

## **Corporate Governance, Firm Attributes and Financial Performance of Saudi Listed Banks**

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*The aim of the current study is to examine the determinants of financial performance by Saudi listed banks. In fact, three corporate governance namely, board size, board composition, and board meeting and two firm variables namely firm size and leverage were used in the present study. The population for this study defined as listed banks in Saudi exchange market during the period of 2007-2012. There were 11 banks listed in Saudi exchange market. After excluding one bank that has incomplete data, the total sample of study becomes 10 banks with 60 observations. The results of multiple linear regressions indicated that the only variable is significantly associated with the financial performance is firm size. Other variable were not related to the financial performance measured by ROA in the Saudi environment.*

**Keywords:** Corporate governance, performance, Saudi Arabia, Banks

### **1. Introduction**

Financial institutions, mainly banks, are particularly concerned with corporate governance. In fact, good corporate governance plays an important role in protecting the depositors, taxpayers, individual banks, and whole financial sector. To do that, Mullineux (2006) argued that the only way to protect banks' stakeholder rights is to have sound regulations and accounting standards that enable us to balance between the rights of different stakeholders and shareholders. This indicates that the banks will fail to obtain good corporate governance without sound regulations. Al-Hussain (2009) argued that the regulations related to board structure is one of very important tools used to enhance the efficiency of corporate governance and improve the value of firms accordingly.

Since the interest of shareholders measured by firms' value, many studies have been conducted to investigate the relationships between firm performance and corporate governance. For example, the studies of Laing and Weir (1999) in the UK, Coleman and Biekpe (2006) in Ghana, Amran and Ahmad (2009) in Malaysia, and Belkhir (2009) in the US, were conducted to investigate the relationship between firm performance and board structures. In fact, most studies of corporate governance have ignored the problems of corporate governance of banks in

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emerging countries (Caprio et al., 2007). Hence, this topic is important for several reasons. On the one hand, banks occupy a dominant role in the economies of these countries. They are a major component of any national economy. On the other hand, the change of the international response to globalization, liberalization, deregulation of financial systems, the adoption of new banking technologies affect the operation of banks.

Saudi Arabia has a modern banking industry with 11 listed commercial banks. Saudi banks provide retail and corporate banking, investment services, brokerage facilities, and derivative transactions in addition to credit cards, ATMs and point-of-sale transactions. The banking and finance sector is overseen by several government agencies. The Ministry of Finance supervises economic policies. The Saudi Arabian Monetary Association (SAMA) manages fiscal policy, issues the country's currency, the Saudi Riyal and supervises the nation's commercial banks. Finally, Capital Market Authority (CMA) controls all companies listed in Saudi exchange market including banking sector. In fact, CMA has issued a corporate governance code in November 2006, revised in 2009 in order to attract more investors to the country. In Saudi Arabia, practice of corporate governance is still new and underdeveloped in comparison with the growth of companies and the stock market.

As a result, this area of research needs a lot of studies to be conducted in Saudi context in general and particularly, among financial sector where such studies are sporadic. Hence, the purpose of the present study is to fill the gap in the accounting and corporate governance literature by attempting to examine the impact of board structure and firm characteristic on the financial performance of Saudi listed banks where such studies are rare. Also the results of this study about the impact of board structure on firm performance may help potential investors to grasp the importance of good corporate governance practices in protecting their interests. Finally, the study will add to the existing body of literature of corporate governance and will contribute particularly to a better understanding of the potential components of board structure.

The findings offer new evidence on the determinants of financial performance, in particular with reference to Saudi listed banks. The findings of this study may be useful to make a comparison with banks of other GCC countries. In general, the findings provide evidence that firm size is positively associated with firm performance by Saudi listed banks. This result is in line with Arouri et al (2014), Dogan, (2013), Ehikioya (2009), Guest (2008). With regards to the board structure variables, the present study does not find any effect of such variables on the financial performance. It means that corporate governance in Saudi context is underdeveloped. This result is similar with other prior studies such as Arouri et al (2014) Dulewicz and Herbert (2004), Guest (2009). Additionally, the findings of this study may have practical importance to regulatory authorities and policy-makers, such as the Ministry of Commerce and Industry, the Ministry of Finance, the Saudi Arabian Monetary Association (SAMA), the Capital Market Authority (CMA), and the Saudi Stock Exchange (Tadawul) in terms of enhancing the market for corporate control as an external governance mechanism.

