RECENT DEVELOPMENTS IN CORPORATE GOVERNANCE IN SAUDI ARABIA

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ABSTRACT

The interest in corporate governance is not a new phenomenon in the Kingdom of Saudi Arabia. This article focusses on the analysis of the most recent developments in the area of corporate governance, specifically in terms of corporate governance codes, board system, executive remuneration and corporate social responsibility. By analyzing the developments, it will be discussed if codes based on directives or standards are better for the economy. The introduction of corporate governance codes seems useful but should not rely on broad standards but on legally enforced binding rules accounting for the discussion of directives versus standards. The paper argues against the blindfold implementation of corporate governance codes and argues for country specific solutions.

Keywords: *Corporate Governance, Saudi Arabia, Codes, Boards, Directives, Standards*

1. Introduction

Saudi Arabia recently announced its decision to move towards a more privatized economy (Stancati & Al Omran, 2016). As the economy moves away from state owned businesses, the government needs to maintain strict corporate governance codes, as companies may be inclined to seek more profit driven approaches that take the company away from previous methods. The socio-cultural environment in Saudi Arabia seems to be different from the Western world in terms of importance and influence of Islam, form of state and other values (Weir, 2011). Moreover, Saudi Arabia, as well as other economies from the Middle East and North Africa (MENA), in the context of corporate governance is relatively young (Braendle, 2013). The objective of the paper is to illustrate the development of corporate governance issues in the Kingdom of Saudi Arabia (KSA) and analyze if codes based on directives or standards are better for the economy. This paper is organized as follows: Analyzing the recent corporate governance literature, I will discuss the recent developments in the area of corporate governance codes in Saudi Arabia (section 2), in the board system (section 3), in executive compensation (section 4), and in corporate social responsibility (section 5). In section 6 the question if directives would be more appropriate than standards in addressing these corporate governance issues. Section 7 presents the implications.

2. Corporate Governance Codes in Saudi Arabia

Until relatively recently, the corporate governance of Saudi based companies was regulated by the 1965 Companies Act (Haniffa & Hudaib, 2007). However, this changed greatly when the Saudi Government implemented the Capital Market Law in 2003. This initial corporate governance guide, however, did not prevent the Saudi exchange failure in 2006, which ultimately ushered in the current Saudi Corporate Governance Code (Al-Abbas, 2009). Aside from Corporate Governance Regulations in the Kingdom of Saudi Arabia which was introduced in 2006 by the Capital Market Authority for publically listed companies, there are also more specific codes e.g. Principles of

Corporate Governance for Banks Operating in Saudi Arabia issued by Saudi Arabian Monetary Agency (SAMA). This code is needed, as the banking industry is crucial for the stability of the economy (SAMA, 2014). Moreover, there is another code specific for Islamic financial institutions as well as several principles for Islamic financial institutions, for instance by the Islamic Financial Services Board. The code and a lot of issued principles and guidelines for Islamic finance are not restricted to Saudi Arabia, but are also valid for the entire Islamic world (Chapra & Ahmed, 2002; Islamic Financial Services Board, 2015). Since Islamic finance plays an important role in Saudi Arabia, this additional corporate governance code could be of importance. However, for the purposes of this paper, only the Corporate Governance Regulations in the Kingdom of Saudi Arabia will be further analyzed, as it is the most general code in terms of industry but at the same time the most country specific code. The 2006 version took into account corporate governance principles that had already been well received in member countries of the Organization for Economic Co-operation and Development (OECD) and drew heavily from the British Cadbury and Greenbury reports (AlAbbas, 2009). It contains 19 articles that are divided into 5 sections. "Preliminary Provisions" consists of Article 1 and 2 and gives insight into who must abide by the regulations that are detailed in the paper, as well as helps to define the terms that are to be used later on. This is followed by "Rights of Shareholders and the General Assembly" which is made up of Articles 3 through 7. The issues of how shareholders are able to obtain information from the company, as well as how they are to vote in company proceedings are discussed here. In the next section, "Disclosure and Transparency", Articles 8 and 9 describe how companies are to disclose information regarding their board, committee appointments, compensation and other financial information. The largest section of the code, "Board of Directors" is comprised of Articles 1018. This will be further discussed in the paper, however in short, the section details how the board is to represent the shareholders as this is considered to be one of the most vital tasks that the board is charged with. The Saudi Corporate Governance Codes close with Part 5, "Closing Provisions". Article 19 is the sole tenant and serves only to notify readers that the codes listed above are effective as soon as the Codes are published.

