DETERMINANTS OF EXECUTIVE COMPENSATION: EVIDENCE FROM A FAMILY-FIRM DOMINATED ECONOMY

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Abstract

This thesis investigates the role and effect of corporate governance and political connections on determining executive compensation in the Kingdom of Saudi Arabia (KSA). Given that the framework of Saudi corporate governance is significantly influenced by the Anglo-American model, the thesis aims to evaluate the validity of this model in constraining executive compensation in emerging economies such as Saudi Arabia. The KSA has a unique institutional setting: high ownership concentration, high use of political connections, an absolute monarchical political system and the use of Islamic law. Moreover, the thesis examines the impact of political connections on the arrangements for executive pay and emphasises the principal-principal conflict in family controlled-firms. To achieve these objectives, deductive and inductive methods are employed and three empirical studies are conducted using a sample of 114 non-financial Saudi listed firms during 2008-2015.

Unlike the situation in the Anglo-American economies, pay structure in the KSA is found to be limited to fixed and short-term performance-based compensation (i.e. bonus). This is because long-term incentive methods such as stock options are not allowed for regulatory reasons. Furthermore, although the Saudi corporate governance regulations have been enforced since 2006, the data shows a boom in average executive compensation levels exceeding 100% during the period 2008 to 2015 with a weak link to firm performance. Meanwhile, the Anglo-American model of corporate governance is found to be inadequate to curb managerial incentives in the KSA due to the absence of other effective formal institutions (e.g. an effective legal system). Surprisingly, independent board directors and remuneration committees, which are key recommendations of corporate governance best practice, are found to be associated with higher levels of executive compensation. Moreover, while the model suggests that concentrated ownership could close the gap between shareholders' and managers' interests, thereby shrinking agency costs, the results show the opposite; i.e. ownership concentration is a root cause of principal-principal problems and leads to generous executive pay.

Meanwhile, other informal institutions are observed to influence compensation policy. The study finds that the phenomenon of political connections is prevalent in Saudi Arabia especially in non-family firms and is significantly related to higher levels of executive pay. These connections are derived from the domestic culture of Saudi Arabia which is significantly influenced by *wasta* (personal relationships). The findings also reveal that there are significant differences between family-controlled firms and their non-family counterparts in terms of corporate governance attitudes and the use of political connections. However, the practices of executive compensation are virtually the same in both type of firms. Overall, the thesis demonstrates that the adoption of corporate governance models developed in other country contexts, with no consideration to the cross-country institutional differences, leads to undesirable consequences and facilitates higher executive remuneration.

DECLARATION

I declare that the material contained in this thesis has not previously been submitted for a degree in this or any other institution.

STATEMENT OF COPYRIGHT

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IN THE NAME OF GOD, THE MERCIFUL, THE COMPASSIONATE

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DEDICATION

This effort is dedicated to the loving memory of my affectionate mother who passed away during doing this research, my beloved father whose dream is to see me to be a successful person, my darling wife Eman and my daughter Lana who have encouraged me towards success.

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LIST OF ABBREVIATIONS

BECM	Bureau of Experts at the Council of Ministers
CEO	Chief Executive Officer
CIFA	Council of the Islamic Fiqh academy
CMA	Capital Market Authority
GAZT	General Authority of Zakat & Tax
GLS	Generalized Least Squares
ICG	Islamic corporate governance
KSA	Kingdom of Saudi Arabia
MCI	Ministry of Commerce and Investment
MENA	Middle East and North Africa
NACC	National Anti-Corruption Commission
OECD	Organisation for Economic Co-operation and Development
OLS	Ordinary Least Squares
PBUH	Peace be upon Him
RDT	Resource Dependence Theory
SAMA	Saudi Arabian Monetary Authority
SAR	Saudi Arabia Riyal
SCGRs	Saudi Corporate Governance Regulations
SSE	Saudi Stock Exchange
VIF	Variance inflation factor
USD	United States Dollar

CHAPTER ONE:

INTRODUCTION

1.1 BACKGROUND AND OVERVIEW

During the past two decades, the topic of corporate governance and executive compensation has received considerable attention from academics, practitioners and regulators (Al-Najjar, 2017; Conyon, 2014; Bebchuk *et al.*, 2010; Sun *et al.*, 2010; Jensen *et al.*, 2004; Jensen and Murphy, 1990). This focus is a consequence of global corporate scandals, especially in the US such as Enron in 2001 and WorldCom in 2002. These scandals raise questions regarding business ethics and the effectiveness of corporate governance in constraining managerial opportunism (Janakiraman *et al.*, 2010). Hence, this has raised awareness for the need for more transparency and credibility in terms of corporate governance and has led to several major reforms in corporate governance regulations (Girma *et al.*, 2007). Cadbury (1992, p. 15) defines corporate governance as "the system by which companies are directed and controlled". In other words, it is the system that governs relationships among a company's management, its board, its shareholders and other stakeholders to ensure that the company resources are employed optimally and efficiently to achieve the company objectives (OECD, 2015a).

The main debate in the literature concerning corporate governance and executive compensation is centred around the divergence of interests between shareholders and managers (Young *et al.*, 2008; Jensen *et al.*, 2004). It is argued that managers are self-interested and seek to maximise their own wealth rather than company value (Fama and Jensen, 1983b). As a remedy, some researchers argue that executive compensation should be used as a governance mechanism through which managers are incentivised to achieve a company's objectives and thereby reduce the gap between the interests of the shareholders and managers (Jensen and Murphy, 1990). However, other researchers argue that executive compensation can be problematic if abused (Bebchuk and Fried, 2003). In this context, if managers are able to extract high non-merit compensation, shareholders' welfare is threatened by managerial expropriation (Van Essen *et al.*, 2015). To overcome this issue, corporate governance regulations are reviewed periodically in terms of best practice experience to ensure that top executives are paid on a merit basis using appropriate performance criteria (Sapp, 2008).

Although the issue of executive incentives has received a great deal of discussion in recent years, it is still controversial. For example, after the 2008 financial crisis, the US introduced the Dodd-Frank Act in 2010 as a further attempt to clip the wings of CEOs following the Sarbanes–Oxley Act of 2002 (Conyon, 2014). The Dodd-Frank Act of 2010

introduced major reform to corporate governance and executive remuneration, such as the provision of 'say on pay', which gives shareholders the right to vote on the remuneration awarded to senior managers (Conyon, 2014). Furthermore, in late 2016, the UK government published a green paper on corporate governance reform (BEIS, 2016). A key part of the green paper discusses and criticises current levels of executive pay and provides suggestions on how to control them. The frequent reforms of corporate governance in developed countries provides evidence on the difficulty of governing executive compensation. Undoubtedly, the situation in emerging economies, which have a less effective legal framework and weak property rights, is more complicated (Young *et al.*, 2008).

The practice of corporate governance in emerging economies is still in a rudimentary stage, and has been imported predominantly from the West (Pierce, 2008; Young *et al.*, 2008). In the 2000s, as a response to international demands, many emerging economies imported and adopted Anglo-American (shareholder) frameworks of corporate governance, which did not take into account cross-country institutional differences (Filatotchev and Allcock, 2010; Sun *et al.*, 2010). A brief look into corporate governance in the Middle East and North Africa (MENA) region reveals that its practice is still in its infancy. Oman was the first country in the region to enact corporate governance regulations and was followed by Egypt in 2005, the Kingdom of Saudi Arabia (KSA) in 2006, and the United Arab Emirates (UAE) in 2007 (Koldertsova, 2011). Corporate governance in the KSA, which is the focus of this study, was initiated in late 2006, when the Capital Market Authority (CMA) introduced a code for the first time. The code follows a 'comply or explain' approach and is significantly influenced by the Anglo-American model of corporate governance (Fallatah and Dickins, 2012). However, the adoption of the Western model implicitly assumes that the formal underpinning institutions in relation to corporate governance found in developed countries also exist in emerging economies (Young *et al.*, 2008). This is not the case in Saudi Arabia, where the "formal institutions such as laws and regulations regarding accounting requirements, information disclosure, securities trading, and their enforcement are either absent, inefficient, or do not operate as intended" (Young *et al.*, 2008, p. 198).

Thus researchers argue that adopting the Western corporate governance model, which is based on the premise of principal-agent conflict, in emerging economies could make the situation more costly and problematic (North, 1990; Wright *et al.*, 2005). For

example, ownership concentration, which is suggested as an effective mechanism to enhance governance quality in developed economies (Fama and Jensen, 1983b; Jensen and Meckling, 1976), is a root cause of principal-principal conflict in emerging countries. Therefore, instead of resolving the issue in the Saudi context, the adoption of the Western corporate governance model can exacerbate the principal-principal problem (Faccio *et al.*, 2001; Young *et al.*, 2008). Furthermore, the adoption of such a model disregards the informal domestic institutions, which may influence business policy (Young *et al.*, 2008). These informal institutions include "relational ties, business groups, family connections and government contacts" (Young *et al.*, 2008, p. 198).

Saudi Arabia has an institutional setting that differs from most other countries, with the exception of its Gulf Cooperation Council (GCC) neighbours (Bahrain, Kuwait, Oman, Qatar and the United Arab Emirates). For instance, the ownership concentration is high and dominated by state and family investment. In this context, Young *et al.* (2008) argue that firms with controlling shareholders results in the emergence of principal-principal conflict. Furthermore, the political system in the KSA is based on an absolute monarchy, in which the legal setting is derived from the *sharia* (Islamic law) (Pierce, 2008). In addition, the demographic structure in Saudi Arabia differs significantly from the majority of countries, and is based on a tribal system which is influenced by an orientation to collectivism (The Hofstede Centre, 2014). Such characteristics make *wasta* (the Arabic term for personal connections) and political ties key elements in accomplishing business transactions and in shaping business policy (Budhwar and Debrah, 2013; Tlaiss and Kauser, 2011). These features represent the key divergences between the KSA as an emerging economy and developed economies. Hence, governance regulations should take into account these domestic challenges.

Although Saudi corporate governance regulations (SCGRs) have been enforced since 2006, there was a boom in executive compensation in the country between 2008 and 2015. A review of the statistical trends among the highest-compensated executives reveals that executive compensation increased by more than 100% in that time in most listed firms, while the growth in company profits has been significantly lower. Etihad Etisalat Co (Mobily) is ranked highest in Saudi Arabia with regard to growth in executive compensation from 2010 to 2013 inclusive. However, this led to a massive scandal in late 2014 when manipulation of its financial statements was detected. Consequently, "the company restated profits for 2013 and the first half of 2014" (Smith, 2015), cutting them by USD381 million

combined. In January 2015, it posted a shock fourth-quarter loss of USD608 million. This manipulation saw accounts switch from a USD1.8 billion profit in 2013 to a USD0.24 billion loss in 2014 (Tadawul, 2015). As a consequence, the Chief Executive Officer (CEO) Khalid Al-Kaf was dismissed and by February 2015 Mobily had lost approximately USD13 billion (nearly 65%) of its market value in comparison to May 2014 (Smith, 2015).