The rest of this paper is organized as follows: the next section provides a detailed discussion concerning the literature review and hypotheses development followed by the research methodology; and finally findings, discussion and concluding remarks.

## **2. Literature Review and Hypothesis Development**

### **2.1 Financial Performance**

Financial performance can be described as a measurement of how well a firm uses its assets from its primary mode of business to generate revenue. The term is also used as general measure of firm's overall financial health over a given period of time. The business dictionary (2013) defines financial performance as measuring results of a firm's policies and operations in monetary terms and these results are reflected in firm's return on investment, return on assets, value added etc. Neely (2011) observes that financial performance measures mainly serve three purposes. Firstly, they serve as a tool of financial management, secondly they serve as major objectives of business e.g. to have a 40% ROA and lastly they serve as a mechanism for motivation and control within an organization. According to Klapper and Love (2004) ROA is one of the best performance measures used to address the relationship with corporate governance. Therefore, the study uses ROA to find out the relationship of this measure with independent variables. Likewise Ehikioya (2009), the present study measures ROA as a percentage of profit before interest and tax divided by total assets.

### **2.2 Corporate Governance Definition**

The Organization for Economic Co-operation and Development (OECD) (2004) defines corporate governance as a group of relationships between management, boards, shareholders and other stakeholders of the firm. Based on this definition, the board is not only responsible to the company and its shareholders but also has a duty to other stakeholder's interests such as employees, creditors, customers, suppliers and public. Furthermore, according to agency theory, corporate governance is managerial procedures that force management to protect the welfare of stakeholders (Tirole, 2001). To maximize the welfare of stakeholders, three keys corporate governance structures need to interact together (executive management, board of directors, and shareholders). Unlike OECD, agency theory concerns only about the interest of shareholder, consequently, the code of corporate governance has to focus and give more attention to shareholders rights rather than other stakeholders' rights. Therefore, the present study will focus on the relationship between the internal corporate governance in particular, board structure with financial performance by Saudi listed banks.

#### **2.2.1 Board Structure**

The board of directors is charged with oversight of management on behalf of shareholders. Agency theorists argue that in order to protect the interests of shareholders, the board of directors must assume an effective oversight function. It is assumed that board performance of its monitoring duties is influenced by the effectiveness of the board, which in turn is influenced by factors such as board composition and quality, size of board, duality of chief executive officer, board diversity, information asymmetries and board culture (Brennan,2006). The issue of the board structure as a corporate governance mechanism has received considerable attention in recent years from academics, market participants, and regulators. It continues to receive attention because theory provides conflicting views as to the impact of board structure on the control and performance of firms, while at the same time the empirical

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evidence is inconclusive. To date, the relationship between board structure (as opposed to board processes) and company performance has been the most studied aspect among all board investigations (Bhagat and Black, 2002).

In fact, many studies have been done to address such issue to give clear and complete picture of corporate governance structure as a whole as seen in Laing and Weir (1999) and Belkhir (2009) in the US, Abdullah (2004) and Che Haat et al (2008) in Malaysia, and Ehikioya (2009) in Nigeria. In these studies, it is often assumed that a company's financial performance is mainly determined by board characteristics. Since the one aim of this study is to address the relationship between corporate governance (board structure) and the performance of Saudi listed banks, this part will focus on the literature of firms' performance and board structure in terms of board size, board meeting, and board composition. one of the important board structure variables is board size. It received a great attention by literature in which provides a theoretical and empirical link between board size and financial performance (Yermack, 1996). Yawson (2006) also argued that small board size more efficient compares to large board size. This is because there are higher agencies problems associated with larger boards which may make it less effective compare with smaller boards such as the conflict of interests within small board less when they match with those in large board. However, resource dependence theory assumes that the large board is better for corporate financial performance. Haniffa and Hudaib (2006) found that diversity in skills and experience associated with large boards than small boards, which offers greater opportunity to secure critical resources.

