



Corporate governance Effectiveness and Financial Leverage: Empirical Evidence from Saudi Arabia

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Abstract:

This study aims to examine the impact of corporate governance effectiveness on the firms' financial leverage among Saudi firms. In addition, the study examines the impact of board of director effectiveness and audit committee effectiveness on firms' leverage. This study employs yearly data of Saudi firms over the period of 2012-2016. The study utilizes Ordinary Least Square (OLS) model to support the hypothesis of the study. The study's findings show that Saudi firms with an effective corporate governance are having negative level of leverage in their capital structure. Further, the study finds that firms with effective board of director and less effective audit committee are having more debts in the capital structure. The findings of the study imply that for Saudi firms, effective corporate governance mitigates the agency problem which reflected by the less debts used by Saudi firms in their capital structure. It also provides evidence that effective board reflect that firms are using less debts, this perhaps due to the good performance that means firms are having more internal sources, this leads to use less leverage. It is also found that once audit committee is more effective, firms are having more financial reporting quality which enhance the creditworthiness of the firms and consequently enable firms to get more borrowings. These findings provide implications to the regulators, firms' decision makers, creditors, and investors on the importance of corporate governance monitoring mechanisms namely board of directors and audit committee characteristics. This study enriches the literature and offers valuable implications by providing an empirical evidence on the impact of effective corporate governance captured by internal monitoring mechanisms.

Keywords: Corporate Governance Effectiveness, Board of Directors, Audit committee, Leverage, Saudi Firms.



1. INTRODUCTION:

Corporate governance has received a great attention after the incidence of several corporate frauds and accounting scandals. In addition to its effectiveness to mitigate the potential conflict between managers, shareholders, and stakeholders. This importance led regulators to incrementally making reforms to corporate governance practices to raise the entire standards of corporate governance and to offer corporate organizations positive outcomes. One of the outcomes is the firms' financial leverage. This study aims to examine the impact of the internal corporate governance mechanisms on firms' leverage in an emerging market namely Saudi Arabia. This study further explores whether the relationships found and in lines of theories developed in the West, are applicable in the Saudi context.

For firms that are highly leveraged or highly dependent on short-term debts, might experience financial crisis. Two prime examples namely Asian Financial Crisis of 1997 and Global Financial Crisis of 2007 are widely known and attributed to the firms' financing decisions. In the literature, the impact of corporate governance on firms' performance has been examined. In line with the trade-off theory of capital structure, firms are choosing their optimal composition of debt with an aim to get the maximum benefits of the interest tax shield against the bankruptcy costs. To achieve the study objective, firms leverage (LEV), calculated as the ratio of total debt to total assets is regressed on the corporate governance for a sample of listed firms in Saudi Arabia over the period 2012-2016 with 545 yearly observations. The study found that there is a positive relationship between firms' corporate governance strength and leverage. This implies that firms that are having effective internal governance mechanisms are having relying on debts. This implies that firms are outweigh the bankruptcy costs and take advantage of the interest tax shield due to the good practices of corporate governance that reflect the less agency problem.

The contribution of this study is three-fold: firstly, the study examines the impact of corporate governance strength by using a score for internal governance mechanisms that includes board of directors and audit committee characteristics, this has yet to be done in the Saudi context. Secondly, this study examines the impacts of board of director and audit committee strength separately which enrich the literature and provide valuable implications on the importance of the internal corporate governance mechanisms. Thirdly, the study uses a score to capture the strength of the board of director and audit committee which is yet to be done in the capital structure literature in an emerging country namely, Saudi Arabia.



In the literature, there are several studies that focused on examining the determinants of capital structure, however, the findings lack generalizability due to the unique characteristics of the Saudi Market. In other words, Saudi Arabia has unique characteristics that implies that prior studies' findings are not applicable to be generalized in its Context. One of these characteristics is the absence of corporate tax, and the illiquid bond market. In addition, the banking system in Saudi Arabia is unique as it is dual. This mean that banks are providing both Islamic and conventional banking services. In terms of the regulatory duties, it is assigned to the Saudi Arabian Monetary Authority (SAMA) (Khan et al., 2020). Hence, firms' decisions might by affected to the internal and external corporate governance mechanisms differently in such context.