3. Board of Directors

After the introduction of the corporate governance codex in Saudi Arabia in 2006, various studies investigated the influence of the newly established corporate governance guidelines on Saudi listed companies. As Al-Moataz and Hussainey (2012) sum up in their study on corporate governance in Saudi Arabia, Western-focused research on the relationship between corporate governance mechanisms and their effect on companies had brought differing results in the past. That is why the case of corporate governance in Saudi Arabia, which introduced its regulations quite late in comparison with Western nations, became an interesting field of research due to the "[…] lack of CG studies in the Middle East in general and particularly in Saudi Arabia" (Ghabayen, 2012, p. 172). Al-Moataz and Hussainey (2012) indicate, based on the findings of their study of 97 financial reports of Saudi listed companies in the years 2006 and 2007, that the higher the number of independent board members, the lower the voluntary disclosure of the company; but the higher the number of audit committee members, the higher the voluntary disclosure. In a similar vein, the authors Al-Janadi, Rahman and Omar (2013) conducted research among 87 Saudi listed companies by also analyzing the companies' annual reports of the years 2006 and 2007 in their study on corporate governance mechanisms and voluntary disclosure. In their results, they show that the average Board of Directors in the surveyed companies consists of eight members, with an average number of about seven nonexecutive members. The study also supports the hypotheses that the bigger the board size and the higher the number of non-executive board members, the higher the voluntary disclosure of the company. Although most Saudi companies

seem to have fully independent audit committees, their role within the process of providing quality information is still quite ineffective. It is suggested to develop clear rules to describe the audit committee's responsibilities. The authors also found that the separation of the CEO and Chairman positions has a negative influence on the company's voluntary disclosure. The study concludes that the internal and external corporate governance mechanisms do have a major influence on the companies' disclosure and the development of quality reports for stakeholders and potential investors (AlJanadi et al., 2013).

The influences of the Board of Directors and Audit Committee on the company's performance were the main focus of a study by Al-Matari, Al-Swidi, Fadzil and Al-Matari (2012) among 135 non-financial listed companies in Saudi Arabia in 2010. The authors found that there is no significant relationship between the two aforementioned internal corporate governance mechanisms and the company's performance, except for the size of the audit committee which seems to be best for a company performance if it is small. In line with Al-Janadi et al.'s (2013) conclusions, the authors also suggest that the CMA of Saudi Arabia should take measures to improve the abilities and skills of the Audit Committee members by issuing clearly defining rules and holding conferences on that issue (Al-Matari et al., 2012). In his quite extensive and more recent study on the influence of board characteristics and firm performance of 102 non-financial Saudi listed firms, Ghabayen (2012) investigated the companies' annual reports of 2011. He found that there is no significant relationship between the three mechanisms audit committee size, audit committee composition, and Board of Directors size and the company performance. However, he found a negative and significant relationship between board composition and company performance in Saudi Arabia (Ghabayen, 2012).

Summing up the results of the aforementioned studies on the influence of the Board of Directors on the company, it can be said that the implementation of and compliance with the corporate governance regulations in the Kingdom of Saudi Arabia regarding the Board of Directors seems to be improvable and might need more support and guidance from the Capital Market Authority. However, some of the studies had been conducted before the regulations of the corporate governance codex became mandatory in 2009 (Issa, Al-Ammar, & Alfakhri, 2011) which is why a repeated analysis might come to different, more favorable results.

4. Executive Compensation

Executive compensation is a topic that has grown increasingly more controversial since the 1980s, as compensation of top managers seemingly began to skyrocket in comparison with the salary of normal employees (Davis & Mishel, 2014). Interestingly, this drastic rise is often cited as being without merit and not linked to the increase in the performance of firms (Jensen & Murphy, 1990). However, it is also important to note that the structure of how top managers are compensated has also greatly changed. There is a visible shift where stock options and bonuses have crept into view and now make up high levels of total executive compensation. This worldwide shift makes a Saudi Arabia a particularly interesting country to study, as current compensation tendencies seemingly reject this trend. In fact, the base salary of executives in Saudi companies is on average 80% of their total pay. This is in stark contrast to a country such as the United States which falls on the other end of the spectrum, where executives often find only 30% of their pay coming in the form of base salary (Hill, Lunn, Morrison, Mueller, & Robertson, 2015). Possible reasons for this, as well as its effects will be discussed in detail in the following.

