not indicate the tasks and roles they perform (Bonn *et al.*, 2004).

Therefore, it can be argued that it is the skills and knowledge base that the board brings to the firm that is important for performance, rather than board size. In addition, board size does not indicate process-oriented variables, such as group dynamics and behavior patterns, which might influence firm performance. Therefore, in addition to bringing insufficient members with appropriate skills and knowledge, the ability of boards to leverage the directors' multiple roles may be important for company performance (Dalton, Daily, Johnson & Ellstrand, 1999).

6.2.2.1.4 Chairman of Directors' Shareholdings

Although there is a shortage of studies concerningthe effect of chairman of directors' shareholdingson firm performance,this study adapts the theme of the agency theory to suggest that high performance is associated with the existence of large shareholders held by chairman (Jensen &Meckling, 1976).In contrast to the expectations, the results show that the chairman of directors' shareholdings variableis insignificantly related to marketing performance (TQ). This finding is also not

consistent withthe agency theory which expects that managerial ownership may reduce agency cost.

This result is similar to the finding that is related to accounting performance (ROA) in the first model. A plausible justification of this result is that most chairmen members might beinsider owners and the majority of previous research highlights that insider owners are less active than outsiders (Habbash, 2010).

6.2.2.2 Audit Committee Characteristics

6.2.2.2.1 Audit Committee Independence

In contrastto the expectations of the agency theory that independence of the audit committee leads to effective monitoring, and, consequently, improves firm performance, audit committee independenceis insignificantly related to marketing performance (TQ).Thus, hypothesis 5b is not supported. The finding is consistent withHsu, (2007) who found no relationship between audit committee independence and marketing performance (TQ). This finding is also similar to the results of a study by Kota and Tomar (2010) who revealed that the chairman of audit committee independence is insignificant to firm performance, as measured by Tobin's Q. However, it is in contrast with the studies by Chan and Li (2008), and Nuryanah and Islam (2011) who found a significantly positive relation between Approximate Tobin's Q (i.e. firm value) and Independence of Audit Committee. This result is also similar to the finding related to accounting performance (ROA) in the first model.

A possible reason for the insignificant result of audit committee independence is that audit committees mainly play a 'symbolic or ceremonial role' as many stakeholders feelthat the audit committee system is ineffective, in general, in respect of overseeing independent audits and the financial reporting processes (Kota & Tomar, 2010; Spira, 1999).

6.2.2.2.2 Audit Committee Meetings

The result shows that while there is a significant negative relationship between the number of audit committee meetings and accounting performance (ROA), there is an insignificant effect with a negative directionformarket performance (TQ). Therefore, hypothesis 6b is not supported. This result is in contrast with the finding by Hsu (2007) who found that audit committee meetings are significantly related to marketing performance (TQ). A further examination (using alternate dichotomous variable of audit committee meetings, which is coded 1 if the number of meetings is at least four per year, 0 otherwise) confirmed the main finding that the audit committee meetings variable is reported to be insignificant to TQ.

6.2.2.2.3 Audit Committees' Shareholdings (ACOWN)

The study hypothesized a significant relationship between shares held by audit committee and firm performance (TQ) based on the notion that audit committee members with appropriate shareholding will have anincentive to provide effective monitoring and oversight of important corporate decisions and so improve firm performance. However, the results show that the audit committees' shareholdings variable is insignificantly related to TQ. Therefore, hypothesis 7b is not supported.

6.2.2.2.4 Audit Committee Meetings with the CIA

In contrast to the notion that the frequency of meetings between audit committees and internal auditors serves as a benchmark for the audit committee's effectiveness, the results show that audit committee meetings with the CIA is insignificantly related to marketing performance (TQ). Therefore, hypothesis 8b is not supported. Nevertheless, it is interesting to observe that the coefficient is negative, which is contrary to the expectation in the theoretical model.

6.2.2.2.5 Audit Committee Reviews of IA Proposals

In line with the expectation that the higher the extent to which audit committee reviews IA plans/programs is likely to enhance the efficiency of the IA function and firm performance, as measured by marketing performance (TQ), the relationship is found to be significant and in a positive direction. Therefore, hypothesis 9b is supported. These findings support the recommendations of the Saudi Corporate Governance Code(2006) that audit committees should review internal audit reports in order to enhance the efficiency of the IA function, and, consequently, improve firm performance.

6.2.2.2.6 Audit Committee Reviews of the Result of IA

In contrast to the expectation that the higher the extent to which audit committee reviews IA results are likely to enhance the efficiency of the IA function, and, consequently, improve firm performance, this relationship is found to be insignificant but in the same direction to the expectation. Therefore, hypothesis 10b is not supported. These findings do not support the recommendations of the Saudi

Corporate Governance Code(2006) that audit committees should review internal audit reports in order to enhance the efficiency of the IA function, and, consequently, improve firm performance.

A possible reason for the insignificant result of audit committee reviews of IA results is that audit committee members lack the knowledge and skills that enable them to review the results of IAs efficiently. If the audit committee members have the appropriate skills and knowledge including qualifications and experience, they will be able to review the results of IAs efficiently and evaluate the risks faced by the firm that may lead to enhance firm performance.

6.3 Implications of the Study

The aim of this thesis is to examine the relationship between internal corporate governance and the performance of the companies, in the context of Saudi Arabia. Fundamentally, the current study provides new evidence from a developing country that contributes to the existing literature on the effect of internal monitoring mechanisms on firm performance. This section attempts to discuss the implications of the main findings on theory and practice. Both the theoretical and practical implications of the study are discussed in the following sections.