Adopting a hypothetico-deductive approach through the use of three empirical studies, this thesis investigates the effects of both the formal and informal institutions on executive pay-setting in the emerging economy of the KSA. More specifically, it examines the role of corporate governance and political connections in determining executive compensation, as well as analysing the practices of executive compensation in family and non-family firms. Based on a sample of 114 non-financial Saudi listed firms in the period 2008 to 2015, the study finds that, in general, the Anglo-American model of corporate governance is inadequate in being able to curb managerial incentives in the KSA due to the cross-country institutional differences and the absence of effective formal institutions. For example, the thesis finds that pay structure in the KSA is restricted to fixed and short-term performance-based compensation, because long-term incentives, such as stock options, are not permitted for regulatory reasons. Indeed, this restriction exacerbates the difficulty of linking executive compensation with the company's long-term performance, which is a priority of the Anglo-American model. Furthermore, the data reveal that independent board directors and remuneration committees, which are key instruments in corporate governance best practice, are associated with higher levels of executive compensation in the KSA. Moreover, while the Anglo-American model suggests that concentrated ownership could close the gap between shareholders' and managers' interests, thereby shrinking agency costs, the results show the opposite; i.e. ownership concentration is a root cause of principal-principal problems and leads to more generous executive pay.

Furthermore, informal institutions are also observed to influence compensation policy. The study finds that the phenomenon of political connections is prevalent in Saudi Arabia, especially in non-family firms, and is significantly related to higher levels of executive pay. These connections are derived from the prevailing culture in Saudi Arabia, which is strongly influenced by *wasta*. The findings also reveal that there are significant differences between family-controlled firms and their non-family counterparts in terms of corporate governance attitudes and the use of political connections. However, the practices of executive compensation are virtually the same in both type of firms. Overall, the thesis

demonstrates that the adoption of corporate governance models developed in other country contexts, with no consideration to the cross-country institutional differences, leads to undesirable consequences and facilitates higher executive remuneration in the KSA.

1.2 RESEARCH AIMS AND OBJECTIVES

The main aim of this study is to provide a deep insight into the practices of executive compensation in Saudi Arabia. More specifically, it investigates the role and effect of corporate governance mechanisms and political connectedness in determining executive pay and how these factors interact in family and non-family firms. It also seeks to find out whether the current corporate governance regulations, which follow the Anglo-American model, properly fit the Saudi context, though there are significant different institutional characteristics across the two contexts. To fulfil these goals, the study conducts three empirical studies.

The first study seeks to achieve two objectives: a) to investigate the role of a set of various corporate governance mechanisms in controlling levels of executive compensation; b) to examine the validity and generalisability of the Anglo-American model in emerging economies like Saudi Arabia. This deep investigation helps to draw a comprehensive view of the current norms of corporate governance and their consequences for the practices of executive compensation. The second study aims to go further beyond the formal institutions and thus investigates the role of another contextual informal institution, namely political connections, in enhancing the quality of governance through constraining executive compensation. This study sheds light on other factors that emerged from the context and would have significant impact on business policy in general and governance norms in particular. The final study re-investigates the norms of corporate governance and political connectedness in different sets of firms, namely family and non-family, which allows an understanding of how firms act when large family shareholders are involved in the decision-making process and the consequences of this involvement for executive compensation practices.

1.3 RESEARCH MOTIVATIONS AND QUESTIONS

Although the topic of corporate governance and executive compensation has received considerable attention during the past two decades (Reddy *et al.*, 2015; Conyon, 2014; Bebchuk and Fried, 2003; Core *et al.*, 1999), these studies are primarily centred on the Western economies. Thus, there is still a significant dearth of such research in emerging

economies in general, and in the Arab world in particular which has different organisational culture and management attitudes (Ali, 1995). This dearth of studies has led regulators to import and adopt patterns of corporate governance that were developed in the West with almost no consideration to cross-country institutional differences (Young *et al.*, 2008). For example, formal institutions (e.g. laws, legal enforcement, property rights, and so on) in the Western economies are effective in general and are considered when developing governance mechanisms (Young *et al.*, 2008). However, the case is different in emerging economies which generally suffer from weak legal enforcement and property rights (Rashid, 2013). In such contexts, informal institutions (e.g. personal connections, culture, norms and so on) are found to play a significant role in shaping business policy (Faccio, 2010). Accordingly, as the current regulations of Saudi corporate governance follow the Anglo-American model, the study is motivated to raise the following question: *Is the Anglo-American model of corporate governance generalizable in emerging countries?*

Another motivation for the researcher to carry out this study is the vigorous debate around the importance of executive incentives as a key mechanism by which to align the interests of managers with those of shareholders (Bebchuk and Fried, 2009; Jensen and Murphy, 1990). The best practice framework of corporate governance encourages firms to design well-structured executive compensation with a strong link to firm performance (Jensen *et al.*, 2004; Murphy, 1999). However, Bebchuk and Fried (2003) argue that executive compensation can be also a problematic factor if misused and this exacerbates the agency costs. In turn, corporate governance regulators suggest several mechanisms that help to design merited executive compensation: separating the roles of CEO and board chairperson; appointing independent members to the board of directors; and establishing a remuneration committee (Conyon and He, 2011; Girma *et al.*, 2007; Core *et al.*, 1999). However, these recommendations might not be appropriate for emerging countries where concentrated ownership and personal connections can influence board independence (Young *et al.*, 2008). For example, despite the enforcement of corporate governance regulations from late 2006, there is a noticeable boom in executive compensation in Saudi Arabia from 2008 to 2015. That is to say, executive compensation increased by more than 100% in most listed firms, while the growth in certain firms, such as the Etihad Etisalat Co (Mobily), was threefold (Arqaam, 2014). This fact makes the effectiveness of corporate governance in controlling managerial incentives questionable. Thus, the study raises the following question:

Do corporate governance mechanisms restrain the opportunism of top managers in Saudi Arabia by reining in their compensation?

Furthermore, Estrin and Prevezer (2011) and Young *et al.* (2008) state that in the absence of effective formal institutions as is the case in emerging countries, informal institutions exist as substitutive elements. One key informal institution that exists significantly in immature countries is personal networks among business elites and the government (Faccio, 2010). The situation in Saudi Arabia supports this argument since several studies (Budhwar and Debrah, 2013; Tlaiss and Kauser, 2011) find that *wasta* plays a dominant role in the business field, with a strong influence in decisions related to human resources such as appointments, promotions and compensation. Indeed, political connections are a vital channel of *wasta* through which firms can obtain benefits from the government (Goldman *et al.*, 2009; Kroszner and Stratmann, 1998). Goldman *et al.* (2009) argue that politically connected members are incentivised by their political status. Thus, they enhance corporate governance and constrain managerial opportunism, otherwise they incur high political costs. However, as Saudi firms are in general dominated by families (Al-Ghamdi and Rhodes, 2015; The World Bank, 2009), political connections, if exploited, may harm non-family parties such as minority shareholders. For example, because appointments in Saudi Arabia are influenced by *wasta* (Budhwar and Debrah, 2013), potentially controlling shareholders appoint their relatives or close friends, with no consideration as to their qualifications, to senior executive positions (Tlaiss and Kauser, 2011). These appointments are at the expense of minority shareholders who suffer from both a weak firm performance, since the firm is managed by unqualified-executives, and the extraction of higher non-merit executive compensation (Young *et al.*, 2008). In this regard, political connections can be exploited to reduce regulatory oversight on the firm and to prevent legal sanctions that may result from the exploitation of minority shareholders (Kroszner and Stratmann, 1998). Accordingly, to assess the influence of political connections on the settings of executive compensation, the study raises the following question:

Do political connections enhance governance quality through controlling executive compensation?

The lack of understanding in the literature concerning family business attitudes to corporate governance is another motivation for this thesis. Although the attitudes of family businesses have been extensively studied (Morresi and Naccarato, 2016; Martin *et al.*, 2016;

Al-Ghamdi and Rhodes, 2015; Cheng *et al.*, 2015; Miller *et al.*, 2007), the literature still lacks an understanding of the behaviours of family firms towards corporate governance, and more specifically their influence on executive pay-setting. Typically, decision-making in family businesses is controlled by specific members, unlike non-family firms where various parties are involved and decision-making follows systematic procedures ensuring a minimal conflict of interest among stakeholders (Alriyadh, 2013). There is generally less conflict of interest in entirely family owned-firms. However, this is not the case in joint-stock companies where families hold a high proportion of voting rights and thereby control decision-making, while minority shareholders become subject to controlling shareholders' decisions (Young *et al.*, 2008). This issue is severe in emerging countries that lack effective legal protection for investors and where other informal institutions shape business policy (Rashid, 2013; Young *et al.*, 2008). As the private sector in Saudi Arabia is family-dominated in general (Alriyadh, 2013), this study extends the understanding of whether or not the practices of corporate governance and the need for political connections in family-controlled firms differ from their non-family counterparts and how this affects levels of executive compensation. These issues raise the following two questions:

a) Do the structures of corporate governance and the need for political connections differ between family and non-family firms? and *b) What are the implications of this variation for executive compensation practices in family and non-family firms?*

1.4 RESEARCH CONTRIBUTION

The research is expected to contribute in several ways to certain areas of the literature including executive compensation, corporate governance, political connections and family business. First, to the best of researcher's knowledge, this study is the first that investigates the relationship between a comprehensive set of governance and political connections variables through the lens of principal-principal conflict on the one hand and the level of executive compensation on the other in the Arab world or in the MENA region in general. Although Irani and Gerayeli (2017) and Fallatah (2015) analyse the impact of certain corporate governance mechanisms on managerial remuneration in Iran and Saudi Arabia, respectively, there are differences in the comprehensiveness of the variables used between these studies and this thesis. In addition, the studies of Irani and Gerayeli (2017) and Fallatah (2015) are subject to several limitations, which this thesis overcomes, as is shown in the following chapters.

While prior studies only focus on total incentives of the CEOs (Shah *et al.*, 2009; Firth *et al.*, 2007; Li *et al.*, 2007; Lin, 2005) partly due to disclosure limitation, this study adopts a holistic view of the overall remuneration package granted to the top executives rather than only to CEOs. This is possible because Saudi firms are required by law to disclose information about the top five highest paid executives (CMA, 2010). Moreover, Saudi Arabia has no legislation that allows for the issuing of stock options because of regulatory purposes. Thus, firms are less able to use long-term managerial incentives. This limitation enables the study to analyse the challenges facing boards of directors when designing executive remuneration in contexts where the means to use performance criteria is highly constrained.

Furthermore, with regards to corporate governance, while most countries use the Anglo-American model of corporate governance (Conyon, 2014; Kaplan, 2012; Sapp, 2008; Core *et al.*, 1999), only a few studies investigate the validity and generalizability of adopting this model in emerging economies, which have different institutional characteristics from the West (Young *et al.*, 2008). For example, ownership concertation in Saudi Arabia is high with family and state ownership domination, and also personal connections (*wasta*) play a significant role in the business field. Another crucial difference is that governance policy in Saudi Arabia is significantly influenced by *sharia* (Islamic law); thus, governance recommendations should consider these domestic challenges. Therefore, this thesis, which uses a dataset from Saudi Arabia, provides evidence on the generalizability of the Anglo-American model of corporate governance in developing contexts.

Relatedly, most existent literature concentrates on the traditional agency problem between shareholders and managers (Al-Najjar, 2017; Conyon, 2014; Core *et al.*, 1999). In contrast, this thesis extends the understanding of agency problems that exist among other parties (controlling and minority shareholders) and provides insights into principal-principal conflict which exists in emerging countries (Young *et al.*, 2008). Even though principal-principal conflict is prevalent in the globe, its significance and character differ from one context to another. For example, while market-oriented economies may suffer from a conflict between institutional investors and minority shareholders with the existence of effective regulatory supervision, the case is different in emerging economies since most dominant shareholders are usually families (i.e. the conflict is among individual investors) and the role of external governance is absent. Therefore, understanding the conflict among individual shareholders enables the investigation of new related areas, such

as the influence and role of a blockholder chairperson on pay-setting for top management. Although some studies use chairperson ownership as a proxy by which to measure and observe attitudes of board chairpersons on pay arrangements of executives (Alagla, 2012), this thesis employs a more direct and accurate variable namely blockholder chairman. This ensures that the chairperson has high stakes in terms of equity and voting power. Otherwise his/her influence among other controlling parties is considered insignificant, especially as most Saudi firms are dominated by large shareholders (Al-Ghamdi and Rhodes, 2015).

