

The controlling power of royal family members on the board of directors and audit committee effectiveness

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ABSTRACT

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This paper examines the association of the presence of royal family members on the board of directors with audit committee effectiveness. The sample of this study consists of 444 listed manufactured firms in Saudi Arabia for the period 2012-2019. Using the Pooled *OLS* regression, the result of the study shows that royal family ownership is associated with audit committee effectiveness, giving support to the substitution hypothesis. The result indicates that members from the royal families are good monitors imposed into the companies' managements as both taking the role of decision makers and owners who may substitute the effectiveness of the audit committee. The presence of royal family members on the board has an alternative for the effectiveness of the audit committee. The marginal effect of audit committee effectiveness as an internal corporate governance mechanism is substituted by the presence of royal family members on the board. This study provides insightful evidence to regulators and policy makers at the company and country levels on the relationship of royal family ownership and audit committee effectiveness.

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1. Introduction

Historically, the roots of the Kingdom of Saudi Arabia and in particular the Saudi Royal Family can be traced back to introduction of civilization in the Arabian Peninsula. The Arabian Peninsula has over the centuries played a key role in the history of the civilized world. It is the cradle of Islam, one of the main monotheistic religions in the world, and is also an ancient trade center. The modern Kingdom of Saudi Arabia was established by King Abdulaziz Al-Saud in 1932, and has immensely transformed ever since. During her formation, Saudi Arabia was a mere desert Kingdom, but has since established herself as a key player on the international stage and one of the most sophisticated modern nations (House of Saud, 2021; Chahine & Tohmé, 2009). A noteworthy aspect of the Kingdom of Saudi Arabia is that the nation's royal Families own over US\$ 240 billion of investment in the form of shares in listed companies. Consequently, those investments translate to better government institutions and sovereign wealth funds. Saudi companies are dominated by the royal family members. They hold roughly 10 percent of all boardrooms in listed corporations (Alzahrani & CheAhmad, 2015). The royal family members dominate the Saudi Arabian companies. It is estimated that Saudi royalties occupy approximately 10 percent of boardrooms of registered companies. This kind of ownership practiced by Saudi Royal families can be classified as dominant ownership. This kind of ownership involves a combination of political power and immense wealth allowing owners access to information that affects how the company is governed (Alshammari, 2014). The royal family members are able to sway the decision-making process due to the level of access provided by their high-class status in the Kingdom. The royalties are able to access investee corporations' insider

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information conspicuously due to their status (Hussain et al., 2002). Additionally, the presence of many royal family members in boardrooms may effectively define the actions and views of the other board members (Clark, 2004).

Given the existence of royal family members on the board of directors as a powerful corporate governance mechanism, this study uses the substitutional hypothesis to explain the relationship between royal family members on the board and audit committee effectiveness as another internal corporate governance mechanism. It is argued by this study that members from the royal families are good monitors imposed into the companies' managements as both taking the role of decision makers and owners who may substitute the effectiveness of the audit committee. Specifically, the audit committee is often considered one of the great contributors to the triumph of corporate governance. The audit committee is responsible for supervising the financial reporting process and reports directly to the corporate board of directors (Klein, 2002). Audit committee's other roles acknowledged by previous literature on the audit committee issues include; risk management, external reporting, and improvement of procedures for internal control. The audit committee also improves the firm's book value and protects the interests of shareholders by refining transparency in security markets (Leung et al., 2003; Dey, 2008; DeZoort et al., 2002; Yin et al., 2012; McMullen & Raghunandan, 1996; DeZoort et al., 2002; Bagais and Aljaaidi, 2020; Habtoor, Hassan and Aljaaidi, 2019; Hassan et al., 2018; Alsaeed, 2006).

Experientially, examinations were specifically conducted on the relationship between the audit committee and family ownership, disregarding the royal family members' presence on the board of members. Conclusions from one such analysis by Omer, Aljaaidi and Nasser (2020), indicate that there exists an adverse relationship between the presence of family control on the board of directors and the quality of audits. The study indicated that in Saudi context, the royal family members present on the board of directors act as internal monitors hence substituting demand for additional monitoring by audit committees. Besides, there can be progressive and significant association between Saudi royal family members' presence in boardrooms and the performance of companies such as scantiness of research on frequency of audit committee meetings (Alzahrani & Che-Ahmad, 2015). In particular, there is a limited research examining the determinants of audit committee meeting frequency (Aljaaidi, Bagais and Adow, 2021; Aljaaidi et al., 2021; Aljaaidi & Bagais, 2021; Mendez & Garcia, 2007; Raghunandan & Rama, 2007; Greco, 2011; Al-Najjar, 2011; Thiruvadi, 2012; Yin et al., 2012; Maraghni & Nekhili, 2014; Braswell et al., 2012; Al-Najjar, 2012). Due to the scantiness of evidence on association of effectiveness of audit committees and presence of Saudi royal family members in the board, these studies were based on other developed and developing countries. The results from the studies were also conflicting and inconclusive, hence, he need for conducting additional empirical investigations on the topic. To the best of the researchers' knowledge, an empirical study examining the association of the presence of royal family members on the board with audit committee effectiveness does not exist. Therefore, this study tends to extend the findings of the existing research studies on the frequency of the audit effectiveness by adding new empirical evidence to the literature of corporate governance using recent data.