6.3.1 Implications to Theory

Previous studies have used a number of theories, often competing but sometimes complementary, to explain corporate governance mechanisms practices, such as

agency theory, stakeholder theory, stewardship theory, resource dependence theory and institutional theory.

Agency theory has been a dominant approach in corporate governance and firm performance. Adequate monitoring or control mechanisms need to be established to protect shareholders from management's conflict of interest – so-called agency cost of modern capitalism is the most important implication for corporate governance, which stems from the agency theory. Accordingly, normative recommendations provided by the agency theory, such as a majority of non-executive directors (NEDs), independent audit committee, the positions of chairman and CEO should be held by different people.

From a completely different perspective, institutional theory views these mechanisms as practices or regulations resulting from coercion by legislators who impose certain practices in order to improve organizational effectiveness, or as a result of imitation. The institutional theory also suggests that audit committee effectiveness is more attributable to internal factors, such as topics covered by the audit committee than to external factors, such as agency variables (Kalbers & Fogarty 1998). As a result, researchers (e.g. Kalbers & Fogarty, 1998) who have used institutional theory argued that publicly available information is of limited use in determining the reality of the audit committee, as one of the most important corporate governance mechanisms and its effectiveness. Kalbers and Fogarty (1998) used both agency theory and institutional theory to investigate audit committee effectiveness (ACE). They argued that the use of agency theory alone could not differentiate qualitative degrees of the audit committee as a corporate control mechanism. Moreover, they found that audit

committee effectiveness (ACE) is more attributable to internal factors than to external factors, such as agency variables.

The findings of this study highlight the fact that in explaining the relationship between corporate governance mechanisms and firm performance, the agency theory alone is not enough. Therefore, both theories (agency and institutional theory) have been used to explain the findings of this study. The use of two theories is because Saudi Arabia has a different legal system and religious framework from other countries that could affect the practices of monitoring mechanisms, such as internal corporate governance (board of directors and audit committee practices) (Al-Ghamdi, 2012). Moreover, it appears that the development of corporate governance is another intricate area associated with several factors, such as regulation, culture, religion and ownership structure (Mallin, 2007).

In terms of non-executive directors, the relations with ROA and TQ are contradicted. Based on the relationship with ROA, the result shows that agency theory is applicable in Saudi Arabia. This is based on the premise that the need of non-executive directors on the board substantiated from the agency theory, which states that due to the separation between ownership and control, managers tend to pursue their own goals at the expense of the shareholders (Jensen & Meckling, 1976). Thus having non-executive directors on the board, would help to monitor and control the management, and assist in evaluating the management more objectively.

Regarding board size, the relations with ROA and TQ are contradicted. Based on the relationship with TQ, the result shows that agency theory is applicable in Saudi Arabia. For the audit committee reviews of IA proposals, the relations with ROA and

TQ show that agency theory is applicable in Saudi Arabia. Regarding the audit committee reviews of the result of IA, the relations with ROA and TQ are contradicted. However, based on the relationship with ROA, the result shows that agency theory is applicable in Saudi Arabia.

In terms of CEO duality, Chairman of Directors' Shareholdings, Audit Committee Independence, Audit Committee Meetings, Audit Committees' Shareholdings, Audit committee meeting with the CIA, the results show that agency theory is not appropriate to explain these relationships in Saudi Arabia.

Generally, with the exceptions of non-executive directors, board size, audit committee reviews of IA proposals and audit committee reviews of the result of IA, the findings are not consistent with the agency theory that board of directors and audit committee might mitigate agency problems leading to reduced agency cost by aligning the interests of controlling owners with those of the company. These findings can be interpreted in relation to the institutional theory that views these mechanisms as practices or regulations resulting from coercion by legislators who impose certain practices in order to improve organizational effectiveness, or as a result of imitation.

In other words, the findings might be explained by this theory, which suggests that companies might adopt practices or regulations as a result of coercion from a legislator who imposes some practices in order to improve organizational effectiveness. However, there is no prediction that the adoption of these regulations will improve organizational effectiveness. Overall, this study provides theoretical

validity by suggesting that the institutional theory may be more appropriate than agency theory in describing the practices of corporate governance in developing countries such as Saudi Arabia.

6.3.2 Implications to Practice

From a practical perspective, the findings of this study provide feedback to the regulators (e.g. Capital Market Authority, CMA) and the companies in Saudi Arabia in a number of ways. Firstly, the positive significant relationship between non-executive directors and accounting performance (ROA) has practical implications to corporate governance in Saudi Arabia. As such, regulators and companies ought to emphasize the importance of having non-executive directors on the board.

Secondly, the result provides evidence that audit committee reviews of IA proposals lead to better accounting performance (ROA) and marketing performance (TQ). Possibly this is one of the important areas that CMA should stress to the audit committees in Saudi Arabia to focus on in providing their supervision.

Thirdly, the positive significant relationship between audit committee reviews of the result of IA and accounting performance (ROA) has practical implications to corporate governance in Saudi Arabia. Therefore, the regulators (e.g. CMA) should emphasize the importance of audit committee reviews of the result of IA.