Additionally, as the development of corporate governance in Saudi Arabia is still in its embryonic stage since it was only established in late 2006, this allows the investigation of the effectiveness of the recommendations of international best practice of corporate governance from the first stage of enforcement, when only few firms have complied, to full compliance at present. Four related key recommendations are examined in this thesis: to have a large proportion of independent members on the board of directors (Jensen *et al.*, 2004; Core *et al.*, 1999; Jensen and Murphy, 1990); to limit multi-directorships (Armstrong *et al.*, 2012; Ozdemir and Upneja, 2012; Sapp, 2008); to establish a remuneration committee that is responsible for executive compensation matters (Méndez *et al.*, 2011; Girma *et al.*, 2007); and to separate the roles of board chairperson and CEO (Conyon and He, 2011; Firth *et al.*, 2007; Core *et al.*, 1999). This provides comparative results with practices in mature economies and indicates the implications of following governance mechanisms on managerial incentives.

With respect to the literature concerning political connections, this thesis offers a second empirical study which investigates the effect of firms being politically connected on the setting of executive compensation. The study adds several significant contributions to the literature of political connections and extends the understanding of how executive compensation is determined in the emerging economy of the KSA. First, as mentioned earlier, to the best of the researcher's knowledge, there is no research that analyses the phenomenon of political connections and their implications on managerial incentives, either in the Arab economies or in the MENA region in general. Thus, this research is expected to fill a significant gap in the related literature and provide understanding on the attitudes of politically connected firms towards an important governance mechanism, executive compensation.

Furthermore, the literature concerning political connections is focused on the vital resources that political connections can bring to a firm (Civilize *et al.*, 2015; Goldman *et al.*, 2009; Pfeffer and Salancik, 1978). Therefore, there is a dearth of studies that investigate the implications of political connections from a governance perspective, in particular the ability of political connections to control non-merited executive compensation. Although Chizema *et al.* (2015) and Hearn *et al.* (2017) investigate the relationship between political connections and managerial pay in emerging economies, neither piece of research captures the influence of political connections on controlling shareholders. However, my research analyses the behaviours of political connections towards the arrangements concerning executive remuneration through the lenses of both principal-agent conflict and principal-principal conflict. The Saudi context, which is an arena for both types of conflict, helps to achieve this aim and to observe the interaction between political connections and large shareholders and the effect of this relationship on executive pay levels.

Relatedly, the study uses a sample from Saudi Arabia, which has unique characteristics—an absolute monarchy system, the existence of the *Shura* Council, and a high domination of family and state investment. This enables the research to develop a contextualised definition of political connections. Despite the fact that the literature contains numerous definitions for political connectedness, none is suitable for monarchical contexts such as Saudi Arabia. Hence, the definition developed by this study fills a significant gap with regards to the identification of political connectedness in this type of political system. Thus, the definition enjoys high generalizability to any country that have similar institutional features to Saudi Arabia, such as countries of the GCC.

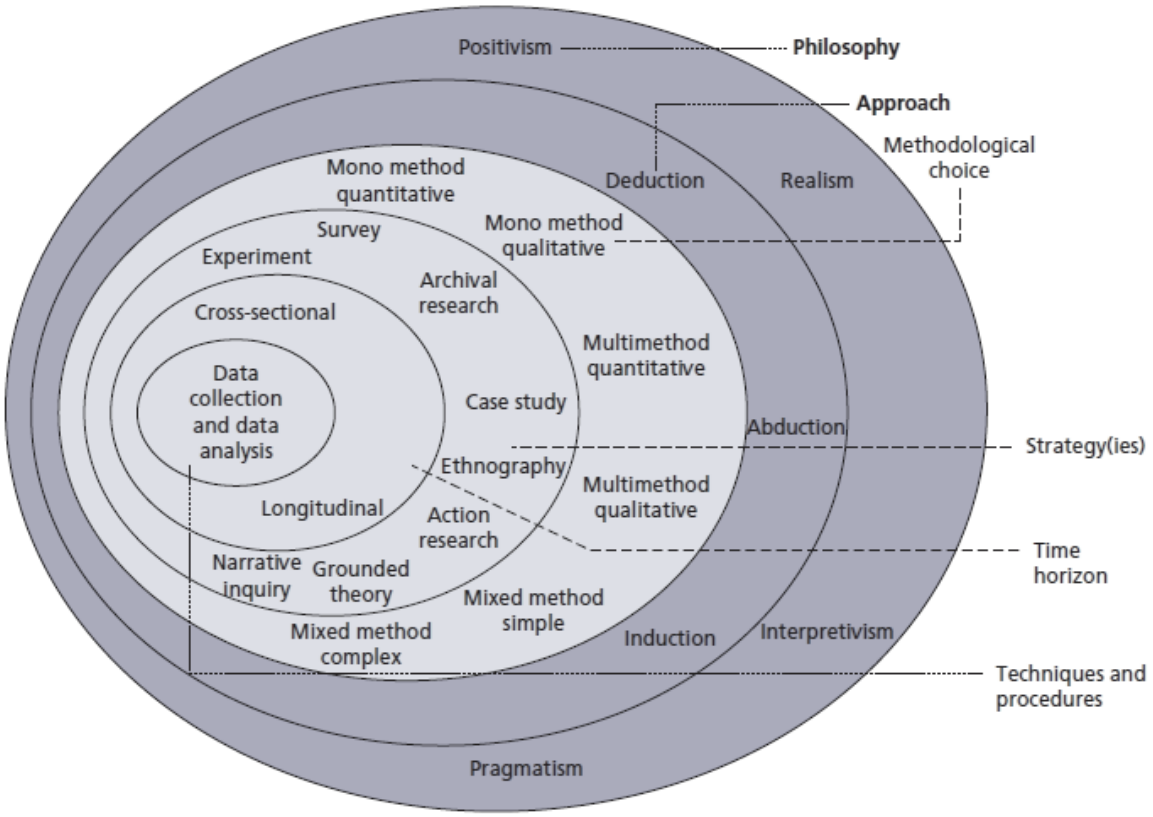
Moreover, the thesis contributes to the existing body of literature concerning family business in the areas of corporate governance and political connections. The third empirical model analyses the practices of executive compensation in both family and non-family firms. The context of Saudi Arabia and the dataset enables the researcher to classify firms into two distinct categories: family-controlled firms and non-family-controlled firms. This classification allows the investigation of the difference in behaviour between the types of firms towards executive compensation arrangements. Specifically, it shows how corporate governance practices and the need for political connections vary between the two types and the implications of these variations for the practice of executive compensation. In addition, corporate governance literature tends to focus on managerial opportunism and its consequences on agency costs (Conyon, 2014; Core *et al.*, 1999; Jensen

and Murphy, 1990). However, this research sheds light on how controlling shareholders and politically connected members also influence agency costs.

1.5 RESEARCH PHILOSOPHY

To answer the research questions properly, it is essential that the research uses a justified structure and follows certain steps and procedures that are formed in the research philosophy. Saunders *et al.* (2012) refer to these procedures as layers of a research onion. Figure 1.1 shows the layers which comprise (from the outer to the inner layer) philosophy, approach, methodological choice, strategies, time horizons, and data collection techniques. Each layer contains a number of approaches from which the researcher should choose the most appropriate one for his/her research objectives. This section discusses the research philosophy that is related to the development and nature of knowledge in terms of the layers of philosophy and approach, while the other research layers are explained in later sections.

Figure 1.1: Research philosophy in the 'research onion'



Source: Saunders *et al.* (2012)

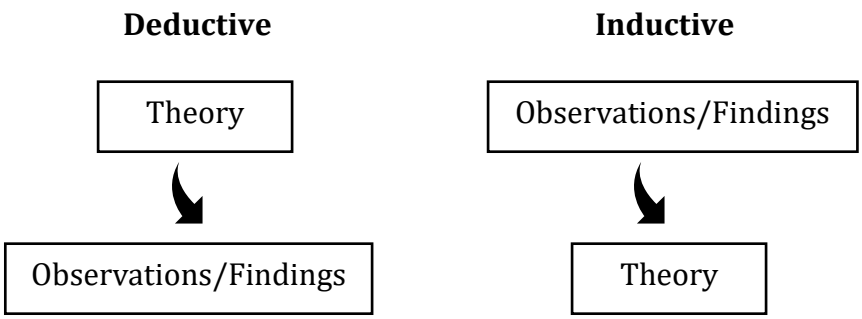
The choice of the most relevant research philosophy depends primarily on the ontological, epistemological and methodological underpinnings of the research (Bryman, 2016). Ontology is simply defined as the "claims and assumptions that are made about the nature of social reality, what exists, what it looks like, what units make it up and how these units interact with each other. In short, ontological assumptions are concerned with what we believe constitutes social reality" (Blaikie, 2009, p. 8). In other words, ontology is related to the central question of whether social phenomenon is observed and analysed objectively or subjectively. Objectivism "is an ontological position that asserts that social phenomena and their meanings have an existence that is independent of social actors" (Bryman, 2016, p. 22). In contrast, subjectivism (or constructionism) is defined as "social phenomena and categories are not only produced through social interaction but they are in a constant state of revision" (Bryman, 2016, p. 22). In other words, constructionism asserts that social phenomena and their perceptions are continually being changed by the interactions with social actors. Applying these definitions to the research phenomenon, namely corporate governance and executive compensation, the ontological position of the research stands between objectivism and subjectivism, since the existence of the phenomenon and its related meanings are not totally independent of social actors and are partly affected by human influence. Indeed, if another researcher re-investigates the phenomenon using the same method and sample, they will get the same results; however, a different sample or time-frame may lead to different findings since, as already mentioned, the phenomenon is partly affected by human influence. Furthermore, the interpretations of the findings are subjective and dependent on the understanding and view of the researcher towards the phenomenon.

The second element of research philosophy is epistemology, which is defined as "the possible ways of gaining knowledge of social reality, whatever it is understood to be" (Blaikie, 2009, p. 8). Epistemology is the part of philosophy related to the theory of knowledge and has two positions, namely positivism and interpretivism (Saunders *et al.*, 2012; Moser, 2002). Positivism is "working with an observable social reality and that the end product of such research can be law-like generalisations similar to those produced by the physical and natural scientists" (Remenyi and Williams, 1998, p. 32). In positivism, the purpose of theories is to generate testable hypotheses which can confirm or develop the theory through the findings which accept or reject the hypothesis (Bryman, 2016). In this context, the findings are expected to develop the theories (Saunders *et al.*, 2012). On

the other hand, interpretivism "is a term given to an epistemology that contrasts with positivism" (Bryman, 2016, p. 26). Under this epistemological position, reality is subjective and influenced by researchers' perceptions since they are part of the phenomenon (Moser, 2002). Consequently, this research adopts an objective and subjective ontological position and perceives the phenomenon of corporate governance and executive compensation through the lens of the existing theories, namely agency theory and institutional theory. As the research hypotheses are developed to confirm or reject the theoretical assumptions, the research follows positivist epistemology. However, the interpretations of the findings are subject to the researcher's perceptions towards the phenomenon; therefore, the research also employs interpretivist epistemology in this part.