Empirically, there is conflict of evidences with regards to the association between board size and firm financial performance. For example, Cheng (2008) in their study of 2,980 US firms (including 122 financial firms) over the period 1996–2004 found there is negative relationship between financial performance and board size. By contrast, Beiner, et al (2006) who used a sample of 235 Swiss listed firms (including banking sector), found a positive relationship between firms performance and board size. Likewise, Coleman and Biekpe (2006) in Ghana (including financial sector), Amran and Ahmad (2009) in Malaysia, and Belkhir (2009) in the US, found same relationship between these variables. As can be seen from the above discussion, there is a mixed result with respect to the association between board size and financial performance. In the present study, board size measured by natural log of the number of members sitting on the board which consistent with (Cheng, 2008; and Belkhir, 2009). Therefore, the study examines this relationship based on the following hypothesis:

**H1:** There is a significant positive relationship between board size and financial performance by Saudi listed banks.

Board composition has been highly debated in the previous literatures. There are mix empirical evidences regarding the relationship between financial performance and board composition. For example, using sample of 164 Malaysian listed firms for financial year 2001 Abdullah (2006) found negative relationship between firm's financial performance and board independence. This result supported the findings of the study of Klein, et al (2005) who found a negative relationship between family firms' performance and board composition. These results suggested that high performance is associated with low board's composition. To sum, these findings in line with the theoretical view of stewardship theory which assumes that the high performance can be

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generated once firms govern by inside directors due to their knowledge and time they spend that enable them to make better decisions.

However, there is empirical evidences supported the view point of agency theory as well. For example, Hossain, et al (2001) who used sample of 633 New Zealand firms over the period of 1991-1997; and Krivogorsky (2006) of 87 firms cross Europe over the period of 2000- 2001. They found positive relationship between financial performance and board composition. These results indicate that the firms' value increase when they mix their boards with outsider directors. Moreover, there is third group of researchers found there is no relationship between these variables. For example, Guest (2009) found the performance of firms who have outsider directors is not deferred of those have fully inside directors of 2,746 UK firms including banking sector over period of the 1981-2002. Similarly, Ehikioya (2009) and Belkhir (2009) found there is no empirical support of agency theory nor stewardship theory suggestion about the impact of board composition on the firms' performance. In the present study, board composition measured as a proportion of independent directors which equal the number of independent directors to total number of directors (Chen et al, 2009). Thus, this study tests this relationship based on the following hypothesis:

**H2:** There is a positive association between the board composition and financial performance by Saudi listed banks.

Although dearth of empirical evidences regarding the impact of frequency of board meetings and firm financial performance, available evidences are in a great conflicting. Vafeas (1999) found negative relationship between firms' financial performance and the frequency of board meetings of sample of 307 US listed firms the period from 1990 to 1994. This findings supported by the study of Fich and Shivdasani (2006) who found that market gives less appreciation to the frequency of board meeting, by using sample of 508 US listed firms over the period of 1989-1995. This indicated that the specific meetings of board directors help firms to perform well by cutting off unnecessary costly gathering. By contrast, Karamanou and Vafeas (2005) found a positive relationship between firms' performance and frequency of board meetings. Moreover, the study of Mangena and Taurigana (2006) found a positive relationship between these two variables of 157 Zimbabwean listed firms from 2001 to 2003. These results suggested to the more frequent board meetings the better performance firms. Unlike above studies, El Mehdi (2007) using sample of sample of 24 Tunisian listed firms over the period of 2000-2005, this study did not find any relationship between firms' performance and board meetings. In the present study, board meeting (BRMTG) measured by the natural log of number of meetings held by the board in the year (Vafeas, 1999). Hence, this study tests this relationship based on the following hypothesis:

**H3:** There is a significant positive relationship between board meetings and financial performance by Saudi listed banks.