Fourthly, given, the findings of audit committee independence, audit committee shares reveal that they are not related to either measure of firm performance (ROA & TQ), and, also the finding of audit committee meetings shows a negative significant

relation to ROA and insignificant to TQ. These findings have implications for developing the role of audit committees in Saudi Arabia by enhancing the auditor's independence and competence and solving the issues that exist in the Saudi audit market. This suggests that the important thing is not only the independence of the audit committee, but rather having the right mix of members with the necessary skills to evaluate the risks faced by the firm. Thus, CMA might be required to improve and enhance the awareness and skills of audit committee members, for example, by holding business conferences or clarifying the roles of audit committee members in order to improve their skills and abilities that lead to enhance firm performance.

Finally, the differences and contradictory results between this study and the earlier studies in other countries contribute to corporate governance debate and support the claim by Haniffa and Hudaib (2006) that governance structures designed to enhance corporate governance cannot be blindly adopted but should take into account the business environment and economic characteristics of the country, such as stock market regulations, disclosure requirements, firm ownership structures and culture.

6.4 Limitations of the Study and Suggestions for Future Research

The conclusions drawn from this study should be interpreted in a limited way, which would represent potential opportunities for further investigation in future research. First, this study only used one year's data for2010 due to the unavailability of certain data (information on internal audit function) from secondary sources, and the fact that it is impractical to request information for several years from a questionnaire. This short period of study might not be representative of the way companies operate their businesses. Future research could extend the study to include more years of

data, thus longitudinal studies can be conducted and further investigation on the impact of the relationship between audit committee and internal audit function on firm performance in the short and long-terms can be analyzed.

Second, although, the small size of the sample (n=62, 44.93 percent useable response rate) is adequate for many statistical analyses, such as multiple regression, a larger sample size would have been desirable for the results of the study to be more representative. Hence, future studies should explore the feasibility of conducting similar research in countries that are located in the same region, Gulf Corporation Council (GCC), such as Bahrain, Kuwait, Qatar, Oman and the United Arab Emirates, in order to increase the size of the sample.

Third, although this study uses the whole population of the Saudi Stock Market, companies that operate in the financial sector are excluded since they have different practices and operations from other companies. Accordingly, although the findings could not be generalized to all sectors in the Saudi market, generalization is possible in other sectors involved in this study.

Fourth, this study is only based on responses from the internal auditors to assess audit committee effectiveness. Therefore, future research should focus on obtaining responses from the external auditors. A study using external auditors as assessors of audit committee effectiveness and their effect on firm performance will be important to validate the findings of the current study.

Fifth, although the research questions regarding the role of internal corporate governance in improving firm performance were mainly answered by the database and questionnaire, interviews may also contribute to reinforce the findings and provide deeper understanding in providing further explanation on the relationship.

Sixth, this study only focused on the variables that are related to the board of directors and audit committee as internal corporate governance mechanisms. Future research could also examine the relationship between internal audit function and firm performance.

Seventh, only seven (7) direct characteristics of board of directors and audit committee are considered in this study. Hence, future study could investigate other board of director and audit committee characteristics that are not included in this study, such as board process, board of director's education and experience of board of directors, which could affect the effectiveness of corporate governance in Saudi Arabia.

Finally, this study only examines the agency theory and institution theory in relation to internal corporate governance mechanisms and firm performance. Future research can also examine other theories that can be associated with these mechanisms and performance, such as stakeholder theory, stewardship theory and resource dependence theory.

6.5 Conclusion of the Study

This study investigates the effect of internal corporate governance mechanisms (board of directors and audit committee) on two firm performance measures, namely, accounting (ROA) and market (TQ) measures. The study was motivated by the gap in the existing literature and the limited evidence concerning developing countries, specifically in Saudi Arabia.

The findings on non-executive directors result in opposite results. Accounting performance measure suggests better performance with non-executive directors while the market does not seem to affect performance. This implies that Saudi Arabia companies produced better accounting results with non-executive directors, but that non-executive directors did not have an effect on firm performance with market performance. Possibly, as suggested by Haniffa and Hudaib (2006), most non-executive directors (NEDs) are not selected due to their expertise and experience but more often for political reasons, to legitimize business activities and for contacts and contracts. Therefore, such directors may not be able to contribute to the independent monitoring and reducing of the agency conflicts associated with the potential misallocation of excess resources. Furthermore, due to a lack of awareness of their responsibilities, they may not be able to perform their role effectively.

One of the main objectives of this study is to reveal the importance of the relationship between audit committee and internal auditors as effective corporate governance mechanisms. This study emphasizes that audit committee reviews of IA proposals are important aspects of corporate governance that lead to a better firm performance regardless of the measures used. Possibly, this is one of the important

areas that CMA should stress to audit committees in Saudi Arabia to focus on in providing their supervision.

The findings based on market measure (TQ) indicate that a large board is seen as less effective in monitoring performance and could also be costly for companies in terms of compensation and benefits. However, board size is not found to be related to accounting measure (ROA). Although the CMA is not informative on this issue, it would be best for Saudi Stock Market companies to evaluate the appropriate board size depending on each individual company's circumstances.

In respect of the issue of CEO duality, this study indicates that its presence in Saudi Stock Market companies did not have a significant negative impact on firm performance when the measure is based on the criteria of CEO duality –the chairman is the same person as the CEO. However, when the alternative measure is based on the family, in which the chairman and the CEO come from the same family, as suggested by Kamardin (2009), it shows a significant relationship to both ROA and TQ, albeit in the opposite direction to the expectation with TQ. Therefore, CMA might be required to consider the same family when separating the positions of CEO and the chairman.