The third element of research philosophy is methodology which is comprised of two nouns method and ology; thus, it is a branch of knowledge that concerns the process of research (Berg and Lune, 2011). Saunders *et al.* (2012) suggest that there are two dominant approaches in the social research discipline, namely deductive and inductive approaches. In the deductive approach, researchers develop and employ a theory to build a testable hypothesis first, then collect data and obtain findings to confirm or revise an existing theory, while in the inductive approach, researchers first observe phenomena and collect data and then develop or generate a theory as a result of data analysis (Saunders *et al.*, 2012). In short, the deductive approach attempts to confirm or reject perceptions of an existing theory, whereas the inductive approach attempts to build or create a novel theory (see Figure 1.2).

Figure 1.2: The process of deductive and inductive approaches



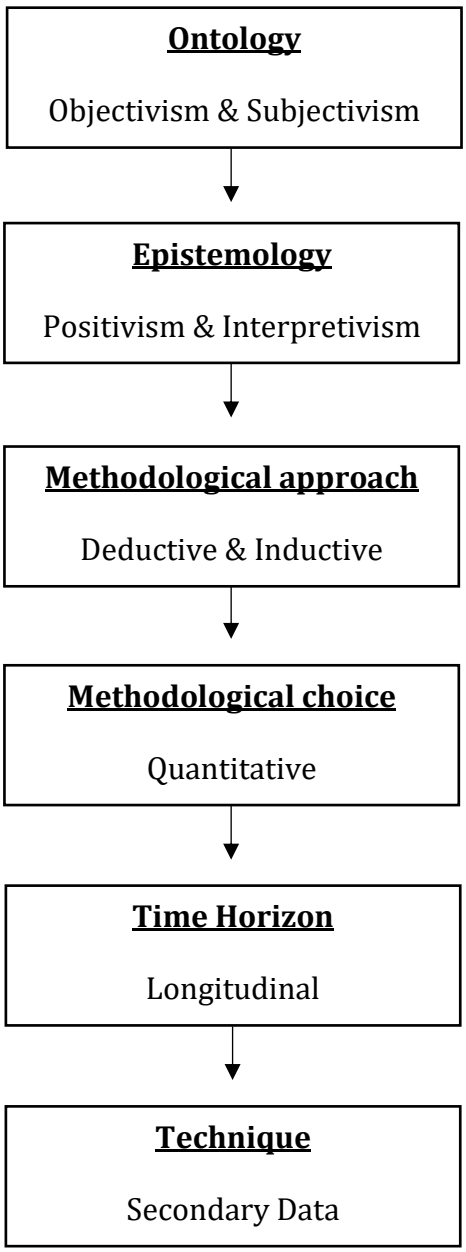
Source: Adapted from Bryman (2016).

In the social sciences, it seems very unlikely that research would be purely

inductive or purely deductive. Consequently, this research employs both deductive and inductive approaches as a methodological position. The deductive position is chosen since the research questions are related to the development of existing theories and require the formulation of hypotheses from existing theories in order to test the existing assumption. The existing literature provides a solid background to formulate a set of hypotheses and examine extant theoretical assumptions, while the inductive approach is used to analyse and interpret the results in order to gather them, to develop and extend the existing theories that explain the phenomenon. In this context, the research employs the quantitative approach, since it is the most relevant technique to its nature and questions.

In conclusion, this research adopts objectivist and subjectivist ontological positions and positivist and interpretivist epistemological positions that are appropriate for the nature of the research. That is to say, the research aims to establish if there is a relationship between the practice of corporate governance and the level of executive compensation. Moreover, it seeks to evaluate how and why this relationship exists, based on contextual appreciation, existing theories and prior findings, to establish good understanding of the phenomenon in Saudi Arabia. In relation to the methodological paradigm of the research, a hypothetico-deductive model and inductive approach are selected as the former allows the testing of pre-formulated hypotheses to confirm or revise existing theories and the latter helps to develop and extend existing theories. To do so, the quantitative technique of collecting data is employed as it is the most relevant and reliable approach for testing the research hypotheses. The main source of data is collected through secondary data (i.e. information published in the annual reports of companies), capturing eight-time horizons (longitudinal/panel data). The research philosophy is summarised in Figure 1.3:

Figure 1.3: Research Philosophy



1.6 STRUCTURE OF THE THESIS

This section presents the structure of the thesis and provides an overview of the contents. The general structure of the thesis is based on the style of empirical essays and thus is comprised of three empirical studies.

Chapter Two provides an overview of different aspects of the KSA that are relevant for the thesis. This includes the economic background, the legal framework and the influence of *sharia*, the development of corporate governance in Saudi Arabia along with an international comparison, and a brief introduction to the ownership structure in Saudi Arabia.

Chapter Three is the first empirical topic which analyses corporate governance and executive compensation. The chapter identifies the relationship between corporate governance and executive compensation in the KSA. It also reviews previous studies and builds the theoretical groundwork for the analysis. In addition, it develops the research hypotheses, illustrates the method, and explains how the study sample is selected. Finally, it discusses the results and develops the conclusions of the first empirical study.

Chapter Four is the second empirical study which analyses political connections and executive compensation. In this chapter, the interaction between political connections and business elites in the KSA is highlighted. Moreover, the chapter develops a contextual-based definition of political connections that takes into consideration the government type and the different political elites that exist in Saudi Arabia. A survey of political connections' literature is presented including a discussion concerning the literature gaps. As the theoretical framework of political connections is significantly different from the previous chapter, a separate section for theories related to political connections is developed. The section on research method identifies the research design, the related hypotheses and the data collection method. Last, the chapter discusses the research outcomes and sums up the conclusions of the second empirical study.

Chapter Five is the third empirical study which investigates the practices of executive compensation in family and non-family firms. Specifically, the chapter discusses the differences concerning corporate governance practices and the use of political connections in family and non-family firms and their implications for pay-setting. It assesses previous studies relating to family businesses and their attitudes with respect to corporate governance and political connections. The chapter also sets the

research hypotheses and illustrates the method. This is followed by a presentation and interpretation of the empirical results; these show the differences in attitudes between family and non-family firms with respect to executive pay arrangements. Finally, the research conclusions are drawn.

Chapter Six provides a summary of the research questions and methods as well as a brief report of the findings of each of the empirical studies. Moreover, it discusses the conclusions of the thesis and how they contribute to the existing body of knowledge concerning corporate governance, political connections, family business, and executive remuneration. This is followed by a summary of the implications for the practice of governance across the three empirical studies. Finally, the chapter acknowledges the study's potential limitations and provides recommendations for future research.

CHAPTER TWO:

OVERVIEW OF THE KINGDOM OF SAUDI ARABIA

2.1 GENERAL BACKGROUND

Saudi Arabia, officially known as the Kingdom of Saudi Arabia (KSA), is an absolute monarchical Arab state, the laws of which are based primarily on Islamic law (*sharia*) (MFA, 2013). Geographically, Saudi Arabia is the fifth-largest state in Asia and second-largest state in the Arab world after Algeria. The political economy of Saudi Arabia changed on 3 March 1938 when oil was discovered in the Eastern Province (OPEC, 2016). This and later findings of oil make Saudi Arabia one of the largest oil producers and exporters, controlling the world's second largest oil reserves, and the sixth largest gas reserves. It has the largest economy in the Middle East and North Africa (MENA) region, and is the only Arab country to be part of the G-20 major economies (World Economic Forum, 2016). This global standing makes Saudi Arabia an important place for doing business. In order to keep pace with the economic boom since the discovery of oil, many legal and economic reforms have been made.

However, in recent years the Saudi government has realised that it has become trapped in the 'resource curse'. The phrase 'resource curse' is commonly used to refer to resource-rich countries that have not properly benefited from their natural wealth (Humphreys *et al.*, 2007). Even though having reserves of oil is a blessing and helps to bring cash inflows with less effort, it can crowd out unrelated industries like manufacturing and agriculture and this comes at the expense of the economy in general (Humphreys *et al.*, 2007). Despite the fact that the Saudi economy has benefited from the oil revenues and has had significant growth during the last three decades, it is still mostly dependent on oil production which is unsustainable and has high risk of price volatility. Accordingly, the Saudi government has adopted several initiatives to diversify its revenues and reduce the risk and uncertainty of oil prices, but none has succeeded as intended and the economy is still highly reliant on oil exports (EIA, 2013). However, in 2016 the government announced a comprehensive strategic plan, the so-called 'Saudi Vision 2030', in order to minimise the reliance on oil (Bloomberg, 2016b). Indeed, this optimistic vision, if successfully implemented, is expected to reshape business policy in Saudi Arabia and the national economy in general.

Structurally, Saudi Arabia has unique institutional settings that significantly differ from other economies, which means that the experience gained in the West or in the East is not necessarily applicable in the Saudi context (Young *et al.*, 2008). For example, in terms of formal institutions, unlike the developed economies, the enforcement of

legislation is weak, albeit improving (World Economic Forum, 2016). Furthermore, Saudi law is heavily influenced by *sharia*, in which certain transactions are not permitted e.g. usury, stock options, betting and any financial transaction that is based on uncertainty or injustice (CIFA, 2000; Chapra, 2006; Abu-Tapanjeh, 2009). Indeed, these domestic norms influence business policy including governance recommendations. For instance, while the shareholder model of corporate governance suggests a link between managerial compensation and long-term performance through granting stock options (Bebchuk and Fried, 2003; Murphy, 1999), this is not permitted in Saudi Arabia for regulatory reasons. Additionally, the ownership structure in Saudi Arabia is concentrated in the hands of certain families and state agencies (Al-Ghamdi and Rhodes, 2015; Fallatah, 2015), while ownership is more diffuse in the US and the UK (Rashid, 2013). This indicates that there is less separation between ownership and control in Saudi Arabia, particularly in family-controlled firms.

With respect to informal institutions, the demographic characteristic of Saudi Arabia increases the role of the tribe and the influence of *wasta* on business policy and practices and the employment environment in general (Tlaiss and Kauser, 2011). From the perspective of employers, *wasta* might be considered as a stewardship role by managers towards their extended family, tribe and friends, and a moral obligation to maintain or gain legitimacy in their community (Budhwar and Debrah, 2013). However, this can lead to the hiring of unqualified managers and allow them to control decision-making for themselves (Young *et al.*, 2008). As a result, the organisation may be exposed to poor performance and squander minority shareholders' wealth. The following sub-sections discuss the key characteristics of the Saudi context in detail.

2.2 THE LEGAL SYSTEM

Understanding the legal system of a country gives an overview of how regulations are set and their impact on practices. The Basic Law of Governance in Saudi Arabia states in Articles 1, 6, 7 and 8 that Saudi Arabia is an Islamic country and its constitution is derived from the Holy Qur'an and the *Sunna* of Prophet Mohammed (the teachings and deeds of the Prophet Muhammad) and is ruled by King Abdulaziz's sons and grandsons in accordance with Islamic law (Shura, 1992). Consequently, there is no written constitution and any new legalisation must be consistent with *sharia* before it is applied.