This study uses a panel data set of listed firms in Saudi Arabia to empirically examine the extent to which corporate governance strength affect the firms' leverage over the period of 2012-2016. Ordinary Least Square (OLS) regressions estimation technique is used, and different tests are employed to assess the robustness of the results. The findings of this study shows that there is a significant negative relationship between corporate governance mechanisms and firms' leverage. These findings implies that firms that maintain effective internal mechanisms are having more less debts in their capital structure. Further, additional tests have been conducted and found that board of directors' attributes are affecting more compared to the audit committee characteristics. These results shows that Saudi firms that have effective board are having more leverage. This implies that firms are using less debts due to the good performance that means firms are having more internal sources, and this leads to use less leverage. In terms of the audit committee, it is also found that once audit committee is more effective, firms are having more financial reporting quality which enhance the creditworthiness of the firms and consequently enable firms to get more borrowings.

This study is organized into five parts; the first section includes an introduction followed by la section for the literature review. In the third part, the methodology of the study is presented. In the following part, the findings of this study and reported and discussed. In the last section, the conclusion in addition to the further suggestion for future researchers are explained.



2. LITERATURE REVIEW :

Corporate governance has been attracting the attention of practitioners over the last three decades. It is the concept that gained its importance after the corporate collapses, such as, Enron and WorldCom, and the 1998 Asian financial crisis. Before, these events, the agency theory of Jensen and Meckling (1976) has been revealed earlier. Based on the agency theory, the aim of corporate governance is to mitigate the conflict of interests not only between the managers and the owners but also between all internal and external stakeholders with an aim to maximize shareholders' wealth.

Among the corporate governance mechanisms, Board of directors attributes have been prominently examined in the literature as it is considered as the apex of a corporate system. It is widely argued that firms with effectiveness of corporate governance practice is a function of the board. Hence, board of directors have an important role in managing and directing the management (Farrar, 2005 and Hussain et al., 2019). In addition, to its monitoring role (Jensen and Meckling, 1979). For emerging markets, board of directors have a vital role as it complements the weakness of other external corporate governance mechanisms (Rajan and Zingales, 1995).

There are several theories that have underlined the arguments of the corporate governance practices such as agency theory, resource dependent theory, stakeholder theory, stewardship theory (Rajan and Zingales, 1995; Hung, 1998). In line with the resource dependency theory, the impact of the board is attributed due to its impact as a linking role, while stakeholder theory stated the coordinating role of the board. In addition to the agency theory which focused on the controlling role. Corporate governance is the framework that reflects accountability, and transparency. It reduces the conflicts between agents and that may have an influence on a firm's capital structure. It has been addressed as the guideline that resolves disputes between agents and principles to ensure that the agents are able to manage funds to get maximum returns. A study done by Chancharat et al. (2012) supported that firms' level of debt is not only affected by the firm's unique feature, but also affected by the level of conflicts of interest between its manager and shareholders.

In the literature, there are several studies that focused on leverage and corporate governance such as Berger et al. (1997) and Wen et al. (2002). Another study done by Jiraporn et al. (2012) found that firms with effective corporate governance mechanisms can reduce the agency costs. Wen et al. (2002) argued that firms' managers tend to prefer less leverage if they are confronting good corporate governance of the board of directors.



Boards of directors are considered as the most important element of the corporate governance mechanism in overseeing the operations of the company to perform accurate and appropriate, through their representatives. It has crucial role in mitigating the agency problem and the failure of the firms (Chancharat et al., 2012). Board of directors is responsible for making decisions to achieve the firms' strategies. It is also argued that the existence of effective board enables the firms to get several sources of borrowing which consequently imply more debt in their capital structure. This is aligned with the agency theory as well.

One of the internal mechanisms that have been examined is board size and its impact on leverage. Thus far, there is no cutoff for the appropriate board size. It depends on each firm's characteristics, monitoring costs and organizational complexity (Uchida, 2011). In the literature, there are several studies but with mixed results regarding the impact of board size on leverage. Berger et al. (1997) supported the negative relationship between board size and leverage. Earlier in 1986 Jensen found that firms with larger board size have higher leverage and are more likely to use more debt financing than equity. This is in line with the argument that firms with more directors can tap into their directors' networks which enable them to get more access to external financing. Another attribute that has been examined in the literature to reflect the effectiveness of the board of directors is the independence of the board members. Independent directors are those who are not either major shareholders or executives of the company. Board member are considered independent if they have appropriate and required qualification for the nature of the firms' operations, and they are qualified based on the criteria prescribed by the board of director. Independent directors perhaps enable firms to rely more on leverage. Berger et al. (1997) supported that firms with more independent directors have higher leverage.

