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Enhancing Shareholder Value through Corporate Governance Mechanism in Saudi Arabia

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ABSTRACT

This study investigates the effect of corporate governance mechanism in relation to shareholder value in Saudi Arabia listed companies. In today's business, shareholder value has a great concern to the company shareholders. Numerous studies have been investigated shareholder value but with inconsistent empirical evidence. The focus of this research is to examine the impact of corporate governance mechanism (board independence) on shareholder value measured by share price and dividend yield. This is an empirical paper which proposes to determine the extent of board independence on shareholder value in the perspective of Saudi Arabia. The current study employed pooling regression analysis to retailing sector companies in Saudi Stock Exchange (Tadawul) from 2010 to 2019. The research has found that the presence of non-executive directors on the corporate board enhanced shareholder value. Likewise, board independence has a significant positive impact on shareholder value. The proposed study has value for Saudi Arabia government, corporate boards, stock exchange, shareholders, and policy makers by highlighting the distinct impact on shareholder value and its relation on board independence.

Keywords: Board independence; Shareholder value; Share price; Dividend yield; Saudi Arabia

JEL Classification: G3, G1

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Mejora del Valor para el Accionista mediante el Mecanismo de Gobierno Corporativo en Arabia Saudí

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RESUMEN

Este estudio investiga el efecto del mecanismo de gobierno corporativo en relación con el valor para el accionista en las empresas que cotizan en bolsa en Arabia Saudí. En los negocios actuales, el valor para el accionista es una gran preocupación para los accionistas de la empresa. Numerosos estudios han investigado el valor para el accionista, pero con pruebas empíricas inconsistentes. El objetivo de esta investigación es examinar el impacto del mecanismo de gobierno corporativo (independencia del consejo de administración) en el valor para el accionista medido por el precio de las acciones y la rentabilidad de los dividendos. Se trata de un trabajo empírico que se propone determinar el grado de independencia de los consejos de administración sobre el valor para los accionistas desde la perspectiva de Arabia Saudí. El presente estudio empleó un análisis de regresión de agrupación para las empresas del sector minorista en la Bolsa de Valores de Arabia Saudí (Tadawul) desde 2010 hasta 2019. La investigación ha descubierto que la presencia de consejeros no ejecutivos en el consejo de administración de las empresas mejora el valor para los accionistas. Asimismo, la independencia del consejo de administración tiene un impacto positivo significativo en el valor para el accionista. El estudio propuesto tiene valor para el gobierno de Arabia Saudí, los consejos de administración de las empresas, la bolsa de valores, los accionistas y los responsables de la formulación de políticas, ya que pone de relieve el impacto distintivo en el valor para los accionistas y su relación con la independencia del consejo de administración.

Palabras clave: Independencia del consejo de administración; Valor para el accionista; Precio de las acciones; Rentabilidad de los dividendos; Arabia Saudí.

Clasificación JEL: G3, G1

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1. Introduction

Over the years the issues of corporate governance concerns have gained much attention from scholars due to the potential performance outcomes for companies in advanced (Alon, Chang, Lattemann, McIntyre, and Zhang, 2014; Kowalewski, 2016) and developing countries (Simpson, 2014; Liedong and Rajwani, 2018). After the recent overnight collapse of WorldCom and Enron, shareholders, stakeholders and investors lost their confidence which enhances the shareholder wealth issues (Puni and Anlesinya, 2020; Sulimany, Ramakrishnan, Chaudhry, and Bazhair, 2021). During the last two decades, the shareholder wealth issues enhancing very quickly throughout the world in developed economies. With the opening up of free trade liberalization and concept, the shareholder value issues also spreading to the emerging and developing economies like Saudi Arabia. Good corporate governance is a system which improves transparency, equity and company overall performance to the various stakeholders. According to (Bauwhede, 2009; Aboagye and Otieku, 2010), corporate governance structure plays a vital role in assuring company sustainability and competitiveness. Firms that provide immense importance to good corporate governance would demonstrate higher shareholder wealth due to reduced cost of capital and higher cash flow (Hofer, 2008; Agyemang and Castellini, 2015; Zgarni, Hlioui, and Zehri, 2016). Good corporate governance practices play a vital role in enhancing shareholder value (Gillani, Ramakrishnan, Raza, and Ahmad, 2018).