As with the rest of the world, CEO compensation in Saudi Arabia has been on the rise. However, this rise has not been linked with the overall rise in firm wealth in the country. In fact, it has been shown that compensation on the whole has increased, while firm performance (in terms of return on investment) has actually decreased (Fallatah, 2015). Saudi Arabia does follow a

similar system to some Western countries however, in the sense that shareholders elect a compensation committee that is charged with the task of developing compensation packages for top executives. A principal agent problem immediately begins to form, in which the principal (compensation committee) needs to try and align the objectives of the firm with those of the agent (the executive). While this problem has been attempted to be alleviated in Western countries through the use of stock options that push executives towards a future oriented approach, Saudi Arabia provides an interesting counter example, with the vast majority of pay coming in guaranteed cash. This pay is not dependent on performance of the firm, and the executive will receive it regardless of how the firm performs. One might argue that this gives the executive little incentive to perform, however there is one significant difference between Western countries and Saudi Arabia, that being the role of Islam. (Hassan & Kayed, 2011) note that Islam influences business in Saudi Arabia and specifically the role of an entrepreneur. They specify that a leader/entrepreneur has the duty to provide financial income to others, and that halal, lawful income, is best achieved through hard and fruitful work. One could argue that this external motivation provides Saudi executives the motivation to work, rather than being provided with bonuses and stock options for growth.

One must also consider that if variable pay is quite limited, the executives are not as likely to act in a way that would be seen as risky. While the company might not see a surge ahead, as the executive creates new strategy to grow both the firm and the variable pay, slower yet safer growth could be observed. An executive without so much variable pay will need to put more emphasis on job retention, as they can always be removed from the position if shareholders are not happy with the results.

Despite the way that executive pay is structured in Saudi Arabia, it is of interest that the country seemingly has little problem attracting foreign talent. One of the main reasons for this is government initiatives that are trying to push the country away from their natural sources of income in oil and gas. In order to do so, foreign executives are offered additional incentive to come to the country and guide companies in industries that may lack local managers. Out of the countries in the Gulf Cooperation Council for the Arab States of the Gulf (GCC), Qatar ranks 1st in terms of executive pay for Arab and Asian managers. However, Saudi Arabia ranks 1st for executives coming from Western countries. Other countries included in the GCC include Bahrain, Kuwait, Oman, and the United Arab Emirates. In fact, on average Western CEOs earn nearly $100,000 more per year than a CEO of a local company (Anderson, 2015). Other factors could be at play here, namely that Western managers may demand a higher salary if they are to leave their home and move to Saudi Arabia, however many expatriates find themselves working for state owned companies and not only for Western multinational corporations. It is however quite possible, that Western executives are also receiving generous perks if they are to relocate to the country. With 50% of the workforce in Saudi Arabia coming from abroad, it shows that the government is willing to offer additional incentives and pay to bring in talent that cannot be found within the kingdom (Hill et al., 2015).

5. Corporate Social Responsibility

Corporate Social Responsibility (CSR) and sustainability are significantly growing in importance for companies, consumers and regulators. In some, particularly Western countries, compliance with CSR and sustainability standards is not only perceived as random acts of goodwill and charity, but as essential to protect and improve companies' reputations, hence engaging in CSR is becoming an aspect of competitiveness. Charity has a long tradition in the Arab and Islamic world since Zakat, i.e. compulsory alms for the poor, is one of the pillars of the Islamic religion (Raimi, Patel, & Adelopo, 2014). Therefore, it is not surprising that the obvious link between modern CSR and traditional Zakat is seen as a major opportunity for the Arab region in general and for Saudi Arabia in particular to promote higher

engagement in CSR activities built on the already deeply embedded tradition of giving (Harvard Kennedy School, 2008). Complying with national law as well as complying with the Islamic obligation of Zakat is not enough to be actually considered proper CSR. Business leaders acknowledge that until recently, a broader perspective on CSR has not been adapted (Ali & Al-Aali, 2012). Currently, corporations have begun to value sustainable business practices instead of mere charity (Tamkeen, 2010). The findings of a study by Ali and Al-Aali (2012) are in line with this development, showing that "both executives and non-traditional students appear to have a broader understanding of CSR that goes beyond charitable involvement" (Ali & Al-Aali, 2012, p. 48).

By virtue of the alignment of CSR with the Islamic principle of Zakat, some scholars (e.g. Raimi et al., 2014) suggest a faith-based model for poverty reduction that would extend the already existing fundament of Zakat by "modern" CSR practices with the scope to achieve a greater reduction of social inequality. Due to the model being rooted in religious values, it should be easier to convince individuals as well as companies to do good beyond the idea of pure charity. Nonetheless, the aim of poverty reduction and redistribution of wealth still does not address several crucial aspects of sustainability and CSR. Due to Saudi Arabia being an arid desert country (Al-Ibrahim, 1990) a major environmental issue in is water scarcity. Water quality and availability is not only important for drinking water, but crucial for food security and hygiene among other aspects (DeNicola, Aburitaiza, Siddique, Khwaja, & Carpenter, 2015). Water shortage is even considered as a potential trigger for future conflicts in the MENA region (Haddadin, 2001; Starr, 1991). Due to the absence of permanent rivers and lakes, 75-85% of Saudi Arabia's water supply comes from groundwater, which is a nonrenewable water resource (Al-Ibrahim, 1991). As a consequence, Saudi Arabia, among most other countries in this region, is classified as water scarce by the United Nations (UNESCO, 2015). Additionally, climate change is increasing the pressure on water resources in this region (DeNicola et al., 2015; UNESCO, 2015).