In the corporate governance literature, audit committee has been addressed largely. Audit committee is a sub-committee of the board of directors that are in charge of preparing the financial reports and making an accurate disclosure in compliant with required standard (Detthamrong et al., 2017). Additionally, audit committee is responsible for proposing external auditors to the board, controlling management, creating confidence and reliability for the financial reports (Anderson et al.; 2004; Harris and Raviv, 2008). These audited reports provide useful and incremental information to stakeholders (Chen et al.; 2016).

In line with the above arguments, it can be said that audit committee effectiveness would enable firms to have more opportunities to get external financing, if needed. This implies that audit committee characteristics might be associated with leverage either positively



or negatively. Another argument that supports the positive association is that effective audit committee might allow firms to increase its leverage due to good quality of the financial reported perceived by the creditors. Another argument that supports the negative association is that audit committee might lower the firm's leverage if it feels that the leverage was already too high (Detthamrong et al., 2017).

3. MODEL AND METHODOLOGY

In this section, the methodology followed in this study is presented. The study employs 545 yearly data observation over the period of 2012-2016 for listed Saudi firms. The model of the study is presented in the below equation:

$$LEV_{it} = \alpha_0 + \alpha_1 CGstrength_{it} + \alpha_2 SIZE_{it} + \alpha_3 ROA_{it} + \alpha_4 TANG_{it} + \alpha_5 \sum Year_{it} + \varepsilon$$

Equ1

$$LEV_{it} = \alpha_0 + \alpha_1 BODstrength_{it} + \alpha_2 ACstrength_{it} + \alpha_3 SIZE_{it} + \alpha_4 ROA_{it} + \alpha_5 TANG_{it} + \alpha_6 \sum Year_{it} + \varepsilon$$

Equ 2

As shown in Equation 1, LEV is the firms' financial leverage measured by total debt divided by total assets. This measurement has been used widely by enormous studies. In terms of the CGstrength it is a score that proxy the level of corporate governance effectiveness. This score is constructed by using three attributes related to board of directors (board size, independence, and number of meeting) and three attributes of audit committee (audit committee size, independence and number of meeting). A value of "1" is given if the firm is above the median for the respected mechanisms in each year for all sample of the study, otherwise, a value of "zero" would be given. Hence, the score for any firm would range between 6 and Zero. Several studies have followed and supported capturing the corporate governance by constructing a score (Al-Rassas and Kamardin, 2016).

In equation 2, the effectiveness of Board of directors and audit committee are regressed to examine their impact on firms' leverage. BODstregnth is the score of the board of directors' effectiveness constructed by using three board of directors' characteristics (board size, independence, and meeting) where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and three. For board size, it is measured by the number of directors in the firm's board while independence is measured by the percentage of the independent directors who are serving in the board. For the meeting, it is measured by the number of meetings held by the board within one year. In addition, ACstrength is the score of the audit committee effectiveness constructed by using three audit committee characteristics (board size, independence, and meeting), where value one is given for each attribute if it is above the sample median



otherwise zero is given. This index ranges between zero and three. For AC size, it is measured by the number of directors in the firm's AC while independence is measured by the percentage of the independent directors who are in the audit committee. For the meeting, it is measured by the number of meetings held by the AC within one year. In this study, control variables are included in the model of this study following what has been used by previous studies. The first variable is firm size (SIZE) which is measured by using log for the total assets for each firm i in year t . It is expected that large firms exhibit more debts compare to the small firms. Further, the study follows Al-Jaifi and Al-Rassas (2019) and Detthamrong et al. (2017) who used the firm's profitability and tangibility as control variables for the leverage variation. The profitability of firms (ROA) is calculated as net income divided by the total assets. In terms of the tangibility (TANG), it is calculated as net amount of property plants and equipment divided by total assets. The year dummy variables are included to capture any possible variations.

4. RESULTS AND DISCUSSION

Table 1 presents the descriptive statistics. It includes the mean, standard deviation, minimum and maximum for all variables used in this study. The mean (median) value of LEV is 0.372 and 0.354, respectively, suggesting that the average firm in Saudi Arabia is not overleveraged, whereas the mean (median) value of CGstrength is 2.242 and 2, respectively. for board of directors and audit committee strength is shown that the mean is 1.031 and 1.211 respectively.

TABLE 1: Descriptive statistics of the study variables.