On the other hand, firms with weak mechanism of corporate governance would be deficient to hold directors accountable, thus cannot guarantee shareholders wealth creation (Jensen and Meckling, 1976; Kyereboah-Coleman, 2008; Agyemang and Castellini, 2015). Many companies realized the concept of shareholder value and begin to implement initiatives for enhancing shareholder wealth (Bazhair, 2021; Sulimany et al., 2021). Once system of corporate governance is inadequate or absent, outside investors invest their capital to companies which have enough corporate governance framework to protect shareholder value. Shareholders usually prefer good corporate governance structure due to sometimes conflicting and divergent objectives between shareholders and executives (Fama and Jensen, 1983; Kyereboah-Coleman, 2008).

According to (Maseda, Iturralde, and Arosa, 2012), agency theory is the supporting theory for corporate governance research studies because it can be applied and employed in the value maximization area. Furthermore, separation of control and ownership produce an agency association between executives and shareholders making it inaccessible to settle a perfect agreement between executives and shareholders (Williamson, 1979, 1981; Fama and Jensen, 1983). Moreover, in an agency perspective, shareholder value would be assured and enhanced if there are framework of good corporate governance to mitigate the agency conflicts. Besides the theoretical discussion, the empirical studies lacks consistency (Puni and Anlesinya, 2020). Nevertheless, a major portion of previous studies have paid attention on emerging and developed countries while little attention shown by scholars in developing countries (Makhlouf, Laili, and Basah, 2008; Omran, Bolbol, and Fatheldin, 2008; Arora and Sharma, 2016), due to underdeveloped corporate governance regulations and rules, and lack of data.

A literature review has provided evidence that board independence was among the most important factors impacting shareholder value around the world. Previous researches have confirmed that board independence is linked with performance (Reddy, Locke, Scrimgeour, and Gunasekarage, 2008). On the other hand, some researches reveal a negative effect on performance (Fauzi and Locke, 2012). The Cadbury published report in 1992, administered that all listed companies of UK in their boards must appoint a minimum three outside directors, whom majority will be independent in the companies (Cadbury, 1992). Similarly, The New York Stock Exchange (NYSE) required from all listed companies, that independent representatives of boards will establish the majority on the boards (NYSE, 2009).

Further, in Saudi Arabia context, the Capital Market Authority (CMA) circulated regulations of corporate governance in 2006, accentuate on the significance of board independence in enhancing status of corporate governance and shareholder value. Particularly, the corporate governance regulations required that all companies listed should identify the numbers of board of directors', the majority of whom will be non-executive representatives (CMA, CG Regulation, 2006).

Moreover, as demonstrated earlier, the empirical studies are contradictory. Thus, this research gives new outcomes that could fill the gaps in the literature of good corporate governance comparatively to deficiency of consensus on shareholder value effect of corporate governance structure. Hence, the research contributes to the understanding of how practices of corporate governance impact shareholder value for both policymakers and academics of Saudi Arabia.

The remainder of this study is organized as follow: the literature review and research assumption are described in Section 2. Section 3 consists of research methodology. Section 4 discusses and reports the findings of the research. The final section contains the discussion and conclusion, and possible future research areas.

2. Literature Review and Hypothesis Development

Various studies have defined the concept of corporate governance (Aboagye and Otieku, 2010; Mensah and Adams, 2014). Furthermore, corporate governance indicates the structure, processes, mechanisms and systems by which firms are directed and controlled (Aboagye and Otieku, 2010). President of the World Bank James Wolfensohn: "the governance of companies is more important for world economic growth than the government of countries". Moreover, (Mensah and Adams, 2014), described corporate governance as the process of "directing and managing business affairs towards enhancing business prosperity and corporate sustainability with the ultimate goal of realizing organisational objectives and long-term shareholder value". Corporate governance structure is a productive monitoring tool for improving shareholder value and constraining illegal activities (Hashim and Devi, 2008). The connection between CG and shareholder value is vital because creditors and investors may desire to invest in companies with good corporate governance to increase the company value and reduce their costs of capital (Ali Shah, Butt, and Hassan, 2009). Hence, mechanism of corporate governance is like a supervising system that is linked in enhancing shareholder value (Gul, Chen, and Tsui, 2003).

Independent directors imply to who are not associated with the company in any aspect. In value maximization context independent directors viewed by literature as more persuasive (Smulowitz, Becerra, and Mayo, 2019). Further, this has been affiliated with the broad expertise they converge from possessing multiple boards. On the other hand, literature highlights that independent director may not be conversant with the firm operations because of less information, hence could not be capable in enhancing the value for shareholders. Moreover, in the literature there is ongoing debate on board independence and its influence on maximization of value. Various researchers evaluate that in decision makings independent directors are not independent. Rather, they hold a significant say in the company performance and act according to the interest of the sizeable net-worth shareholder. Although, independent directors hold power to dismiss and appoint top-level managers in the best interest of the company at any point in time and control the activities of the company (Naseem, Xiaoming, Riaz, and Rehman, 2017).