The findings of direct audit committee characteristics (independence, meetings, shareholdings) did not add value to firm performance in Saudi Stock Market companies, which have implications for developing the role of audit committees in Saudi Arabia by enhancing the auditor's independence and competence and solving the existing issues in the Saudi Stock Market. Thus, the CMA might be required to

improve and enhance the awareness and skills of audit committee members, for example, by holding business conferences or clarifying the roles of audit committee members in order to enhance their skills and abilities that lead to better firm performance.

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APPENDICES

APPENDIX A

Saudi Corporate Governance Code

CAPITAL MARKET AUTHORITY

CORPORATE GOVERNANCE REGULATIONS IN THE KINGDOM OF SAUDI ARABIA

Issued by the Board of Capital Market Authority
Pursuant to Resolution No. 1/212/2006
dated 21/10/1427AH (corresponding to 12/11/2006)
based on the Capital Market Law
issued by Royal Decree No. M/30
dated 2/6/1424AH

Amended by Resolution of the Board
of the Capital Market Authority Number 1-1-2009
Dated 8/1/1430H Corresponding to 5/1/2009G

English Translation of the Official Arabic Text

Arabic is the official language of the Capital Market Authority

The current version of these Rules, as may be amended, can be found aton the CMA website: www.cma.org.sa

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PART 1

PRELIMINARY PROVISIONS

Article 1: Preamble

a) These Regulations include the rules and standards that regulate the management of joint stock companies listed in the Exchange to ensure their compliance with the best governance practices that would ensure the protection of shareholders' rights as well as the rights of stakeholders.

b) These Regulations constitute the guiding principles for all companies listed in the Exchange unless any other regulations, rules or resolutions of the Board of the Authority provide for the binding effect of some of the provisions herein contained.

c) As an exception of paragraph (b) of this article, a company must disclose in the Board of Directors` report, the provisions that have been implemented and the provisions that have not been implemented as well as the reasons for not implementing them.

Article 2: Definitions

a) Expression and terms in these regulations have the meanings they bear in the Capital Market Law and in the glossary of defined terms used in the regulations and the rules of the Capital Market Authority unless otherwise stated in these regulations.

b) For the purpose of implementing these regulations, the following expressions and terms shall have the meaning they bear as follows unless the contrary intention appears:

Independent Member [1]: A member of the Board of Directors who enjoys complete independence. By way of example, the following shall constitute an infringement of such independence:

[1] The Board of the Capital Market Authority issued its resolution number (1-10-2010) Dated 30/3/1431H corresponding to 16/3/2010G amending the definition of "Independent Member" in paragraph (b) of Article 2 of these Regulations to include as infringements of independence the ownership of 5% or more of the company or its group by the member of the Board of Directors or a representative of a legal entity which owns 5% or more of the company or its group. The amendments shall be applied on companies that apply for listing on the Saudi Stock Exchange (Tadawul) from the date of its publication. And will be applied on companies listed on the Exchange upon the appointment of any member of the board, starting from the date of 1/1/2011.

1. he/she holds a controlling interest in the company or in any other company within that company's group.

2. 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.
3. he/she is a first-degree relative of any board member of the company or of any other company within that company's group.

4. he/she is first-degree relative of any of senior executives of the company or of any other company within that company's group.

5. he/she is a board member of any company within the group of the company which he is nominated to be a member of its board.

6. 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.

Non-executive director: A member of the Board of Directors who does not have a full-time management position at the company, or who does not receive monthly or yearly salary.

First-degree relatives: father, mother, spouse and children.

Stakeholders: Any person who has an interest in the company, such as shareholders, employees, creditors, customers, suppliers, community.

Accumulative Voting: a method of voting for electing directors, which gives each shareholder a voting rights equivalent to the number of shares he/she holds. He/she has the right to use them all for one nominee or to divide them between his/her selected nominees without any duplication of these votes. This method increases the chances of the minority shareholders to appoint their representatives in the board through the right to accumulate votes for one nominee.

Minority Shareholders: Those shareholders who represent a class of shareholders that does not control the company and hence they are unable to influence the company.

PART 2

RIGHTS OF SHAREHOLDERS AND THE GENERAL ASSEMBLY

Article 3: General Rights of Shareholders

A Shareholder shall be entitled to all rights attached to the share, in particular, the right to a share of the distributable profits, the right to a share of the company's assets upon liquidation; the right to attend the General Assembly and participate in deliberations and vote on relevant decisions; the right of disposition with respect to shares; the right to supervise the Board of Directors activities, and file responsibility claims against board members; the right to inquire and have access to information without prejudice to the company's interests and in a manner that does not contradict the Capital Market Law and the Implementing Rules.

Article 4: Facilitation of Shareholders Exercise of Rights and Access to Information

a) The company in its Articles of Association and by-laws shall specify the procedures and precautions that are necessary for the shareholders' exercise of all their lawful rights.

b) All information which enable shareholders to properly exercise their rights shall be made available and such information shall be comprehensive and accurate; it must be provided and updated regularly and within the prescribed times; the company shall use the most effective means in communicating with shareholders. No discrepancy shall be exercised with respect to shareholders in relation to providing information.