In accordance with the Qur'an [verse 3:159] "and consult them in the matter", the Saudi legal process and decision-making are subject to consultation with an importance

placed on reaching consensus (Alturki, 2006). The Consultative Council (*Majlis Al-Shura*) consists of 150 members who are nominated and appointed by the King (Shura, 1992). The *Majlis Al-Shura* is responsible for studying the policies and laws raised by the Council of Ministers and providing recommendations for such policies and laws. Its responsibilities also cover other obligations as follows (Shura, 1992):

"a) Discuss the general plan for economic and social development and give view.
b) Revising laws and regulations, international treaties and agreements, concessions, and provide whatever suggestions it deems appropriate.
c) Analyzing laws.
d) Discuss government agencies' annual reports and attaching new proposals when it deems appropriate".

The Council of Ministers consists of a Prime Minister (the King), first and second Deputy Prime Ministers (first and second Crown Princes), 21 Minsters with ministerial portfolios, seven Ministers of State, and other consultants of the king (Shura, 1992). All members of the Council of Ministers are appointed by the monarch. Moreover, the Council of Ministers performs as an executive and legislative simultaneously. In other words, all laws must be approved by the Council of Ministers before they became active. The Council of Ministers usually refers proposed laws (by governmental institutions) to the *Majlis Al-Shura* to review and comment upon; however, the final decision of the implementation is subject to the approval of the Council of Ministers (Alturki, 2006). The Council's responsibilities include (Shura, 1992):

"a) Monitoring the implementation of regulations, By-laws and resolutions.
b) Creating and arranging public institutions.
c) Following up on the implementation of the general plan for development.
d) Forming committees for the oversight of the ministries and other".

2.2.1 *Sharia*

Sharia is an Arabic word which can be literally defined as 'water resource' (Almaany, 2014). However, the Islamic meaning of *Sharia* refers to the approach of life which contains instructions, guidelines, principles, orders and prohibitions that God prescribed to his servants through the Holy Qur'an and *Sunna* of his Prophet Mohammed peace be upon him (PBUH) (Alkahtani, 2013). *Sharia* has a major impact on Muslims in all aspects of life. This effect covers daily financial transactions which are explained in detail by the *sharia*. Consequently, understanding *sharia* in depth is necessary to comprehend Saudi laws and culture.

2.2.1.1 The Sources of Sharia

Sharia is based on two primary sources; the Holy Qur'an and *Sunna* of Prophet Mohammed (PBUH) which are universally accepted by all Muslims. However, there are other secondary sources, which are derived from the Qur'an and the *Sunna*, namely *ijma* (consensus of opinions) and the *qiyas* (analogical deduction) *(Al-Zuhaili, 1989)*. These sources are subject to religious scholars' *ijtihad*. *Ijtihad* refers to the opinion that the Islamic scholar reaches according to his own knowledge and understanding of the Qur'an and *Sunna* in matters that are not explicitly mentioned or clearly explained in the primary sources such as modern financial transactions (Alsanosi, 2010). The following sections give a brief introduction on each source.

a) The Holy Qur'an (God's words)

The Holy Qur'an is the main and the most important source of Islamic jurisprudence as it contains the words of God sent down to his Messenger Mohammed (PBUH) during the 23 years until his death. The Qur'an has 114 chapters and 6,236 verses and all Muslims believe that it is complete and perfect (16:89). Moreover, they believe that the Qur'an is valid for anytime and anyplace as God said: "And We have sent down to you the Book (the Qur'an) as an exposition of everything, a guidance, a mercy, and glad tidings for those who have submitted themselves (to God as Muslims)" (16:89). The Qur'an's subjects address all aspects of life including, in order, "unity with God, modes of worship, judicial proceedings, political and governmental issues, crimes, punishments, marriage, divorce and financial transactions" (Alkahtani, 2013).

b) The *Sunna* (Prophet Mohammad's Traditions and Customs)

The *Sunna*, which is an Arabic word that literally means a route (method), is the second source of *sharia* (Almaany, 2014). However, the technical Islamic meaning denotes to all that has been ascribed about Prophet Mohammed (PBUH), which includes his utterance, deeds, or reports (Alkahtani, 2013). The *Sunna* significantly adds to the Qur'an by explaining its instructions in full and that Muslims are ordered by God to follow the Prophet Mohammed's guidelines (PBUH) (Al-Zuhaili, 1989). The command to follow the Prophet is mentioned in multiple places in the Qur'an; in one of these verses for instance, God said "And whatsoever the Messenger (Muhammad) gives you, take it; and whatsoever he forbids you, abstain (from it)" (59:7).

c) Ijma

Ijma (consensus) is the first and most significant secondary source of *sharia* (Al-Zuhaili, 1989). *Ijma* refers to the general agreement among respected Islamic scholars regarding a matter that is not explicitly mentioned or clearly explained in the primary sources (Alsanosi, 2010). If all respected Islamic scholars agree about a certain issue, Muslims are required to follow this *ijtihad* because Prophet Mohammed (PBUH) said, "my community shall never agree on an error" (Nisaboori, p. 975). In other words, God will not make Muslim scholars reach a consensus of opinion if their judgement is wrong. Therefore, if all well-respected Islamic clerics reach agreement on a particular ruling, Muslims should accept and follow this judgment. However, throughout Islamic history, only a few issues have been resolved by consensus (Alsanosi, 2010). In modern times, it is difficult to reach agreement among Islamic scholars due to their large numbers around the world. Alternatively, local *ijma* (within a particular country) can work and this helps an Islamic country to set local rules (Aksoy, 2005), as in the case of Saudi Arabia. However, local *ijma* (according to the definition) is not binding for Muslims and is not considered as a consensus of community opinion as mentioned in the Prophet Mohammed's speech.

d) *Qiyas*

The last important source of Islamic jurisprudence is the *qiyas* (analogy), which refers to the process of making a jurisprudential ruling on a new situation (an emerging issue) based on analogy with a known ruling that has similar characteristics and purpose (Alsanosi, 2010). In the case of a lack of textual evidence from the primary sources of *sharia* or *ijma* in relation to a certain matter, scholars resort to the *qiyas*. The *qiyas* is subject to the cleric's knowledge and understanding of the main sources of Islamic jurisprudence. Thus, rulings differ from one scholar to another, and therefore from one country to another. Accordingly, the *qiyas* is not binding for Muslims and its acceptance depends on self-conviction regarding the inference provided by the scholar. A good example of the *qiyas* is the prohibition of wine. As the reason behind forbidding wine is to prevent the intoxication of an individual, scholars generalize the ruling to all other intoxicating substances whatever their type or name.

In summary, Islamic jurisprudence is based on two primary sources in order; namely the Holy Qur'an and *Sunna* of Prophet Mohammed (PBUH). However, if there is no textual evidence of a ruling in the primary sources regarding a specific issue, Islamic

scholars utilise two other secondary sources in order; namely *ijma* and the *qiyas*. Both of the ancillary sources are derived and deduced from the Qur'an and *Sunna*.

2.2.1.2 Maqasid Alsharia

Maqasid alsharia refers to the objectives and rationale of *sharia*. Islamic scholars define *Maqasid alsharia* in different ways; however, all of them deliver the same meaning. Imam Al-Ghazali (1992, cited in (Dusuki and Bouheraoua, 2011, p. 3), defines *sharia's* objectives as *"*to promote the well-being of all mankind, which lies in safeguarding their faith (*dīn*), their human self (*nafs*), their intellect (*'aql*), their posterity (*nasl*) and their wealth (*māl*). Whatever ensures the safeguard of these five serves public interest and is desirable". Therefore, the main and comprehensive purpose of *sharia* rulings is to guard and maintain public interests (*maslaha*) in all aspects of life.

Maqasid alsharia has been classified into five primary objectives (known also as five necessaries) namely "wealth (*mal*), unity with God (*tawheed*), the human self (*nafs*), the intellect (*aql*) and posterity (*nasl*)" (Alkahtani, 2013).

- **Public Interest (maslaha)**

Maslaha literally means benefit or interest, while there is a more narrow term *almasaleh almursalah* which means unrestricted interests (Elvan Syaputra *et al.*, 2014). Basically, *almasaleh almursala* considers public interest rather than merely individual interest and is used when there is no specific and clear text in the main sources of sharia: the *Qur'an* and the *Sunna* which deal with such matters (Alsanosi, 2010). In other words, it seeks to obtain a benefit or prevent harm to the public interest within the frame of *sharia* objectives. *Almasaleh almursala* is considered as a source of legislation in Islam (Alsanosi, 2010). Thus, it is widely used in modern financial and trading transactions and it is the basis of most current regulations in Islamic countries such as Saudi Arabia (Alsanosi, 2010). Corporate governance is just such a kind of regulation that should protect public interest. In this context, the governance regulations are supposed to consider all the stakeholders' interests, such as those of the shareholders, employees, creditors, suppliers, government and the whole community.

a) Wealth (*mal*)

As the Islamic objective: wealth (*mal*) is most directly related to the research questions, the study analyses this single objective in detail. The objective of wealth seeks

to preserve individual and public wealth. Thus, *sharia* frames the financial transactions that help to attain this target. Wealth from the *sharia's* perspective is broad and contains all things that can be owned, attained, and used for usual benefits (Al-Zuhaili, 1989, p. 40). In Islam, ownership of everything in the universe, including all types of properties, is with God; however, God gives humans the right to use some of these properties and makes them successors on earth (Hasan, 2009). This statement is mentioned in the Qur'an in various verses, for example:

> "To Him belongs all that is in the heavens and all that is on the earth, and all that is between them, and all that is under the soil", and in another verse, "And it is He Who has made you generations coming after generations, replacing each other on the earth. And He has raised you in ranks, some above others that He may try you in that which He has bestowed on you. Surely your Lord is Swift in retribution, and certainly He is Oft-Forgiving, Most Merciful" (20:6, 24:33, 6:165).

There are different levels of property rights in the s*haria*. Some properties are owned only by God such as the universe. Other property rights are the oceans and common land, which are owned by all humans. The final type of property rights is possession by individuals (Hasan, 2009). *Sharia* sets out the duties and responsibilities imposed upon humans who own a particular property (Alsanosi, 2010). Islam gives individuals the right of acquisition, utilisation, and disposal of a property, based on two substantial conditions: the first is that the property must be obtained through 'permissible means', and the second is that the property must not be utilised in a way that harms other parties (Alsanosi, 2010). 'Illegitimate means' of obtaining wealth includes gambling (*maysir*), bribery, stealing, cheating, forgery, coercion, by lying or any bad conduct that would cause harm to others (Alsanosi, 2010). An example of bad conduct is a monopolisation of people's basic needs such as food, since this conduct causes harm for others especially the poor (Badawi, 2014). Therefore, humans are accountable for the way in which he/she conducts their wealth; that is, from where he/she earned it and where he/she spent it. This accountability was explicitly reported by Prophet Mohammed (PBUH) when he said "The feet of the servant will not move before his being asked about four (things): His life, how did he spend it? His deeds, what did he do with it? His money, how did he earn it and where did he spend it? His body, how was it worn out?" (as reported by Al-Tirmidhi, [2417]).

In order to preserve individual wealth and to attain justice and equality among the involved parties, *sharia* encourages the use of contracts. Furthermore, it identifies prohibitions that must be avoided when dealing with wealth and the rights of others to that particular wealth. Islam prohibits certain financial transactions that include usury or interest (*riba*), gambling (*qimar*) and uncertainty (*gharar*) due to the potential harm that may affect one party only. For example, the interest (*riba*) that conventional banks apply on some loans due to default is not accepted in Islam since it benefits the bank and harms the other party, 'borrowers' (Alkahtani, 2013). Moreover, Islam imposes a right of others (certain parties) on certain wealth, which is the paying of alms (*zakat*), as long as the underlying asset meets certain conditions. Since these instructions are important to determine the validity of financial transactions and their compliance with *sharia*, the following sections shed light on each principle separately.