According to (Ayuso and Argandoña, 2009), boards with high presence of non-executives directors who share no material connection such as professional services, employment, financial relationship, family ties and interlocked directorship with management have been described as effective and independent. Non-executive directors also known as independent directors are commonly called as experts who can bring onto the board their knowledge, experience and expertise to significantly impact CG outcomes and contribute to the success of the company (Haniffa and Cooke, 2002). Moreover, higher levels of voluntary disclosure could be possible when there is higher presence of independent directors (Barako, Hancock, and Izan, 2006; Cheng and Courtenay, 2006).

Independence of board can be measured by the non-executive or outside directors on the board (John and Senbet, 1998). A common consent, nevertheless, is that independent directors are consider to act as "professional referees" to assure maximization of shareholder value (Fama, 1980). Therefore, independent director's appointment increases performance of company (Byrd and Hickman, 1992; Brickley, Coles, and Jarrell, 1997). Although, there are empirical studies which does not found significant association between board independence and performance of a firm (Yermack, 1996; Bhagat and Black, 2001). Independent boards could add value to companies in terms of the financial performance and monitoring management of the company (Hillman and Dalziel, 2003). Further, they also enhance performance of the company in such matters as authorizing the decisions of management based on whether they benefit shareholders (Fama and Jensen, 1983), encouraging managers to focus on long-run performance rather than routine activities (Alves, 2014) and monitoring the operational processes (Fuzi, Halim, and Julizaerma, 2016). Moreover, (Buallay, Hamdan, and Zureigat, 2017) mentions that corporate governance (board independence) play no role in enhancing market performance. In addition, (Alkazali, Al-Eitan, and Aleem, 2021) highlights that board independence has no significant effect on companies market performance. Furthermore, (Nazar, 2021) reveals that board independence is negatively but significantly influenced the dividend pay-out ratio in Sri Lanka.

An efficient independent board assists in mitigating agency cost resulting from misappropriation of resources (Haniffa and Hudaib, 2006). In fact, independent board with higher presence of independent directors can provide companies better contacts, skill and experience (Hermalin and Weisbach, 1988; Haniffa and Hudaib, 2006) and assisting companies to recognize better performance opportunities. The higher presence of non-executive directors is vital for establishing strategies through their participation in discussions and debates related to established long-run objectives and strategies (Zahra and Pearce, 1989). In this regard, independent boards ensured that the company strategies are consistently developing with the objectives of shareholders. Moreover, (Waked and Aljaaidi, 2021) indicates that there is paucity of corporate governance research in Saudi Arabia. (Aljaaidi and Bagais, 2021) mentions that future studies in Saudi Arabia may include board independence. Hence, the hypothesis of this study is stated as follows:

H1: There is a positive significant relationship between the proportion of non-executive directors on the board and the shareholder value of Saudi retailing sector listed firms.

3. Research Methodology

The current study explores the effect of board independence on the shareholder value (share price and dividend yield) of retailing sector of Saudi stock exchange (Tadawul). The current research employs secondary data and analytical in nature. It comprises of 8 companies listed in Saudi Arabia stock exchange (Tadawul). The data is collected from different sources such as Tadawul, DataStream and annual reports of these companies. This study uses ten years unbalanced panel data ranging from 2010-2019. The data of share prices and dividend yield are gathered from Tadawul and DataStream. The data analysis is performed in this study by employing descriptive statistics, correlation matrix, pooled ordinary least square, to examine the empirical link and draw a conclusion, which would be the most suitable method for such type of data. Furthermore, shareholder value (share price and dividend yield) is used as a dependent variable, board independence is independent variable and firm size is control variable.

3.1. Variable Measurement

The basic measurement of the selected variables in this study have been depicted as under.