Since people notice this problem, there has been a growing emphasis on environmental impact, healthy living and water conservation in the Arab world (Ali & Al-Aali, 2012) with Saudi Arabia as a pioneering country in urban planning, organic agriculture and water conservation (Abaza, Saab, & Zeltoon, 2011). An example of the important role water security plays for Saudi Arabia is the King Abdullah Initiative for Solar Water Desalination, a project that aims to desalinate sea water at a low cost in order to reduce dependency on fossil water reserves (Al-Zubari, 2015). The newly developed technology in this project is supposed to be licensed to other countries. However, it must be noted that not all resources are as well protected as water in Saudi Arabia. Especially resources that are not scarce, for instance oil, are treated lavishly. For instance, only 17% of Saudis compared to 72% of Jordanians would buy a car for its fuel efficiency. This clearly demonstrates the direct impact of fuel prices on the handling and appreciating of the natural resource (Saab, 2015; AFED, 2015).

The government sees itself to a large extent as responsible for social sectors, such as education and environment (Mandurah, Khatib, & Al-Sabaan, 2012), a perception that also the Saudi business world and the broad public seem to share (Ali & Al-Aali, 2012; Tamkeen, 2010). Secondly, albeit trying to strengthen cooperation between the public and private sectors (Ali & Al-Aali, 2012), there is still a lack of systematic government incentives for social and environmental performance of companies (Tamkeen, 2010). Especially in the sector of small and often family-owned businesses, the culture of giving, again linked to Zakat, already exists. What is missing is the initiative to build an institutionalized framework for all the businesses to participate in all the aspects of CSR. Respondents of the survey by Ali and Al-Aali (2012) view CSR as a voluntary activity, hence "on top" of the compulsory Zakat. Therefore, framework like the above-mentioned faith-based

model linked with stronger governmental incentives might be a way of bridging the gap between what is necessary and what is good.

6. Corporate Governance Directives versus Standards

Directives are legal commands which differentiate wished from unwished behaviour in a simple and clear way. Standards, however, are general legal criteria which are unclear and fuzzy and therefore require judiciary decision making and classification. In the most uncomplicated sense, directives and standards can be differentiated by the level of complexity. Directives are inherently simple, clear and based on a command-like system of "tell and do". An incomplete corporate governance report leading to a liability for the management is a directive whereas a norm for the management body to "disclose investor relevant data" without defining relevance is a standard. Such principles leave open what exactly the right level of disclosure is and how a violation of this standard is evaluated by a judge. A standard is therefore less straightforward in a basic sense of the word, only creating a point of reference. There are systematic factors affecting the relative costs of directives and standards. A standard may have lower initial specification costs, but higher enforcement and compliance costs than a directive. For instance, promulgating the standard "to take responsibility for all stakeholders" is easy and does not generate any cost at all. However, applying this standard in practice would generate significant costs for both judges who have to determine whether the accused company has complied with the standard and for the defendants who have to determine the relevant stakeholders and the level of responsibility ex ante in order to escape liability. Directives, however, are more expensive to implement due to higher negotiation costs in the legislative process (because of active lobbying on behalf of different interest groups, for example). But clear rules have lower enforcement and compliance costs than standards.

For countries with a long established corporate governance system standards seem to be the accurate means to deal with issues. For the Middle East being relatively inexperienced with corporate governance issues directives might be better against the background of their specific corporate governance problems such as court delays, and lack of investor protection. Under these circumstances directives seem to be a better means to attract investors and guarantee good corporate governance.

7. Implications and Conclusion

The mechanisms of corporate governance are already in place in Saudi Arabia and seem to be appropriate for the socio-cultural framework of the Kingdom. Nevertheless, several things could be improved upon. For instance, the code itself could – as discussed above - more be based on directives, especially when compared with the code for other countries.

There appears to be hesitation in accepting outsiders onto the boards, hence the use of a one-tier board. However, this could result in too much power being centralized into one channel. The topic of outsiders is also applied to compensation for both executives and employees. If the Kingdom wants to attract foreign investment, they will need to show a higher willingness to accept outsiders into their companies. Islamic principles dictate that people should give money to charity. Saudi companies apply this to their CSR policies, however they often do not go beyond this Islamic principle. If companies would see CSR as a potential competitive advantage, they may start to engage more heavily in CSR activities. The government could help to encourage this behaviour for the sake of the whole economy as it transitions to a more privatized and modern economy.

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