Article 5: Shareholders Rights related to the General Assembly

a) A General Assembly shall convene once a year at least within the six months following the end of the company's financial year.

b) The General Assembly shall convene upon a request of the Board of Directors. The Board of Directors shall invite a General Assembly to convene pursuant to a request of the auditor or a number of shareholders whose shareholdings represent at least 5% of the equity share capital.

c) Date, place, and agenda of the General Assembly shall be specified and

announced by a notice, at least 20 days prior to the date the meeting; invitation for the meeting shall be published in the Exchange' website, the company's website and in two newspapers of voluminous distribution in the Kingdom. Modern high tech means shall be used in communicating with shareholders.

d) Shareholders shall be allowed the opportunity to effectively participate and vote in the General Assembly; they shall be informed about the rules governing the meetings and the voting procedure.

e) Arrangements shall be made for facilitating the participation of the greatest number of shareholders in the General Assembly, including *inter alia* determination of the appropriate place and time.

f) In preparing the General Assembly's agenda, the Board of Directors shall take into consideration matters shareholders require to be listed in that agenda; shareholders holding not less than 5% of the company's shares are entitled to add one or more items to the agenda. upon its preparation.

g) Shareholders shall be entitled to discuss matters listed in the agenda of the General Assembly and raise relevant questions to the board members and to the external auditor. The Board of Directors or the external auditor shall answer the questions raised by shareholders in a manner that does not prejudice the company's interest.

h) Matters presented to the General Assembly shall be accompanied by sufficient information to enable shareholders to make decisions.

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.

j) The Exchange shall be immediately informed of the results of the General Assembly.

Article 6: Voting Rights

a) Voting is deemed to be a fundamental right of a shareholder, which shall not, in any way, be denied. The company must avoid taking any action which might hamper the use of the voting right; a shareholder

must be afforded all possible assistance as may facilitate the exercise of such right.

b) In voting in the General Assembly for the nomination to the board members, the accumulative voting method shall be applied.

c) A shareholder may, in writing, appoint any other shareholder who is not a board member and who is not an employee of the company to attend the General Assembly on his behalf.

d) Investors who are judicial persons and who act on behalf of others - e.g. investment funds- shall disclose in their annual reports their voting policies, actual voting, and ways of dealing with any material conflict of interests that may affect the practice of the fundamental rights in relation to their investments.

Article 7: Dividends Rights of Shareholders

a) The Board of Directors shall lay down a clear policy regarding dividends, in a manner that may realize the interests of shareholders and those of the company; shareholders shall be informed of that policy during the General Assembly and reference thereto shall be made in the report of the Board of Directors.

b) The General Assembly shall approve the dividends and the date of distribution. These dividends, whether they be in cash or bonus shares shall be given, as of right, to the shareholders who are listed in the records kept at the Securities Depository Center as they appear at the end of trading session on the day on which the General Assembly is convened.

PART 3

DISCLOSURE AND TRANSPARENCY

Article 8:Policies and Procedure related to Disclosure

The company shall lay down in writing the policies, procedures and supervisory rules related to disclosure, pursuant to law.

Article 9 [2]: Disclosure in the Board of Directors' Report

In addition to what is required in the Listing Rules in connection with the content of the report of the Board of Directors, which is appended to the annual financial statements of the company, such report shall include the following:

a) The implemented provisions of these Regulations as well as the provisions which have not been implemented, and the justifications for not implementing them.

b) Names of any joint stock company or companies in which the company Board of Directors member acts as a member of its Board of directors.

c) Formation of the Board of Directors and classification of its members as follows: executive board member, non-executive board member, or independent board member**.**

d) A brief description of the jurisdictions and duties of the Board's main committees such as the Audit Committee, the Nomination and Remuneration Committee; indicating their names, names of their chairmen, names of their members, and the aggregate of their respective meetings.

e) Details of compensation and remuneration paid to each of the following:

[2] The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making Article 9 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from the first board report issued by the company following the date of the Board of the Capital Market Authority resolution mentioned above.

1. The Chairman and members of the Board of Directors.
2. The Top Five executives who have received the highest compensation and remuneration from the company. The CEO and the chief finance officer shall be included if they are not within the top five.

   For the purpose of this paragraph, “compensation and remuneration” means salaries, allowances, profits and any of the same; annual and periodic bonuses related to performance; long or short- term incentive schemes; and any other rights *in rem*.

f) Any punishment or penalty or preventive restriction imposed on the company by the Authority or any other supervisory or regulatory or judiciary body.
g) Results of the annual audit of the effectiveness of the internal control procedures of the company.

PART 4
BOARD OF DIRECTORS

Article 10: Main Functions of the Board of Directors

Among the main functions of the Board is the fallowing:

a) Approving the strategic plans and main objectives of the company and supervising their implementation; this includes:

   1. Laying down a comprehensive strategy for the company, the main work plans and the policy related to risk management, reviewing and updating of such policy.

   2. Determining the most appropriate capital structure of the company, its strategies and financial objectives and approving its annual budgets.

   3. Supervising the main capital expenses of the company and acquisition/disposal of assets.

   4. Deciding the performance objectives to be achieved and supervising the implementation thereof and the overall performance of the company.

   5. Reviewing and approving the organizational and functional structures of the company on a periodical basis.

b) Lay down rules for internal control systems and supervising them; this includes:

   1. Developing a written policy that would regulates conflict of interest and remedy any possible cases of conflict by members of the Board of Directors, executive management and shareholders. This includes misuse of the company's assets and facilities and the arbitrary disposition resulting from dealings with the related parties.