The remainder of the paper is organized as follows. The next section highlights the sample, data and model of the study. The third section presents the results, tests and analysis. The final section concludes the study.

2. Research methodology

2.1 Data collection

This study is based on manufactured Saudi firms listed on Saudi Stock Exchange (Tadawul) for the periods ranging from 2012 to 2019. This is the most recent period for which data were available at the time of the study. Our final sample comprises 430 firm-year observations. The number of the audit committee meetings, board size, board meetings, total assets, debts, performance, and age were hand-collected from annual reports available on the web site of the Saudi Stock Exchange (Tadawul). Samples selected depicted in Table 1.

Table 1

Sample Selection

	Total Observations
Total observations	465
Observations discarded (outliers, missing and incomplete data)	(21)
Final sample	444

We control for several variables that are evidenced by prior studies to have associations with audit committee effectiveness as a monitoring mechanism, varying based on the level of the agency costs. These include family ownership (negative expected sign, Omer et al., 2020), board size (positive expected sign, Al-Najjar, 2011; Maraghni & Nekhili, 2014), board meeting (positive expected sign, Maraghni & Nekhili, 2014; Thiruvadi, 2012; Raghunandan & Rama, 2007), firm performance (negative

expected sign, Raghunandan & Rama, 2007; Sharma et al., 2009; Yin et al., 2012), leverage (negative expected sign, Yin et al., 2012; Méndez & García, 2007; Al-Shammari et al., 2008), and firm size (positive expected sign, Yin et al., 2012; Raghunandan & Rama, 2007; Méndez & García, 2007; Gillan & Starks, 2003; Sharma et al. 2009; Maraghni & Nekhili, 2014; Braswell et al., 2012).

2.2 Regression model and definition of variables

Due to the continuous nature of the dependent variable, Pooled Ordinary Least Square *OLS* was utilized as the method of analysis to test the hypothesis. The OLS model can be formulated as following:

$$ACEFFEC = \beta_0 + \beta_1 RFWN + \beta_2 FOWN + \beta_3 BDSIZE + \beta_4 BDMEET + \beta_5 ROA + \beta_6 LEV + \beta_7 FSIZE + e \quad (1)$$

where

<i>ACEFFEC</i>	=	Number of audit committee meetings held during the year
<i>RFWN</i>	=	Percentage of common shares held by royal family members on the board
<i>FOWN</i>	=	Percentage of common shares held by founding family and their relatives
<i>BDSIZE</i>	=	Number of directors on the board
<i>BDMEET</i>	=	Number of meetings held during the year
<i>ROA</i>	=	Return on assets
<i>LEV</i>	=	Total book value of debt to total assets ratio
<i>FSIZE</i>	=	Log ₁₀ of total assets
<i>e</i>	=	error term.

As for the measurements of the variables, Table 2 exhibits the dependent and test variables.

Table 2
Summary of the Operationalization of the Research Variables

Variables	Acronym	Operationalization	Type of variable
Dependent Variable			
Audit committee effectiveness	<i>ACEFFEC</i>	Number of audit committee meetings held during the year	d.v
Hypothesized variable			
Royal family ownership	<i>RFWN</i>	Percentage of common shares held by royal family members on the board of directors	i.v
Control variables			
Family ownership	<i>FOWN</i>	Percentage of common shares held by founding family and their relatives	i.v
Board size	<i>BDSIZE</i>	Number of directors on the board	i.v
Board meeting	<i>BDMEET</i>	Number of meetings held during the year	i.v
Firm performance	<i>ROA</i>	Return on assets	i.v
Firm leverage	<i>LEV</i>	Total book value of debt to total assets ratio	i.v
Firm size	<i>FSIZE</i>	Log ₁₀ of total assets	

Note: d.v – dependent variable, i.v – independent variable

3. Results and discussions

3.1 Statistics and correlation

The descriptive statistics are presented in Table 3, showing the mean, standard deviation, minimum and maximum of each variable in the sample data set. Table 3 displays that there is a significant range of variation among the considered samples of this study. Table 3 shows that the range of *RFWN* ranges from .00 to .501 with a mean of .01441 and a standard deviation of .059322. It is illustrated that the range of *FOWN* ranges from .00 to .725 with a mean of .05395 and a standard deviation of .110391. *ACEFFEC* is from 2 to 12 with an average of 5 and a standard deviation of 1.55894. The range of *BDSIZE* is from 4 to 11 with an average 8 and a standard deviation 1.50067. The mean of *BDMEET* is 5 and it ranges from 2 to 22 and a standard deviation of 2.14453. The *ROA* ranges from -.51 to 1.00 with an average of .5062 and a standard deviation of .32358. As for the *LEV*, the mean is .2670 and it ranges from .00 to .86 and a standard deviation of .20453. The *FSIZE* ranges from 35461604 to 340041000000 with an average of 13519849111 and a standard deviation of 45180718146.

