Chapter 2
The Effects of Corporate Governance (CG) on Saudi Arabian Companies' Earnings Quality

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ABSTRACT

High earnings quality (EQ) is one of the company's pillars of long-term success in building investor confidence. This study investigates whether or not corporate governance (CG) affects the EQ of non-financial companies listed on the Saudi Arabian Stock Exchange known as Tadawul. This research study uses data from a sample of 482 firm-year observations of these companies in the period from 2009 to 2013. The author adopts the Generalized Method of Moments (GMM) regression model. This research study contributes to the current literature by providing new evidence of the effect of CG on the EQ of the Saudi Arabian non-financial companies listed on the Tadawul. Specifically, not all CG attributes affect each company's EQ in the same way. This study's findings show that important CG attributes, which enhance the company's EQ, are the number of the company's independent directors, the separation of the dual role between the company's CEO and chairperson, and the financial or accounting expertise of the members of the company's audit committee members.

INTRODUCTION

The company managers' efficient use of Corporate Governance (CG) practices allow the Board of Directors (BoD) to evaluate its monitoring role and help, also, to develop favourable perceptions among the shareholders of the quality of the company's available financial information. The availability of reliable and accurate information enables the shareholders to make effective decisions about the company's financial performance (Afzal and Habib, 2018; Masulis and Mobbs, 2014). Despite the worldwide revision

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and enhancement of Corporate Governance Codes (CGCs) and regulations, investors have experienced in previous years large numbers of CG violations through scams and financial frauds. More especially in emerging markets, policy makers and regulators try to achieve the global CG standards. However, the high number of financial fraud cases demonstrate the poor implementation of CG standards in emerging economies. This study attempts to examine empirically the effectiveness of CG standards on the EQ of Saudi Arabian non –financial companies listed on the Tadawul.

Earnings are one of the important factors used by shareholders when deciding whether or not to invest in a company (Masulis and Mobbs, 2017). Additionally, the company's earnings are more likely to be the basis of the salaries paid to its managers (Masulis and Mobbs (2016). Therefore, managers may be incentivised to use different accounting techniques in order to manipulate the company's earnings; this is known as Earnings Management (EM)[1] (Masulis and Mobbs,2017;Healy and Wahlen, 1998). Consequently, in order to protect and enhance the confidence of the existing and potential investors, it is important to detect and prevent EM. Therefore, in the context of Saudi Arabia, there is a need for companies to have effective CG standards in order to maximise their shareholders' wealth and to increase both their growth and stability and the long term success of the Saudi Arabian economy. Consequently, in the light of financial crises and corporate scandals, much worldwide attention has been paid recently to CG standards. In other words, weak CG structures may provide companies' managers to engage in behaviours that would result in poorer quality of the companies' reported earnings. Such behaviours are a strong indicator of a serious break-down in business ethics and CG (Gonzalez and Garcia-Meca, 2014).

Therefore, in this study, the author investigates the effects of CG standards on the EQ of non-financial companies listed on Saudi Arabia's Tadawul. The author used data from a sample of 482 firm-year observations of these companies in the period from 2009 to 2013. The findings provide four contributions. First, they add to the limited number of previous studies on CG and EQ in emerging markets and, more especially, in GCC countries. Consequently, this study's findings present a more comprehensive picture of the relationship between CG and EQ. Second, in the context of Saudi Arabia, the findings evidence provide useful reference points for investors and corporations from other regions and, more especially, from developed countries. Third, the findings show that in emerging economies, while CG attributes are important, not all of them have a positive effect on companies' EQ. Consequently, policymakers should customise CGC standards to match their market and cultural needs. Fourth, to the best of the author's knowledge, this is the first Saudi Arabian research study that has used GMM regression analysis to eliminate from regular and tradition regression analysis shortcomings such as eteroskedasticity, serial (auto) correlation and endogeneity. This study's results show that, in order to enhance the company's EQ, the important CG attributes, are: the number of independent directors; the separation of the dual role between CEO and chairperson; and the financial or accounting expertise of the members of the company's audit committee. However, the findings show that the company's board meetings do not play an effective role in improving the management of the company's EQ. In summary, this study's findings demonstrate that efficient CG practices increase investor confidence and their faith in the transparency, accountability and integrity of the companies' financial reporting. Also, in the context of emerging economies, this study's findings should expand the existing literature by improving understanding of the CG attributes on companies' EQ.

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