   2. Ensuring the integrity of the financial and accounting procedures including procedures related to the preparation of the financial reports.

3. Ensuring the implementation of control procedures appropriate for risk management by forecasting the risks that the company could encounter and disclosing them with transparency.

4. Reviewing annually the effectiveness of the internal control systems.

c) 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.

d) 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.

e) Outlining a written policy that regulate the relationship with stakeholders with a view to protecting their respective rights; in particular, such policy must cover the following:

1. Mechanisms for indemnifying the stakeholders in case of contravening their rights under the law and their respective contracts.

2. Mechanisms for settlement of complaints or disputes that might arise between the company and the stakeholders.

3. Suitable mechanisms for maintaining good relationships with customers and suppliers and protecting the confidentiality of information related to them.

4. A code of conduct for the company's executives and employees compatible with the proper professional and ethical standards, and regulate their relationship with the stakeholders. The Board of Directors lays down procedures for supervising this code and ensuring compliance there with.

5. The Company's social contributions.

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.

Article 11: Responsibilities of the Board

a) Without prejudice to the competences of the General Assembly, the company's Board of Directors shall assume all the necessary powers for the company's management. The ultimate responsibility for the company rests with the Board even if it sets up committees or delegates some of its powers to a third party. The Board of Directors shall avoid issuing general or indefinite power of attorney.

b) The responsibilities of the Board of Directors must be clearly stated in the company's Articles of Association.

c) The Board of Directors must carry out its duties in a responsible manner, in good faith and with due diligence. Its decisions should be based on sufficient information from the executive management, or from any other reliable source.

d) A member of the Board of Directors represents all shareholders; he undertakes to carry out whatever may be in the general interest of the company, but not the interests of the group he represents or that which voted in favor of his appointment to the Board of Directors.

e) The Board of Directors shall determine the powers to be delegated to the executive management and the procedures for taking any action and the validity of such delegation. It shall also determine matters reserved for decision by the Board of Directors. The executive management shall submit to the Board of Directors periodic reports on the exercise of the delegated powers.

f) The Board of Directors shall ensure that a procedure is laid down for orienting the new board members of the company's business and, in particular, the financial and legal aspects, in addition to their training, where necessary.

g) 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.

h) The Board of Directors shall not be entitled to enter into loans which spans more than three years, and shall not sell or mortgage real estate of the company, or drop the company's debts, unless it is authorized to do so by the company's Articles of Association. In the case where the company's Articles of Association includes no provisions to this respect, the Board should not act without the approval of the General Assembly, unless such acts fall within the normal scope of the company's business.

Article 12 [3]: Formation of the Board

Formation of the Board of Directors shall be subject to the following:

a) The Articles of Association of the company shall specify the number of the Board of Directors members, provided that such number shall not be less than three and not more than eleven.

b) The General Assembly shall appoint the members of the Board of Directors for the duration provided for in the Articles of Association of the company, provided that such duration shall not exceed three years. Unless otherwise provided for in the Articles of Association of the company, members of the Board may be reappointed.

c) The majority of the members of the Board of Directors shall be non-executive members.

d) It is prohibited to conjoin the position of the Chairman of the Board of Directors with any other executive position in the company, such as the Chief Executive Officer (CEO) or the managing director or the general manager.

e) The independent members of the Board of Directors shall not be less than two members, or one-third of the members, whichever is greater.

f) The Articles of Association of the company shall specify the manner in which membership of the Board of Directors terminates. At all times, the General Assembly may dismiss all or any of the members

[3] The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making paragraphs (c) and (e) of Article 12 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from year 2009.

of the Board of Directors even though the Articles of Association provide otherwise.

g) On termination of membership of a board member in any of the ways of termination, the company shall promptly notify the Authority and the Exchange and shall specify the reasons for such termination.

h) A member of the Board of Directors shall not act as a member of the Board of Directors of more than five joint stock companies at the same time.

i) Judicial person who is entitled under the company's Articles of Association to appoint representatives in the Board of Directors, is not entitled to nomination vote of other members of the Board of Directors.

Article 13: Committees of the Board

a) A suitable number of committees shall be set up in accordance with the company's requirements and circumstances, in order to enable the Board of Directors to perform its duties in an effective manner.

b) The formation of committees subordinate to the Board of Directors shall be according to general procedures laid down by the Board, indicating the duties, the duration and the powers of each committee, and the manner in which the Board monitors its activities. The committee shall notify the Board of its activities, findings or decisions with complete transparency. The Board shall periodically pursue the activities of such committees so as to ensure that the activities entrusted to those committees are duly performed. The Board shall approve the by-laws of all committees of the Board, including, *inter alia*, the Audit Committee, Nomination and Remuneration Committee.

c) A sufficient number of the non-executive members of the Board of Directors shall be appointed in committees that are concerned with activities that might involve a conflict of interest, such as ensuring the integrity of the financial and non-financial reports, reviewing the deals concluded by related parties, nomination to membership of the Board, appointment of executive directors, and determination of remuneration.