### 2.3 Firm Characteristics

Certain firm characteristics are associated with financial performance such as firm size and leverage (Dogan, 2013). Firm size is considered to be one of the firm characteristic that is constantly associated to financial performance. Larger firms are associated with having more

diversification capabilities, ability to exploit economies of scale and scope and also being highly formalized in terms of procedures. Bigger firms can seize a profitable opportunity that comes in their way since they have bigger capital resources than smaller sized firms. Another school of thought argues that due to organizational rigidity brought about by bigger firm size and a lot of unnecessary bureaucracies, profitable opportunities that may want urgent attention will easily pass the firm and thus making them less profitable in relative terms and thus negatively impact on firm performance (Banchuenvijit, 2012; Goddard et al., 2005).

Based on these arguments, it is expected that firm size to be an important predictor for financial performance. There is a mixed evidence with respect to the association between firm size and financial performance. For instance, Hossain et al (2001), Coleman and Biekpe (2006), and Amran and Ahmad (2009) found negative relationship between firm size and firm performance. Unlikely, Guest (2008), Ehikioya (2009), and Haniffa and Hudaib (2006) found that firm size have a positive impact on firm performance. The current study, firm size in this study defines as a natural logarithm of total assets (Belkhir, 2009; and Ehikioya, 2009). Therefore, this study tests this relationship based on the following hypothesis:

**H4:** There is a positive association between the bank size and financial performance by Saudi listed banks.

Another important firm characteristic which found to be related to financial performance is leverage. Leverage is ratio between total debt and total assets of the company that shows the extent to which the totals assets are financed by loans. An increase in this ratio shows the dependence of the company on external debt financing and greater score being given the firm by debt providers. This however, may decrease firm's autonomy because of the restrictive covenants imposed by debt providers and may in the worst case scenario lead to financial solvency. Mixed conclusions were found in prior studies. For example, Guest (2008) and Ehikioya (2009), found positive relationship between leverage and financial performance. However, Al-Sakran (2001) found a negative relationship between ROA and leverage ratios for Saudi public firms. Furthermore, Hossain et al, (2001), Goddard et al., (2005); and Dogan (2013) a negative relationship between the leverage and financial performance. In line with Henry (2008), the study measures the leverage ratio as the book value of total debt to the book value of total assets. Thus, this study proposes the following hypothesis:

**H5:** There is an negative association between the leverage and financial performance by Saudi listed banks.

### 3. Research Method and Data Analysis

#### 3.1 Sample Selection and Data Collection

The selection of the survey population and the sample size are the most important issues for any empirical research. The population for this study defined as listed banks in Saudi exchange market during the period of 2007-2012. There were 11 banks listed in Saudi exchange market. After excluding Alnima bank which listed at the end of 2006 and had incomplete data, the total sample of study becomes 10 banks with 60 observations. The main aim of this study is to

examine the association between board structure, firm characteristics and financial performance for listed Saudi banks. Secondary source is used to collect required data. Annual reports is downloaded from the website of Saudi exchange market and Gulf base for all sampling banks for the period of 2007-2012. The period of study is 2007-2012 this is because the implementation of Saudi Governance Code 2006 has taken place in 2007.

### 3.2 Data Analysis

This study used descriptive statistics such as means, standard deviations etc. The study also ran multivariate regression analysis to see the extent of relationship of the various corporate governance factors and firm characteristics in explaining variations in bank financial performance. Several significance tests were applied to the variables and model under study to see the significance of the variables and the fitness of the overall model. Correlation analysis was employed in the study to see the direction and effect of various corporate governance factors and firm characteristics on bank financial performance. Further the researchers analyzed using multivariate linear regression the coefficient of determination (R squared), ANOVA, and beta coefficients for the model to explain how much the model will explain the changes in the dependent variable, which is ROA. In fact the study have one dependent variable is financial performance measured by ROA and five independent variables namely, board size, board composition, board meetings, bank size and leverage. Therefore, the current study used the following research model:

$$\text{FINPER} = a + \beta_1 \text{BSIZE} + \beta_2 \text{BCOM} + \beta_3 \text{BMEET} + \beta_4 \text{SIZE} + \beta_5 \text{LEVRG} + \varepsilon$$

Where FINPER is dependent variable measured as ROA, BSIZE, BCOM, BMEET, SIZE, and LEVRG refer to independent variables.