- **Undertaking of Contracts**

Sharia takes into consideration the importance of contracts in protecting the rights of involved parties. Therefore, Muslims are asked to fulfil their contractual obligations in many places in the Qur'an and the *Sunna*. For example, God said: "You who believe! Fulfil (your) obligations" (The Noble Qur'an [5:1]), "And fulfil the Covenant of Allâh (Bai'ah: pledge for Islâm) when you have covenanted" (The Noble Qur'an [16:93]) and "Verily! Allâh commands that you should render back the trust to those to whom they are due" (The Noble Qur'an [4:58]).

Even Prophet Mohammed (PBUH) exhorted Muslims to fulfil their commitments and warned those who break agreements, when he said

> "There are four characteristics, whoever possesses them all is a pure hypocrite, and whoever possesses one of them has one of the characteristics of hypocrisy, until he abandons it: when he is entrusted, he betrays; when he speaks, he lies; when he makes a covenant, he proves treacherous; and when he disputes, he resorts to obscene behaviour" (As reported by Al-Bukhari [2459]).

In addition, he said, "Give the worker his wages before his sweat dries" (as reported by Al-Qazwini [1995]), which means to give others their rights on time without procrastination.

- **Prohibition of Usury or Interest (*riba*)**

One of God's names in Islam is 'The Utterly Just'; hence, *sharia* aims to impose equality and justice among people regardless of their power or affluence, especially the

poor who lack the power and influence to protect their own rights. Before the mission of the Prophet Mohammed, the elite of Mecca were lending money to people and stipulating to have interest if they did not repay the dues on the maturity (Alkahtani, 2013). The interest may increase as long as the capital is not repaid. *Sharia* argues that *riba* is iniquitous and harmful for society since it unjustly takes money from the poor and gives it to the rich (Al-Zuhaili, 1989). Ultimately, this concentrates wealth in the hands of the rich. In other words, the poor get poorer which the rich get richer. With time, this would impact on the range between social classes and thereby societal hierarchy (Alkahtani, 2013).

The interest on loans is prohibited because it is not consistent with the social justice that Islam seeks to achieve. Instead, several alternative methods of financing (*sharia*-compliant), which are based on profit and loss sharing (PLS), have been suggested to provide fair financing for beneficiaries, such as *mudarabah* ("trustee finance contract or passive partnership") and *musharakah* (equity participation contract) (Febianto, 2012). Other sources of Islamic financing that are also based on PLS include sukuk (Islamic bonds) and direct equity investment, such as the purchase of common shares of stock. In such transactions, the capital provider acts as a capital partner: along with the principal of the financing, the provider gains a pre-agreed percentage of the profits or bears the same percentage of losses if there are any (Febianto, 2012). Accordingly, as there is risk sharing in Islamic financing, such transactions and the relationship between the provider and the beneficiary are controlled within an appropriate effective governance system that ensures all parties' interests are protected (Dar and Presley, 2000). This raises the necessity of a *sharia* board in financial institutions that comprises Islamic scholars who review products of financing and ensure that they do not contradict the Islamic ethical standards (Suleiman, 2000).

- **Prohibition of Gambling (*qimar*)**

As discussed earlier, *sharia* seeks to build a society upon fairness and justice; hence, legalising a comprehensive fair financial system is necessary to preserve and protect the rights of all parties engaged in any financial transaction. One trading transaction that *sharia* forbids is *qimar* (gambling). *Qimar* (known also as *maisir*) refers to the easy transference of money among parties when playing games of chance (gambling), such as raffles and lotteries (Alkahtani, 2013). The purpose behind the prohibition of *qimar* can be attributed to the loss or damage that would occur to one party

because of the high level of uncertainty (*gharar*). Moreover, it could induce enmity between the engaged parties.

- **Prohibition of Uncertainty (*gharar*)**

Unlike conventional economic laws which do not proscribe the potential harm that can result from uncertainty, Islamic law takes into consideration the negative consequences that could occur for one party as a result of trading under uncertainty. Therefore, it forbids trading under the uncertainty principle. *Gharar* can be defined as the case where there is uncertainty regarding a matter, and where it is possible that there are two outcomes, of which one is very risky and significantly harmful (Aldemiati, 2013). The reason for prevention is attributed to the significant loss or damage that would affect one party on one hand, and the unfair increase in the wealth of the other party on the other hand (Alkahtani, 2013). An example of *gharar* in modern financial transactions is stock options, because the transaction is based on uncertainty and the seller can agree to sell a stock that in some cases, he does not have at the time of the contract (Alshubaili, 2014; CIFA, 2000).

- **Paying of Alms (*zakat*)**

Sharia not only clarifies the prohibited aspects of trading wealth, but also proscribes the duties imposed on wealth for the benefit of society, such as *zakat* (alms). *Zakat* literally means the increase or the growth; however, it can be defined technically as the estimated amount that Islam imposes to help the deserving (Al-Qaradawi 1994). In the Islamic view, *zakat* is a mean by which wealth is redistributed, thereby, building an economy that is based on special care to the poor and the dispossessed.

Zakat is very important in Islam and is considered to be one of the five pillars of Islam. It is a compulsory for all Muslims to give *zakat* as long as certain conditions are met and it is allocated to certain categories of people who deserve it. *Zakat* is set at 2.5% of the total *zakat* base (GAZT, 2014). Many Islamic countries, such as Saudi Arabia, Bahrain, and Pakistan, have created institutions to collect *zakat* from Muslims. In Saudi Arabia, the General Authority of Zakat & Tax is responsible for collecting *zakat* from Muslim investors of the GCC countries, as well as taxes from non-Muslims, which is estimated as 20% of the net income (GAZT, 2014). *Sharia* through the imposition of *zakat* aims to protect Islamic society from political and economic instability that would occur as a result of serious deprivation (Alkahtani, 2013). Thus, the primary goal of *zakat* is to reduce the gap between the rich and poor; which can help eliminate hatred and envy

among the poor towards the bourgeois class. Moreover, it can reduce crime as the poor have less need to commit crimes such as robbery or forgery.

The brief background about the legal system and the property rights in *sharia* enhances the understanding of business policy in Saudi Arabia and shows how financial transactions and corporate governance regulations are subject to such norms. Although there is a high degree of harmony between Saudi Arabia and the Anglo-American contexts in terms of the norms of commerce, there are still major differences in certain economic transactions, especially ones that are based on usury or uncertainty. One example is the use of stock options, which is not legal in Saudi Arabia because of regulatory and religious reasons (CIFA, 2000). In this context, there is a challenge in adopting the international best practice recommendations that encourage linking executive compensation with long-term firm performance through offering stock options.

2.3 THE DEVELOPMENT OF CORPORATE GOVERNANCE

Saudi Arabia, like other emerging countries, has suffered for a long time from weak financial disclosure and almost total ignorance of corporate governance mechanisms. The demand for introducing corporate governance regulations in emerging economies has been inflamed by stakeholders, in particular, after the financial scandals that occurred in the US by Enron (2001) and Worldcom (2002). Saudi authorities were hesitant, because they argued that enacting such regulations could negatively affect the share prices at a time when the stock market was becoming more liquid. However, the failure to enact corporate governance regulations by the Saudi Capital Market Authority (CMA), was one of the main reasons that made the level of transparency in Saudi Arabia extremely low. In turn, this contributed to the stock market collapse in 2006, usually referred to as 'the stock collapse 2006'.

In order to absorb the public outrage that resulted from the collapse, the CMA introduced the first version of the Saudi corporate governance regulations (SCGRs) in late 2006. The first version was introduced as a guideline with the option to comply. However, firms were required to include a table of compliance in their annual reports that shows which of the code articles had been implemented and if not implemented, the forms had to provide the reasons and justifications why they were not implemented. However, firms have been gradually enforced to comply with the code articles and by 2010 most of the articles were mandatory (CMA, 2010).

The Saudi Corporate Governance Code (2010) consists of five main parts. The first part contains preliminary provisions and clear definitions of certain terminologies such as the meaning and conditions of being an independent director. The second part gives details of shareholders' rights and issues related to general assemblies. The third section contains the policies and procedures related to transparency and disclosure requirements. The fourth part presents and explains the duties, responsibilities, and formation of the board of directors and its sub-committees. Finally, the fifth part includes information related to the implementation.

2.3.1 Board of Directors

The Saudi code emphasises the importance of the board of directors as a primary mechanism of internal governance; thus, it identifies the issues related to the board of directors in a separate section. Before explaining the duties and responsibilities of the board of directors, it is worth outlining the transparency requirements related to the board of directors which all Saudi listed firms are obliged to disclose. The code requires the board of directors' report to comprise information about the board members including their names, their classifications (executive, non-executive, independent member), names of other firms that a director serves in concurrently, and their compensation. Moreover, a firm must release a table that shows the Articles which the firm complied with; otherwise, they should state the reasons for not applying those Articles thus far. Furthermore, the report must declare any punishment or penalty or preventative restriction imposed by the CMA or any other supervisory, regulatory, or judiciary body (CMA, 2010).

2.3.1.1 Duties of board of directors

The code identifies the functions of the board of directors as follows (CMA, 2010):

a) To determine the strategic and main goals of the company and to oversee the implementation of them, including:
    - To set the comprehensive strategy of the company, the main plans of implementation, and policy of risk management;
    - To determine the optimal capital structure for the company's strategies and financial objectives; moreover, to approve annual budgets;
    - To supervise major capital expenditure for the company, and issues related to the assets such as possession or disposal;

- To set performance goals and means to monitor the implementation; and
- To review the organisational and functional structures of the company periodically.

b) To set systems and mechanisms of internal control and supervise them, including:
   - To set a written policy that governs conflicts of interest and addresses any potential conflicts among the members of the board of directors, executive management, and shareholders, including misuse of the company's assets and facilities, and misconduct resulting from transactions with persons concerned;
   - To ensure the safety of the financial and accounting systems, including regulations related to the preparation of financial reports;
   - To ensure that the current control systems are appropriate to manage the company's risks; and
   - To review the effectiveness of internal control procedures in the company annually.

c) To set a private governance system—that is not inconsistent with Saudi corporate governance code—and generally supervise it, examine it, and adjust it when needed.

d) To set clear and specific policies, standards, and procedures for membership in the board of directors, and implement them after being approved by the general assembly.

e) To set a written policy governing the relationship with stakeholders in order to protect them and save their rights. The policy must cover, especially, the following:
   - Mechanisms of compensating the stakeholders in the case where their rights have been violated according to the regulations and contracts;
   - Mechanisms for settling complaints or disputes that may arise between the company and stakeholders;
   - Appropriate mechanisms to maintain good relations with clients and suppliers, and protect their confidentiality;
   - Rules of professional conduct for managers and employees in the company to comply with the proper professional and ethical standards and regulate their relationship with the stakeholders; and
   - The company's social contribution.

f) To set policies and procedures which ensure that the company respects rules and regulations and its commitment to disclose important information to shareholders, creditors and other stakeholders.