Variable	Mean	Median	Std. Dev.	Min	Max
LEV	0.372	0.354	0.212	0.013	1
CGstrength	2.242	2	1.369	0	6
BODstrength	1.031	1	0.807	0	3
ACstrength	1.211	1	0.877	0	3
SIZE	14.736	14.560	1.641	10.887	19.814
ROA	0.063	0.048	0.090	-0.512	0.3885
TANG	0.480	0.489	0.236	0	0.941

LEV is leverage calculated by total debts divided by total assets; CGstrength is the score of the corporate governance effectiveness constructed by using three board of directors' characteristics (board size, independence, and meeting) and three audit committee



characteristics (board size, independence, and meeting), where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and six; BODstrength is the score of the board of directors' effectiveness constructed by using three board of directors characteristics (board size, independence, and meeting) where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and three; ACstrength is the score of the audit committee effectiveness constructed by using three audit committee characteristics (board size, independence, and meeting), where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and three; SIZE is the firms size calculated as the log of the total assets for each firm; ROA is the profitability calculated as the net income divided by the total assets; TANG is the firm tangibility calculated as net amount of property, plants and equipment divided by total assets.

Table 2 reports the correlations between the variables included in the model of this study. This correlation test shows the associations between the study variables. it is shown that corporate governance strength has a significant negative association with leverage. Profitability has similar association with leverage while firms' size and tangibility are having positive associations with leverage. This test provides preliminary findings, but it does not reflect the concurrent effect of all variables on the firms' leverage. Hence, regression estimation is employed to provide more robust findings.

TABLE 2: Correlations tests

Variables	LEV	CGstrength	BODstrength	ACstrength	SIZE	ROA	TANG
LEV	1.000						
CGstrength	-0.150***	1.000					
BODstrength	-0.246***	0.794***	1.000				
ACstrength		0.829***	0.320***	1.000			
SIZE	0.412***	-0.086**	-0.0850**	-0.0565	1.000		
ROA	-0.306***	-0.104**	-0.079*	-0.088**	-0.007	1.000	
TANG	0.146***	0.065	-0.0118	0.112***	0.235***	-0.068	1.000

LEV is leverage calculated by total debts divided by total assets; CGstrength is the score of the corporate governance effectiveness constructed by using three board of directors characteristics (board size, independence, and meeting) and three audit committee characteristics (board size, independence, and meeting), where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and six; BODstrength is the score of the board of directors effectiveness



constructed by using three board of directors characteristics (board size, independence, and meeting) where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and three; ACstrength is the score of the audit committee effectiveness constructed by using three audit committee characteristics (board size, independence, and meeting), where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and three; SIZE is the firms size calculated as the log of the total assets for each firm; ROA is the profitability calculated as the net income divided by the total assets; TANG is the firm tangibility calculated as net amount of property, plants and equipment divided by total assets.

*, **, *** represent the significant levels of 10%, 5% and 1%, respectively.

In table 3, the findings of the multiple regression is presented. The findings show the relationship between the independent variables, control variables and dependent variable by using multiple regression model namely Ordinary Least Square (OLS). The model shows that R square is 28.77 percent which means these variables used in the model can explain 28.77 percent of the variation leverage. The significance of p-value also confirms that the model is fit.

TABLE 3: Multiple regression analysis result

Variables	Model 1	Model 2
CGstrength	-0.023*** (-4.16)	
BODstrength		-0.068*** (-6.95)
ACstrength		0.016* (1.77)
SIZE	0.050*** (10.25)	0.050*** (10.52)
ROA	-0.759*** (-8.65)	-0.762*** (-8.93)
TANG	0.039 (1.16)	0.020 (0.63)
_cons	-0.280*** (-3.79)	-0.271*** (-3.76)
Year Dummies	Included	Included
P Statistic	27.07***	28.73***
R Squared	0.2877	0.3258
N	545	545

LEV is leverage calculated by total debts divided by total assets; CGstrength is the score of the corporate governance effectiveness constructed by using three board of directors' characteristics (board size, independence, and meeting) and three audit committee



characteristics (board size, independence, and meeting), where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and six; BODstrength is the score of the board of directors' effectiveness constructed by using three board of directors' characteristics (board size, independence, and meeting) where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and three; ACstrength is the score of the audit committee effectiveness constructed by using three audit committee characteristics (board size, independence, and meeting), where value one is given for each attribute if it is above the sample median otherwise zero is given. This index ranges between zero and three; SIZE is the firms size calculated as the log of the total assets for each firm; ROA is the profitability calculated as the net income divided by the total assets; TANG is the firm tangibility calculated as net amount of property, plants and equipment divided by total assets. Three-time dummy variables are included in the regression model to capture the time variation.