## 4. Results

### 4.1 Descriptive Statistics

The descriptive statistics of all variables is presented in Table1. The minimum value of the dependent variable (financial performance) was from -1.43 % to a maximum of 5.16 % with a mean of 1.8823 %. The Board size ranges from a minimum of .90 and maximum of 1.04 with a mean of .9976 of Saudi listed banks. The results is consistent with Saudi corporate governance code, which stated that the listed firms must have directors not less than three and not more than eleven. With respect to Board composition, the result indicates that board composition ranges from a minimum of .27 and maximum of 1.00 with a mean of .6555. The findings point out that (65%) of Saudi listed banks' boards' members are independent directors. This is also in line with the guidelines of Saudi corporate governance code that proposed that the composition of the board must be not less than one-third of the members. In addition, firm size ranges from a minimum of 7.21 and maximum of 8.43 with a mean of 7.9322. Finally, the leverage ranges from a minimum of .74 and maximum of .91 with a mean of .8577.

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**Table 1: Descriptive Statistics**

	N	MINIMAM	MAXIMAM	MEAN	SD
ROA	60	-1.43-	5.16	1.8823	1.09264
BRDSIZE	60	.90	1.04	.9976	.03467
BRCMP	60	.27	1.00	.6555	.19589
BRMTG	60	.48	.90	.6775	.11527
FSIZE	60	7.21	8.43	7.9322	.32605
LEVE	60	.74	.91	.8577	.03218

## 4.2 Correlation Analysis

The Pearson correlation matrix is useful for analyzing data that is non-categorical in nature and uses interval measurement scale (Field, 2009). Table 2 shows the correlation coefficient between the independent variables and dependent variable. It can clearly be seen that there is a positive significant relationship between board size and financial performance at significant of 1% level. Likely, firm size has a positive significant relationship with financial performance by Saudi listed banks. However, board composition, board meetings and leverage do not have any significant correlation with financial performance measured by ROA.

**Table 2: Correlations Coefficients**

	ROA	BSIZE	BCIMOISIT	BMEETINGS	FSIZE	LEVERAGE
ROA	1					
BSIZE	.338**	1				
BCOMPOSIT	-.244-	-.383- **	1			
BMEETINS	.187	.397**	-.040-	1		
FSIZE	.580**	.300*	-.274-*	.369**	1	
LEVERAGE	.055	-.076-	-.160-	-.060-	.233	1

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

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

However, Pearson correlation matrix may pose a problem if two variables are analyzed but the effect of the third confounding variable(s) is/are not controlled for (Field, 2009). This problem will however be corrected by analyzing further the isolated effect of two variables and controlling for the other four variables in our study using partial correlation matrix to aid in clearly isolating the size effect of all the six variables under study. Thus, it shall be imperative to analyze the effect of a single independent variable to the dependent variable while controlling the effects of shared influences of the independent variables to ROA. In effect, we analyze only the “true and unshared” effects board size, board composition, board meetings, firm size, and leverage. The findings of the partial correlation test is that the only variables related significantly to the financial performance is board size and firm size which is consistent with the above results.

**4.3 Multivariate Analysis Results and Discussions**

Table 3 reports the OLS regression results the adjusted R-squared of 32% which suggest that 32% of the variations in the dependent variable of sampled firms are explained by the quality of the independent variables of three board structure variables and two firm variables. This finding is better compared to similar studies conducted in this area. For example, Cheng (2008) reported only 28% of adjusted R-squared. Moreover, it shows F-value of model is statistically significant at the 1% level. This means that the coefficients on the corporate governance variables and firm characteristics can jointly explain significant variations in the sampled firms' ROA. In terms of the first hypothesis, this study finds that board size (BRDSIZE) is a positive association with firm performance but not significance. The result indicates that larger boards are ineffective in enhancing financial performance in the context of Saudi banks. The no association between large boards and financial performance is similar to the findings of Dulewicz and Herbert (2004) who pointed out that boards of directors size are incapable of affecting the financial performance.