2.3.1.2 Responsibilities of board of directors

The code also clarifies the responsibilities that rest squarely on the shoulders of the board of directors as follows (CMA, 2010):

- Without violating the competences of the General Assembly, the board of directors is responsible for all powers and authorisations necessary to manage the company. The ultimate responsibility remains upon the shoulders of the board of directors, even if other sub-committees have been established or other bodies have been delegated to, and the board of directors should avoid issuing general authorisations or authorisations with unlimited validity;
- The responsibilities of the board of directors must be clearly stated in the Company's Articles of Association;
- The board of directors must perform its duties in a responsible manner, in good faith, with serious diligence; and its decisions should be based on sufficient and adequate information from the executive management, or from any other reliable source;
- A member of the board of directors represents all shareholders, and he/she should be committed to perform in the general best interest of the company, not in the best interests of the group that he/she represents or which voted in his/her favour for the appointment to the board of directors;
- The board of directors is responsible for granting and determining authorisations to the executive management, and the procedures of taking any action and the validity of such delegations. Moreover, it determines the matters that are reserved for decision by the board of directors. The executive management raises periodic reports about their practices in relation to those delegated authorisations;
- The board of directors must make sure of setting procedures to orientate new board members to the company's business, particularly financial and legal aspects, and train them if necessary;
- The board of directors must make sure that sufficient and adequate information about the company is available to all members of the board of directors in general and to Non-Executive Directors in particular, in order to enable them to carry out their duties and their tasks effectively;
- The board of directors shall not sign loan agreements whose maturities exceed three years, or sell the company’s real estate or mortgage them, or discharge company's debtors from their obligations, unless it has been authorised to do so by the

company's Articles of Association. If the company's Articles of Association has no provisions in this regard, the board of directors shall not do so without approval from the General Assembly, unless those acts are lying in the scope of the company business.

2.3.1.3 Formation of the board of directors

Formation of the board of directors must be subject to the following (CMA, 2010):

a) The Association of Articles of the company decides the number of members of the board, provided that such number is between three and eleven.
b) The General Assembly shall appoint the members of the board of directors for the duration stated in the Association of Articles of the company, provided that such duration must not exceed three years. Members' re-appointment is allowed unless the Association of Articles of the company provides otherwise.
c) The majority of the board of directors shall be non-executive members.
d) It is prohibited to combine the positions of chairman of the board and any executive position such as the Managing Director or Chief Executive Officer or the General Director.
e) The number of independent directors shall not be less than two members or third of the board of directors, whatever is greater.
f) The Association of Articles of the company must specify the manner in which Board membership terminates. The General Assembly can, at any time, dismiss all or some members of the board, even if the Association of Articles of the company provides otherwise.
g) On termination of a member of the board of directors by any means of termination, the company must promptly notify the Capital Market Authority and stock market with a statement of the reasons for the termination.
h) A member of the board of directors shall not perform as a member of the board in more than five joint stock companies simultaneously.
i) A legal person, who is entitled under the Association of Articles of the company to appoint representatives to the board of directors, is not allowed to vote for nominating other members of the Board.

2.3.1.4 Conflict of interest within the board

Preventing conflict of interests within the company is at the core of the board of director's mission. Conflict of interests may not only arise between management and shareholders, but also may exist between a board member and the company. Therefore, the Saudi code focuses on this aspect and determines the procedures and policies that would control such conflict of interest as follows (CMA, 2010):

- A board member shall not, without prior approval from the General Assembly (to be renewed each year), gain any personal interest (whether directly or indirectly) in any business or contract done for the company, with the exception of business and contract being done on a competition basis and that member being the best bidder.
- Additionally, the member must notify the board of directors of any personal interest he/she may have in the business and contracts that are completed for the company's account. If so, the member is not permitted to vote for the related resolution neither in the board of directors nor in the General Assembly. Furthermore, the Chairman of the board of directors shall notify the General Assembly when any business or contract that a member of the board has a personal interest in takes places, and attaches with the notification a special report from the external auditor thereon.
- A board member shall not, without prior approval from the General Assembly (to be renewed each year), participate in any business that may compete with the company's activities, or to trade in on one of the company's activities.
- The company shall neither grant cash loans for any member of the board of directors, nor guarantee any loan that is granted for a member from a third party, with exception of banks and other fiduciary companies.

2.3.2 Board Subcommittees

Due to the time limits on membership of the board of directors and to ensure sufficient use of board members' expertise, the board of directors typically establishes subcommittees and delegates them to undertake certain tasks (Conyon, 2014). The committee members are appointed and overseen by the board of directors (Baker and Anderson, 2010). Furthermore, the committees are required periodically to raise reports to the board that show the progress and results of their delegated activities. These reports are usually recommendations and advice while the ultimate approval is retained by the board of directors. However, there are a number of matters on which committees are delegated to make decisions (De Lacy, 2005).

In order to enhance the quality and meet the minimum needs of governance requirements among listed firms, the Saudi governance code requires all firms to establish at least two subcommittees under the board of directors; the audit committee and the nomination and remuneration committee. However, some firms have voluntarily established extra committees such as the executive committee, the governance committee, the risk management committee, and the investments committee. Moreover, firms are encouraged by the code to establish any necessary committees that would help the board to accomplish its missions effectively. The General Assembly is responsible, upon the board of directors' recommendations, to issue the rules for appointing the committee members and to determine their office duration and the procedures to be followed by the committees (CMA, 2010).

In essence, the subcommittees are where the 'real work' of the board is fulfilled (De Lacy, 2005); therefore, it is essential to understand the role and responsibilities of each committee in-depth.

2.3.2.1 Audit committee

Although the establishment of audit committee was referred as a recommendation in the introduction of the code in 2006, many firms voluntarily complied with the code and established an audit committee. However, by 2008 all firms were compelled by law to form an audit committee (CMA, 2010); otherwise, they are subject to regulatory penalties.

- **Formation of audit committee**

According to the code, all seats on the audit committee must be occupied by non-executive directors. Moreover, the number of the committee members shall not be less than three; one of them, at least, must be a specialist in financial and accounting matters (CMA, 2010).

- **Duties and responsibilities of audit committee**

The code outlines the duties and responsibilities of the audit committee as follows (CMA, 2010):

a) To oversee the internal audit of the company, in order to verify its effectiveness in the implementation of the business and the tasks set by the board of directors.

b) To study the internal control system and to raise a written report including the committee's recommendations in this respect.
c) To study the reports of the internal audit and to follow-up the implementation of the corrective actions for the notes contained therein.
d) To raise recommendations to the board of directors to appoint, dismiss, or determine fees of external auditors; the independence of the external auditor should be taken into consideration when raising such recommendations.
e) To oversee the activities of the external auditor and to approve any activity of the scope of audit work assigned to them during their audit duties.
f) To review the audit plan and make any comment thereon.
g) To review the comments of the external auditor on the financial statements and to follow up the actions taken thereupon.
h) To review interim and annual financial statements before they are submitted to the board of directors and to provide an opinion and recommendation thereon.
i) To review the used accounting policies and provide advice and recommendations to the board of directors in respect thereof.

2.3.2.2 Nomination and remuneration committee

Unlike the US and UK which encourage establishing a separate committee responsible for executive remuneration matters, the Saudi code requires firms to form a committee that performs the functions of both compensation and nomination matters. Moreover, with regards to the formation of the committee, the code neither requires the presence of independent directors nor prohibits executive directors from taking part in such a committee. On the contrary, the code does not mention any matters related to the formation of this committee; it leaves the composition to the board of directors. Furthermore, it is worth mentioning that unlike many Western economies, in Saudi Arabia there is no requirement for the remuneration committee to consult an external independent party with respect to executive perks' packages.

- **Duties and responsibilities of nomination and remuneration committee**

The code outlines the duties and responsibilities of the audit committee as follows (CMA, 2010):

a) To recommend nominees of Board membership to the board of directors according to the approved policies and standards; taking into account not nominating any person who has been previously convicted of any offence impacting honour or honesty.
b) To annually review the needs of appropriate skills for Board membership and to prepare description of the capabilities and qualifications required for such membership, including the required time to devote in such office.
c) To review the structure of the board of directors and raise recommendations if changes are needed.
d) To identify weaknesses and strengths of the board of directors, and recommend remedies that are compatible with the interest of the company.
e) To ensure on an annual basis the independence of independent directors and the absence of any conflict of interests if a member holds Board memberships in other companies.
f) To draw clear policies for indemnities and remuneration of board of directors and senior executives; and taking into account when setting such policies, the standards related to performance.

2.4 CORPORATE GOVERNANCE FROM A *SHARIA* PERSPECTIVE

The principles of corporate governance are not new to Islam as *sharia* captures the main aim of conventional corporate governance, which is the protection of the shareholders' rights and interests. However, Islamic corporate governance (ICG) extends this protection to cover other stakeholders, including employees, customers, suppliers, creditors, needy people and the whole of society (Abu-Tapanjeh, 2009). Consequently, ICG is primarily based on the stakeholder-oriented model of corporate governance but is subject to Islamic rules (Bhatti and Bhatti, 2010; Hasan, 2009). For example, one group of stakeholders that is considered in the Islamic world is the poor, who are eligible for *Zakat* (Alnasser and Muhammed, 2012). Although the ICG performs in a similar way to conventional corporate governance, it differs in its consideration of the public interest.

ICG is grounded on the ethical and moral framework of the *sharia* to ensure justice, honesty, fairness and equality of treatment for all parties involved (Mirakhor, 2000; Abu-Tapanjeh, 2009). Bhatti and Bhatti (2010) argue that Muslims are supposed to be collectivist and focused on the community rather than individualistic. Accordingly, ICG is based on the stewardship model in which the major actors are perceived as stewards who represent the stakeholders and are inspired by the spirit of partnership (Bhatti and

Bhatti, 2010). This theorisation contrasts with the Anglo-Saxon model which is based on agency theory, in which agents are assumed to behave opportunistically with self-interest motivations and must therefore be monitored (Jensen and Meckling, 1976).

Moreover, the fundamental Islamic faith of the Unity of God (*tawhid*) plays a significant role in ICG (Choudhury and Hoque, 2006). That is to say, the strong belief in accountability and answerability not only to stakeholders but also to God, the ultimate authority in life and on the day of judgement, has a significant influence on every individual Muslim (Bhatti and Bhatti, 2010). This extends the scope of governance far beyond the conventional corporate governance regimes. Abu-Tapanjeh (2009) conducts a comparative study between the principles of ICG and OECD and concludes that although the two versions are similar, the Islamic model has a wider scope of stakeholders and stronger self-accountability. With regard to the governance structure, unlike the Anglo-Saxon corporate governance system which is based on a one-tier board containing both executive and non-executive directors, the ICG has a two-tier system: the board of directors and a *sharia* supervisory board (Alnasser and Muhammed, 2012; Bhatti and Bhatti, 2010; Hasan, 2009) see Figure 2.1.

In the Islamic environment, the process of decision-making is subject to consultation (*shura*) with the important aim of reaching consensus provided that no harm is done to any stakeholders (Abu-Tapanjeh, 2009). Furthermore, *sharia* demands high transparency of all necessary information on transactions and operations conducted inside the organisation (Abu-Tapanjeh, 2009). This requirement emanates from the fact that Muslims are required to tell the truth and be fair and just in all aspects of life. The wide scope of accountability towards stakeholders and God, the Ultimate Authority, and the tenet that all resources are provided by God in the form of trust raises the expectation of *sharia* compliance in such a way that organisations are inspired to achieve high levels of accurate disclosure (Bhatti and Bhatti, 2010).