Table 3

Descriptive statistics

.	Minimum	Maximum	Mean	Std.Deviation
RROWN	.00	.501	.01441	.059322
FOWN	.00	.725	.05395	.110391
ACEFFEC	2	12	5	1.55894
BDSIZE	4	11	8	1.50067
BDMEET	2	22	5	2.14453
ROA	-.51	1.00	.5062	.32358
LEV	.00	.86	.2670	.20453
FSIZE	35461604	34004100000	13519849111	45180718146

Table 4 confirms that the multicollinearity problem does not exist because the correlation matrixes among the variables do not exceed 0.90. All the variables have a correlation of equal to or less than .730.

Table 4

Correlation matrix of independent variables

	RROWN	FOWN	BDSIZE	BDMEET	ROA	LEV	FSIZE
RROWN	1						
FOWN	-.107*	1					
BDSIZE	.109*	-.122*	1				
BDMEET	.024	-.158**	-.092	1			
ROA	.034	.151**	-.136**	.058	1		
LEV	-.030	-.074	.108*	-.078	-.730**	1	
FSIZE	.055	-.257	.486**	-.012	-.516**	.369**	1

3.2 Regression results

Table 5 depicts the estimated regression coefficients for the regression model.

Table 5

Audit committee effectiveness regression model

Variables	Expected Sign	Coef.	<i>t</i>	<i>P</i> > <i>t</i>
Hypothesized Variables				
RROWN	-	-2.107	-1.765	.078
Control variables				
FOWN	-	-1.769	-2.644	.008
BDSIZE		.116	2.133	.034
BDMEET		.233	6.976	.001
ROA		-.865	-2.482	.013
LEV		-1.056	-2.077	.038
FSIZE		-.251	-1.856	.064
<i>F</i>		10.590		
Adjusted <i>R</i> ²		13.5		
<i>P</i> -value		0.000		

Bold = significance at 1%, 5% and 10% (one-tailed significance)

Table 5 reports the adjusted R^2 and the F -value for the audit committee activity model. The F -value for the model is statistically significant at the 1% level, indicating that the overall model can be interpreted. The adjusted R^2 is 0.135, indicating that the model has explained 13.50% of the variance in the audit committee effectiveness. This indicates a good fit of the audit committee effectiveness model. The regression results in Tables 5 show that the sign of the coefficient of the *RROWN* is in the predicted direction (i.e., negative), giving support for the hypothesis H_1 expecting the higher the percentage of royal family ownership, the lower the effectiveness of the audit committee. This gives support to the substitutional hypothesis in which the presence of royal family members on the board has an alternative for the effectiveness of the audit committee. The marginal effect of audit committee effectiveness as an internal corporate governance mechanism is substituted by the presence of royal family members on the board. This result is consistent with the findings of the previous studies such as Omer et al. (2020) and Alzahrani and Che-Ahmad (2015).

4. Conclusions and implications

The objective of this study was to investigate the association of the presence of royal family members on the board with audit committee effectiveness among 444 listed manufactured companies in Saudi Arabia for the period 2012-2019. This study finds that the existence of royal family members on the board is associated negatively with the audit committee effectiveness. This result is consistent with the prediction of the substitutional hypothesis and the findings of the extant studies such as Omer et al. (2020) and Alzahrani and Che-Ahmad (2015). Therefore, the presence of royal family members on the board has an alternative for the effectiveness of the audit committee. The marginal effect of audit committee effectiveness as an internal corporate governance mechanism is substituted by the presence of royal family members on the board. Therefore, this study provides an additional empirical evidence to the literature body of corporate governance.

The results of this study provide new insights to policy makers in Saudi Arabia in understanding the monitoring role of the royal members on the board and how this role influences the effectiveness of the audit committee. Further, the findings of the study should be of interest to managers and boards of companies in understanding the effectiveness of the audit committee in the presence of royal's family members on the board. In addition, the findings of this study could be useful to regulators as they understand the effectiveness of corporate governance mechanisms in the presence of various types of owners sitting on the board. The findings of this study might have practical implications for the Saudi stock market (Tdawul) in providing a new understanding regarding the extent to which royal family ownership impacts the effectiveness of audit committees in manufacturing companies in a manner to practice their monitoring responsibility and to protect the interests of shareholders. The findings of this study cannot be generalized to other Arab and some of the GCC countries due to the Saudi unique context. It would be attractive for future studies to examine the other audit committee characteristics in the model either in an individual or a combined manner. Future studies could also investigate the other ownership classifications such as governmental ownership and institutional ownership.

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