The findings of the current study show that there is a negative and insignificant relationship between board composition (BRCMP) and the firm performance. This result is in line with Guest (2009) who found the performance of firms who have outsider directors is not different of those have fully inside directors of 2,746 UK firms including banking sector over period of the 1981-2002. Similarly, Ehikioya (2009) and Belkhir (2009) found there is no empirical support of agency theory nor stewardship theory suggestion about the impact of board composition on the firms' performance.

**Table3: Regression result**

ROA	Exp Sign	Coefficient	t-statistic	Tolerance	VIF
BRDSIZE	+	.145	1.477	.685	1.460
BRCMP	+	.806	-.247-	.777	1.287
BRMTG	+	.406	-.838-	.739	1.354
FSIZE	+	.000	4.573	.740	1.351
LEVERAGE	-	.517	-.653-	.890	1.123
_cons		.007	-2.817-		
R Square	.379				
Adj R-2	.321				
F	(6.590) ***				
Durbin-Watson	1.597				

Notes: \*p < .10, \*\*p < .05, \*\*\*p < .01

With respect to the third hypothesis which states that there is a significant positive relationship between board meetings and financial performance among Saudi listed banks, the findings of the present study find a negative insignificant association between the board meetings and financial

performance. This result is in line with El Mehdi (2007) who did not find any relationship between firms' performance and board meetings among sample of 24 Tunisian listed firms over the period 2000-2005. In terms of the fourth hypothesis which states that there is a positive significant association between the firm size and financial performance, this hypothesis cannot be rejected. This result is with line Dogan, (2013), Ehikioya (2009), Guest (2008), and Haniffa and Hudaib (2006) found that firm size have a positive impact on financial performance. This is because bigger firms have stronger resource base which they can use to seize a profitable opportunity that comes along their way and needless to mention the bigger market share they command. As for the leverage, the findings show that there is an negative insignificant relationship related to performance as measured by ROA though the effect was small. This finding is in contrast with Guest (2008) and Ehikioya (2009), Dogan (2013).

### 5. Conclusion

This paper examines the determinants of the financial performance of Saudi listed banks. In fact, the present study attempts to investigate the relationship between the corporate governance factors, firm variables and financial performance among banking sector in one of the emerging market. In general, the findings provide evidence that firm size is positively associated with firm performance by Saudi listed banks. With regards to the board structure variables, the present study does not find any effect of such variables on the financial performance. It means that corporate governance in Saudi context is underdeveloped. As for leverage, the findings show that there is no relationship between the leverage and financial performance among Saudi listed banks.

Like all studies the present study has some limitations. First, the study focuses only on the determinants of financial performance by Saudi listed banks. Therefore, the results may be not generalizable to other Saudi companies. It is better for further research to sample companies from a wider range, such as non-financial listed companies, non-listed companies and family firms. the data was collected through publicly available data sources such as annual reports. Other data could be helpful to gain more of an insight. Finally, while the study focuses only on a limited number of corporate governance variables (three variables), and two firm variables, other variables have been excluded from the current study due to unavailability of the data. For example, the governmental ownership, forging ownership and individual ownership, the characteristics of audit committee and remuneration committee.

In spite of their inherent limitations, the findings provide valuable insights to regulators for developing suitable regulations on the corporate governance system of Saud listed banks. Even though that Saudi capital market authority issued its own corporate governance code, the study shows empirically there is no impact of its variables, particularly board size, board meeting and board composition on Saudi banks' financial performance. Therefore, Saudi capital market authority recommended to develop new regulations, recommendations and take the necessary corrective decisions regarding the effectiveness of firms' board structure.

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