Article 14 [4]: Audit Committee

a) The Board of Directors shall set up a committee to be named the "Audit Committee". Its members shall not be less than three, including a specialist in financial and accounting matters. Executive board members are not eligible for Audit Committee membership.

b) The General Assembly of shareholders shall, upon a recommendation of the Board of Directors, issue rules for appointing the members of the Audit Committee and define the term of their office and the procedure to be followed by the Committee.

c) The duties and responsibilities of the Audit Committee include the 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 recommend to the Board of Directors the appointment, dismissal and the Remuneration of external auditors; upon any such recommendation, regard must be made to their independence.
5. 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.
6. To review together with the external auditor the audit plan and make any comments thereon.

[4] The Board of the Capital Market Authority issued resolution Number (1-36-2008) Dated 12/11/1429H corresponding to 10/11/2008G making Article 14 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from year 2009.

7. To review the external auditor's comments on the financial statements and follow up the actions taken about them.

8. To review the interim and annual financial statements prior to presentation to the Board of Directors; and to give opinion and recommendations with respect thereto.

9. To review the accounting policies in force and advise the Board of Directors of any recommendation regarding them.

Article 15 [5]: Nomination and Remuneration Committee

a) The Board of Directors shall set up a committee to be named "Nomination and Remuneration Committee".

b) The General Assembly shall, upon a recommendation of the Board of Directors, issue rules for the appointment of the members of the Nomination and Remuneration Committee, their remunerations, and terms of office and the procedure to be followed by such committee.

c) The duties and responsibilities of the Nomination and Remuneration Committee include the following:

1. Recommend to the Board of Directors appointments to membership of the Board in accordance with the approved policies and standards; the Committee shall ensure that no person who has been previously convicted of any offense affecting honor or honesty is nominated for such membership.

2. Annual review of the requirement of suitable skills for membership of the Board of Directors and the preparation of a description of the required capabilities and qualifications for such membership, including, *inter alia*, the time that a Board member should reserve for the activities of the Board.

3. Review the structure of the Board of Directors and recommend changes.

[5] The Board of the Capital Market Authority issued resolution Number (1-10-2010) Dated 30/3/1431H corresponding to 16/3/2010G making Article 15 of the Corporate Governance Regulations mandatory on all companies listed on the Exchange effective from 1/1/2011.

4. Determine the points of strength and weakness in the Board of Directors and recommend remedies that are compatible with the company's interest.

5. Ensure on an annual basis the independence of the independent members and the absence of any conflict of interest in case a Board member also acts as a member of the Board of Directors of another company.

6. Draw clear policies regarding the indemnities and remunerations of the Board members and top executives; in laying down such policies, the standards related to performance shall be followed.

Article 16: Meetings of the Board

1. The Board members shall allot ample time for performing their responsibilities, including the preparation for the meetings of the Board and the permanent and ad hoc committees, and shall endeavor to attend such meetings.

2. The Board shall convene its ordinary meetings regularly upon a request by the Chairman. The Chairman shall call the Board for an unforeseen meeting upon a written request by two of its members.

3. When preparing a specified agenda to be presented to the Board, the Chairman should consult the other members of the Board and the CEO. The agenda and other documentation should be sent to the members in a sufficient time prior to the meeting so that they may be able to consider such matters and prepare themselves for the meeting. Once convened, the Board shall approve the agenda; should any member of the Board raise any objection to this agenda, the details of such objection shall be entered in the minutes of the meeting.

4. The Board shall document its meetings and prepare records of the deliberations and the voting, and arrange for these records to be kept in chapters for ease of reference.

Article 17: Remuneration and Indemnification of Board Members

The Articles of Association of the company shall set forth the manner of remunerating the Board members; such remuneration may take the form of a

lump sum amount, attendance allowance, rights *in rem* or a certain percentage of the profits. Any two or more of these privileges may be conjoined.

Article 18. Conflict of Interest within the Board

a) A Board member shall not, without a prior authorization from the General Assembly, to be renewed each year, have any interest (whether directly or indirectly) in the company's business and contracts. The activities to be performed through general bidding shall constitute an exception where a Board member is the best bidder. A Board member shall notify the Board of Directors of any personal interest he/she may have in the business and contracts that are completed for the company's account. Such notification shall be entered in the minutes of the meeting. A Board member who is an interested party shall not be entitled to vote on the resolution to be adopted in this regard neither in the General Assembly nor in the Board of Directors. The Chairman of the Board of Directors shall notify the General Assembly, when convened, of the activities and contracts in respect of which a Board member may have a personal interest and shall attach to such notification a special report prepared by the company's auditor.

b) A Board member shall not, without a prior authorization of the General Assembly, to be renewed annually, participate in any activity which may likely compete with the activities of the company, or trade in any branch of the activities carried out by the company.

c) The company shall not grant cash loan whatsoever to any of its Board members or render guarantee in respect of any loan entered into by a Board member with third parties, excluding banks and other fiduciary companies.

PART 5

CLOSING PROVISIONS

Article 19: Publication and Entry into Force

These regulations shall be effective upon the date of their publication.

Appendix B

Questionnaire

English Version

APPENDIX B

Universiti Utara Malaysia

Dear Chief Audit Executive,

Thank you for taking time to consider my survey. I would appreciate your assistance in this research, which I am currently working on my PhD thesis in Utara University Malaysia in Malaysia.

This research aims to examine the impact of internal corporate governance on the performance of public listed companies in Saudi Arabia and I am presently conducting this survey to gain an understanding of the relationship between audit committee and internal audit function. I envisage that the result of this study will contribute to the improvement of auditing practice in Saudi Arabia.