*, **, *** represent the significant levels of 10%, 5% and 1%, respectively.

In Table 3, model 1, the regression estimation findings are presented. It shows that the corporate governance strength variable is affecting firms' leverage negatively and significantly at a level of 1 percent. This finding implies that firms that are effective in terms of its internal governance mechanisms are relying on less debts in their capital structure. This finding is in line with the argument that the effective governance mechanisms are reducing the agency conflict that might arise due to the high leverage which reflect the bankruptcy costs. Table 3 shows that the coefficient for CGstrength is -0.023 a significant level of 1 percent, which suggests a 1 percent addition to CGstrength score will cause a 0.023 percent decrease in LEV. This finding is in line with the trade-off theory of capital structure and agency theory. However, this finding is not consistent with other studies that examined firms in developing countries. For example, Rajan and Zingales (1995) find no relationship between board size and financial leverage for listed firms in China. Detthamrong et al. (2017) found no significant relationship between corporate governance variables and leverage among listed firms in Thailand.

Based on the finding shown in Table 3 model 2, regressing board of directors and audit committee effectiveness along with the control variables, show that the association between board of directors' strength and leverage is negatively significant at 1 percent level, whereas the association of audit committee strength and leverage is positively significant at 10 percent level. These findings imply that Saudi firms that have effective board are having more leverage. This can be explained by the good performance



attributed by the effective board of directors. This means that firms with effective board of directors are using less debts due to the availability of internal sources. This finding is in line with the pecking order theory. In terms of the audit committee, it is also found that once audit committee is more effective, firms are having more financial reporting quality which enhance the creditworthiness of the firms and consequently enable firms to get more borrowings.

In terms of the control variables in model 1 and model 2, firm size, is found positively associated with leverage. It is in line with the argument that bigger firms have more assets. Hence, higher creditworthiness for the firms to get more debts. Table 3 also shows that the firms that are more profitable are using less leverage. This negative relationship is in line with the picking order theory that states that firms start financing their assets by using internal sources followed by external sources. This means that firms with higher profit are having more retained earnings to finance their capital expenditure. It is also found that firms' tangibility is not significant determinant of leverage. The finding is consistent with the pecking order theory. Several studies have supported the negative relationship between leverage and profitability (Booth et al.; 2001). This also could be predicted by the pecking order theory (Rajan and Zingales, 1995). In the Saudi context, a study done by Khan et al. (2020) found that banks in Saudi Arabia are highly leveraged. Earnings volatility, growth and bank size are positively affected while profitability and tangibility are negatively related to the book leverage. Another study done by Khaki and Akin (2020). found that size, tangibility, and growth opportunities have positive impact on leverage. However, financial constraints, liquidity, and government ownership affect the leverage negatively. These findings attributed to the low tax environment, less developed capital markets, influential and wealthy ownership, and difficulty to access external financing.



5. CONCLUSION:

This study aims to examine how the firms' leverage in Saudi Arabia is affected by the strength of the corporate governance in an emerging market namely Saudi Arabia. It also provides evidence on which internal monitoring governance namely board of directors and audit committee are affecting largely on the firms' decision to rely more on debts in their capital structure. The study employs 545 yearly data observation over the period of 2012 and 2016. Using OLS regression estimation, the study finds that the association between corporate governance strength and leverage is negatively significant. This finding is in line with the pecking order theory that states that firms are choosing the internal sources first followed by the external financing. It is also in line with the agency theory that states that firms with effective monitoring mechanisms are having less agency conflict which is reflecting positively on the firms' financial outcomes. When additional regression is employed to examine the association between board of directors, audit committee with leverage are exist in the Saudi context, it is shown that board effectiveness significantly affecting negatively which is consistent with the earlier findings of corporate governance effectiveness. While audit committee effectiveness is significantly positive. This finding shows that firms with effective audit committee reflect the high financial reporting quality which enhance the creditworthiness of the firms. Hence, this allows firms to get more borrowing opportunities from the creditors. These findings provide valuable implications to regulators in formulating the corporate governance codes. This means that both attributes of board of directors and audit committee need to be considered jointly since both could affect firms' decision making and outcomes differently. It also enriches the literature on the importance of corporate governance monitoring mechanisms on the firm's financing decisions. For future researchers, it is suggested to examine other attributes of the board of directors and audit committee.



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