Table 1 Variables measurement

Sr. No	Variables	Type	Measurement
1	Share Price	Dependent	Annual closing market price of share
2	Dividend Yield	Dependent	Dividend Per Share/Price Per share
3	Board Independence	Independent	the proportion of nonexecutive directors to total number of directors on the board
4	Size	Control	the natural log of total assets

3.2. Regression Models

The models for this study were then specified as follows;

$$SPit = \beta 0 + \beta 1\ BIit + \beta 2\ FSit + \varepsilon it \qquad \textit{Equation 1}$$

$$DYit = \beta 0 + \beta 1\ BIit + \beta 2\ FSit + \varepsilon it \qquad \textit{Equation 2}$$

Where;

SP = Predicted Variable (Share Price)

DY= Predicted Variable (Dividend Yield)

BI = Board Independence

β_0 = β_0 is the intercept of an equation

FS_{it} = Control Variable (Firm Size)

β_1 = coefficient assigned to the predictor variable

ε_{it} = standard error of estimates

4. Empirical Results

4.1. Descriptive Statistics

The study uses a data-set of 8 listed companies of retailing sector on Saudi Stock Exchange for the period of 2010 to 2019. Table 2 shows the detailed description of the descriptive outcomes of the variables employed in the research over a period of time. Dividend yield shows the mean value of 7.610 which represents higher mean whereas board independence has indicated minimum level of mean with a value of 0.590.

Table 2 Descriptive statistics of variables

Variables	Mean	Standard Deviation	Minimum	Maximum
SP	4.234	0.961	0.693	5.285
DY	7.610	8.277	0	20.88
BI	0.590	0.135	0.33	0.75
SIZE	6.503	1.011	3.37	8.52

SP= Share Price, DY = Dividend Yield, BI= Board Independence, Size = size of a firm

4.2. Correlation Matrix

In this research paper, the correlation matrix was developed to check the probability of multi-collinearity. Table 3 depicts the findings of correlation matrix, which is employed to determine the extent of association among the variables studied. Multi-collinearity of more than or equal to 70 percent between two variables is usually a matter of concern (Drury, 2008). In current study, the maximum correlation coefficient is 49 percent between share price and board independence as shown in table below.

Table 3 Correlation matrix for variables

Variables	SP	DY	BI	SIZE
SP	1.0000			
DY	0.2170	1.0000		
BI	0.4881	0.3543	1.0000	
SIZE	-0.0057	0.3876	0.1003	1.0000

SP= Share Price, DY = Dividend Yield, BI= Board Independence, Size = size of a firm

4.3. Determinants of Shareholder Value

Table 4 Results of Pooled OLS regression

Variables	Coefficient	Std. Error	t-value	P-value
BI→SP	3.507	0.7598	4.62	0.000***
BI→DY	19.479	6.4975	3.00	0.004***
SIZE→SP	-.0525	0.1017	-0.52	0.607
SIZE→DY	2.911	0.8699	3.35	0.001***

Note: 1%***, 5%**
Dependent variable: shareholder value (SP and DY)
Periods included: 10
Cross-sections included: 8
Total (unbalanced) observations: 70

The results of the estimated Pooled Ordinary Least Square for the retailing sector listed firms at Saudi Stock Exchange (Tadawul) for the period 2010 to 2019 are shown in Table 4. The coefficient of dependent variable shareholder value (SP and DY) is positive and significant with board independence whereas the coefficients of control variable (size) are negative but insignificant with SP and positive but significant with DY. Thus, this research found that board independence is expected to improve shareholder value (SP and DY).

5. Conclusion

This study examines the effect of corporate governance determinant such as board independence on dependent variable shareholder value in retailing sector in Saudi listed companies. The current research employs unbalanced data comprising of annual data of 8 firms for the period of ten years from 2010 to 2019. The statistical analysis techniques like descriptive statistics, correlation matrix, pooled ordinary least square is tested. Based on testing, the findings reveal that there is a positive and significant association between explanatory variable (board independence) and shareholder value (SP and DY), and negative but insignificant relationship between size and SP whereas positive and significant relationship of size with DY, which recommends that board independence is a major factor of increasing shareholder value of listed companies in retailing sector on the Saudi Stock Exchange (Tadawul). These findings recommend that when a there is a higher presence of both outsiders and insiders directors in the board that enhance co-ordination and communication on board and in this way shareholder value maximizes. Hence, this study recommends that the board independence is sustained at an optimal level by retailing sector listed companies in Saudi stock exchange.

This research is of great help to policy-makers and shareholders because it permits them to make decision related to profitable investment. Furthermore, the findings of this study could also be helpful to shareholders and portfolio managers in terms of managing risk by identifying the vital factors that derive to shareholder value creation. Moreover, future research can be carried out by considering other macroeconomic and microeconomic factors. Additional research on this framework can be conducted by considering market as a whole or in different sectors.

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