The questionnaire is too short and should take no more than 5 minutes of your time.
Please be assured that all information collected will be held in the strictest confidence and only aggregated results will be reported.

Thank you for your kind assistance, and please do not hesitate to contact me on matariyahya@yahoo.com if you have further queries.

Yours sincerely

Yahya Ali Al-Matari
PhD Accounting candidate
Othman Yeop Abdullah Graduate School of Business
Universiti Utara Malaysia
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APPENDIX B

Did your company have internal audit function during the year of 2010?	Yes □ (If Yes, please proceed to Section A) No □ (If No, please return the questionnaire)

Section A: General and Background Information

1. Name of your organization: --

2. Your present position: --

3. Number of years you have been:

a) With this organization: --

b) In your present position: -------------------------------------

c) An internal auditor: --

Section B: Audit committee characteristics

4. Each year, your audit committee meets ____ times; you meet ____ times a year with the audit committee.

5. You meet privately (without management presence) with the audit committee ____ times.

6. The chief internal auditor has private access to the audit committee. Yes □ No □

7. Please circle your response as to whether the audit committee reviews:

IA proposals related to:	
-Programs/plans	Yes/ No
-Budget	Yes/ No
-Coordination with the external auditor	Yes/ No
The results of internal auditing related to:	
-Financial reporting	Yes/No
-Internal control	Yes/No
-Compliance with laws and regulations	Yes/No
-management responses to internal auditing findings / suggestions	Yes/No

THANK YOU FOR YOUR ASSISTANCE IN COMPLETING THIS QUESTIONNAIRE

Appendix C
Questionnaire
Arabic Version

APPENDIX C

Universiti Utara Malaysia

<u>إستبيان حول العلاقه بين لجنة المراجعه وإدارة المراجعه الداخليه</u>

السيد/ مدير إدارة المراجعه الداخليه المحترم

السلام عليكم ورحمة الله وبركاته

إسمحولي في البداية أن أشكركم على موافقتكم المشاركة في هذا الإستبيان. كما أود أن أقدم لكم نفسي , يحيى علي المطري طالب يمني في برنامج الدكتوراه تخصص محاسبه في ماليزيا.

يهدف البحث الى التعرف على تأثير خصائص مجلس الاداره ولجنة المراجعه على اداء الشركات المدرجه أسهمها في السوق الماليه السعوديه, ويقوم الباحث في هذا الإستبيان بجمع معلومات عن العلاقه بين لجنة المراجعه وإدارة المراجعه الداخليه, بالإضافة الى أن نجاح هذا الإستبيان والنتائج المترتبة عليه أمر مهم لحصولي على درجة الدكتوراه, فإنها قد تكون مهمة أيضاً في تطوير المهنه وإثراء عملية البحث العلمي.

بناءً على ذلك فأنا اكتب اليكم هنا لمساعدتي في هذا الإستبيان من خلال تخصيص مده لاتتجاوز 5 دقائق من وقتكم الثمين لتعبئة هذا الإستبيان.

أخيراً, أشكر لكم تعاونكم معي سلفاً بتعبئة هذا الإستبيان وأؤكد لكم أن هذه المعلومات ستعامل بسرية تامة ولن تستخدم إلا لغرض البحث العلمي , كما يمكن مراسلتنا على العنوان التالي في حالة وجود أي إستفسار.

يحيى علي المطري

Yahya Ali Al-Matari, 39, 2D, Sisiran, Sintok 06010, Kedah, Malaysia

E-mail: **matariyahya@yahoo.com**

Tel: **0060108915679**;

APPENDIX C

هل كانت تقوم شركتك بوظيفة المراجعه الداخليه خلال السنه الماليه 2010؟	نعم □ يرجى الانتقال الى الجزءالاول لا □ يرجى إعادة الاستبيان

الجزء الأول :معلومات عامه

1) اسم شركتك : --

2) وظيفتك الحالية بالشركة : --

3) عدد سنوات خدمتك :

أ) في هذه الشركة: ---

ب) بوظيفتك الحالية: --

ج) بوظيفة مراجع داخلي: --

الجزء الثاني: فعالية لجنة المراجعه الداخليه

1) تجتمع لجنة المراجعة في السنة ---------- مرات, تجتمع حضرتك مع لجنة المراجعة ---------- مرات سنويا

2) تجتمع حضرتك مع لجنة المراجعة اجتماع خاص (بدون حضور الاداره التنفيذية) ---------- مرات سنويا

3) يستطيع مدير إدارة المراجعة الداخلية الدخول الخاص إلى لجنة المراجعة متى شاء. نعم □ لا

APPENDIX C

4) يرجى وضع دائرة على الاجابه المختارة فيما إذا كانت لجنة المراجعة تطلع على :

خطط المراجعة الداخلية المتعلقة ب:	
• الخطط والبرامج	نعم / لا
• الموازنة	نعم / لا
• التنسيق مع المراجع الخارجي	نعم / لا
نتائج المراجعة الداخلية المتعلقة ب:	
• التقارير المالية	نعم / لا
• الرقابة الداخلية	نعم / لا
• الالتزام بالقرارات والقوانين	نعم / لا
• متابعة استجابة الاداره لتقارير ومقترحات المراجعة الداخلية	نعم / لا

أشكر لكم وأثمن عالياً مشاركتكم في هذا الإستبيان,,,,,