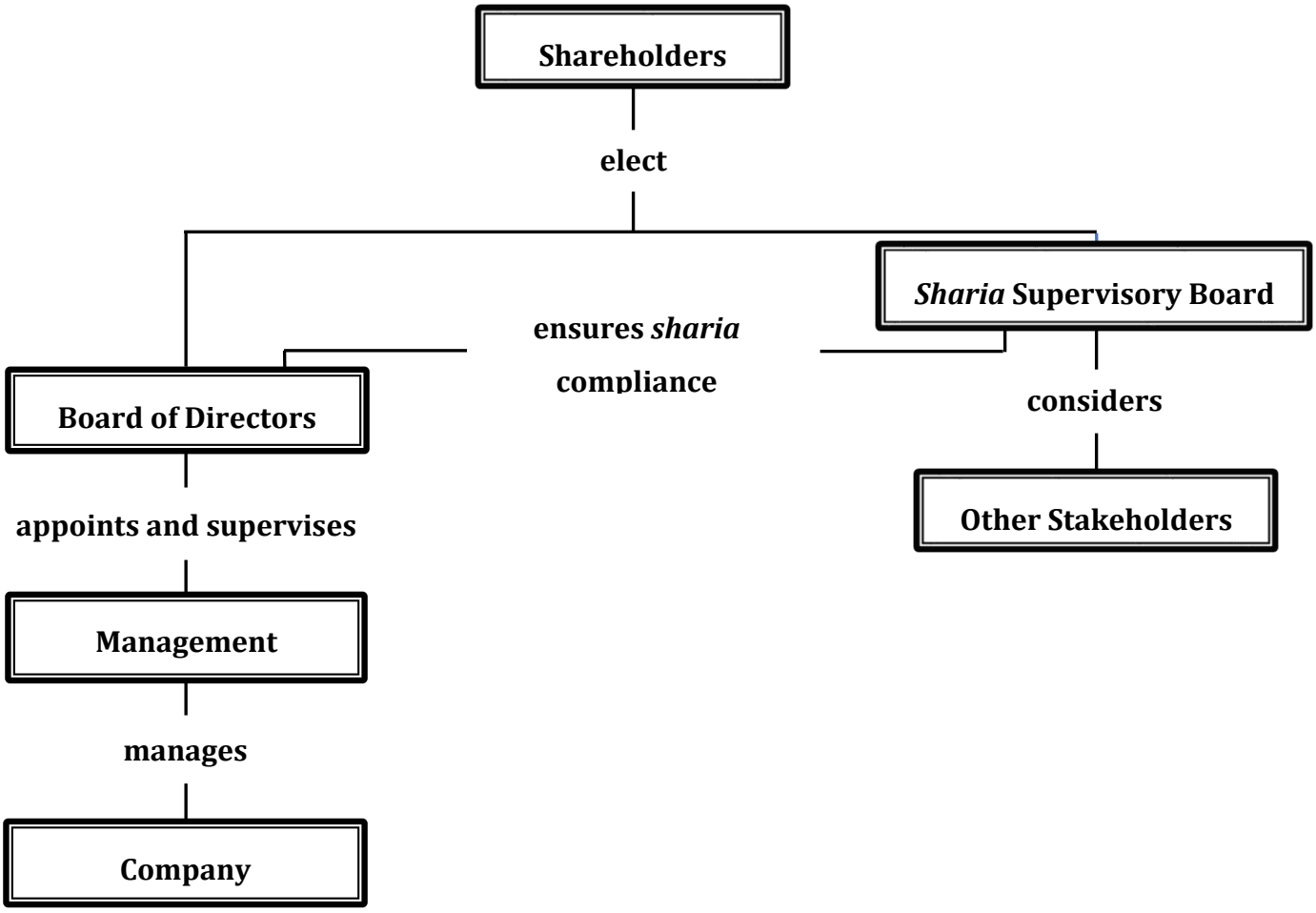
- **The Role of *Sharia* Supervisory Board**

The role of the *sharia* supervisory board is to review financial products in financial institutions and determine the *sharia* compliance of these products and the investments. Therefore, the board performs in an advisory capacity for the board of directors on Islamic matters to ensure that all transactions are compliant with *sharia*, including products, services, marketing advertisements and sources of funds (Hasan, 2009). The Islamic financial services board (IFSB) standards state that *sharia* compliance is central

to assuring the integrity and credibility of the institutions offering Islamic financial services; therefore, the existence of the *sharia* board in Islamic institutions is essential, even for legitimating purposes; otherwise, the institution will not have the public's trust.

In Saudi Arabia, only Islamic financial institutions are found to be compliant with the recommendations of ICG. This is because the majority of transactions conducted by conventional banks are not usually consistent with Islamic law. In addition, these institutions affect a large segment of society. Thus, Islamic banks need to apply ICG to legitimate their existence and to reassure the beneficiaries that their transactions and operations lie within the scope of Islamic requirements. This includes the prevention of *riba*. Consequently, non-financial firms have less need to establish a *sharia* supervisory board since their loans are obtained from Islamic-governed banks.

Figure 2.1: Islamic Model of Corporate Governance



Source: Adapted from Alnasser and Muhammed (2012), Bhatti and Bhatti (2010), and Hasan (2009)

2.5 SAUDI CORPORATE GOVERNANCE VS INTERNATIONAL SYSTEMS

Even though most Saudi firms have ostensibly complied with the SCGRs, the practices of corporate governance in KSA are still immature (The World Bank, 2009). This can be attributed to the domination of blockholders in the Saudi private sector. The control exercised by large shareholders over Saudi firms swims against the tide of good corporate governance practices. That is to say, because blockholders are able to access internal information, they feel less obliged to comply with certain requirements such as the involvement of independent directors and the demand for high transparency (Banghøj *et al.*, 2010). Hence, it was irrational for the CMA to copy corporate governance regulations from another country without taking into consideration the unique characteristics of the Saudi context, such as culture, ownership structure, market liquidity and regulations. It can be seen from Table 2.1 that SCGRs apply rules collected from different codes worldwide.

Nevertheless, SCGRs follow the common regulatory approach of 'comply or explain' which holds that one size does not fit all; some of its Articles are mandatory. In an attempt to limit the power of controlling shareholders, SCGRs require companies to follow the cumulative method of voting that gives minorities a greater opportunity to appoint representatives. However, as this method of voting is inconsistent with Saudi Company Law (1965), firms felt justified in declining to follow such a system. Consequently, hardly any companies applied cumulative voting until 2012, when the Ministry of Commerce (Alriyadh, 2012), which has a higher authority than the CMA, required firms to use the cumulative voting approach in their General Assemblies. The use of cumulative voting was deemed necessary in the Saudi case in order to restrict blockholders' control. In contrast, other authorities such as in Germany and in some American states give firms the option to choose the most appropriate voting method for the company's interest (OECD, 2012).

Structurally, SCGRs are based on a one-tier board system which is identical to the Anglo-Saxon model (Alnasser and Muhammed, 2012). However, unlike other developed countries such as the US, UK and Germany, the Saudi code (2010) limits the size of board of directors to between three and eleven members, in order to eliminate the disadvantages of large boards and the free-rider problem (Lin, 2005). Furthermore, SCGRs adopts three types of membership classification: independent, non-executive, and executive directors (CMA, 2010). Although other systems such as those in the US and Germany categorise board members as executive and non-executive directors, not all non-executive directors enjoy real independence (Chen *et al.*, 2011).

SCGRs mandatorily require firms to establish two subcommittees: the nomination and remuneration committee and the audit committee. However, this approach, especially the combination of nomination and remuneration committee, does not match the international form of board subcommittees' structure. For example, in the US and UK there are two separate committees, one for remuneration and the other for nominations. Even the independence requirements for remuneration and nominations committees differ among the three countries. While the US and the UK require completely independent directors to serve on these committees (FRC, 2014; Conyon, 2014), SCGRs do not mention the independence of such a committee. Consequently, SCGRs do not prevent executives from participating in the decision-making process related to their compensation or the nomination of other members of the board of directors. Indeed, this

amalgamation of the two committees leads to conflicts of interest between the executive team and shareholders.

Table 2.1 shows a comparison between Saudi Arabia and three developed countries, the US, the UK, and Germany, in terms of the main characteristics of their corporate governance mechanisms, market characteristics and executive compensation practices. Although the market characteristics of Saudi Arabia are similar to those of Germany in many aspects, especially the ownership structure and market orientation, the KSA structurally follows the Anglo-Saxon model. However, it differs from the US and the UK in that CEOs are not allowed to serve as board chairmen simultaneously. Moreover, executive incentives mechanisms in Saudi Arabia are limited, while other developed countries have different short- and long-term packages (Bebchuk and Fried, 2003; Conyon, 2014).

In summary, there are significant differences in substance between the characteristics of the Saudi context and its Anglo-American counterparts; thus, Saudi Arabia should develop its own model that fits its unique formal and informal institutions.

Table 2.1: An International Comparison of Corporate Governance Systems

	United States	United Kingdom	Germany	Saudi Arabia
GOVERNANCE CHARACTERISTICS				
Compliance approach	Mandatory	Comply or Explain	Comply or Explain	Comply or Explain, however, some of the Articles are mandatory
Influential party	Shareholders	Shareholders	Stakeholders	Shareholders
Cumulative voting	Mandatory in some States	No	Allowed	Mandatory
Conflict of interests	Principal-agent	Principal-agent	Stakeholders	Principal-principal
BOARD CHARACTERISTICS				
Structure	One-tier	One-tier	Two-tier	One-tier
Size	Not specified	Not specified	Not specified	Three to eleven members
Members' classifications	- Executive - Non-executive	- Executive - Non-executive - Independent non-executive	- Executive - Non-executive	- Executive - Non-executive - Independent non-executive
Independence	Majority of members must be non-executive directors	- At least half the board, excluding the chairman, should comprise independent non-executive directors - A smaller company should have at least two independent non-executive directors	Majority of members must be non-executive directors	Two independent non-executive members or one third of the board, whatever is greater, providing the majority members of the board to be composed of non-executive directors.

CEO duality	Allowed – with a recommendation to separate the two positions	Allowed – with a requirement to report the reason	Not allowed	Not allowed
AUDIT COMMITTEE				
Establishment	Mandatory	Recommended	Recommended	Mandatory
Size	At least three members	- At least three members - Two for small companies	Not specified	At least three members
Independence	All members must be non-executive	All members must be non-executive	- The chairman shall be independent - The board chairman cannot be the committee chairman	- All members must be non-executive
NOMINATION COMMITTEE				
Establishment	Mandatory	Recommended	Recommended	Mandatory
Size	At least three members	Not specified	Not specified	Not specified
Independence	All members must be non-executive	Majority of members should be independent non-executive directors	The committee shall be composed exclusively of shareholder representatives	- Not specified. - Executive members are allowed to serve on the committee - There is a combination of nomination and remuneration committees.
REMUNERATION COMMITTEE				
Establishment	Mandatory	Recommended	Not mentioned	Mandatory
Size	At least three members	- At least three members - Two for small companies	N/A	Not specified

Independence	All members must be non-executive	Majority of members should be independent non-executive directors	N/A	- Not specified. - Executive members are allowed to serve on the committee - There is a combination of nomination and remuneration committees.
MARKET CHARACTERISTICS				
Efficiency	Strong	Semi-strong	Semi-strong	Weak
Liquidity	High	High	Low	Low
Corporate control (takeover)	Active	Active	Inactive	Inactive
Orientation	Outsider	Outsider	Insider	Insider
OWNERSHIP CHARACTERISTICS				
Concentration	Low	Low	High	High
Dominant investors	Institutions	Institutions	Banks and families	Families and state
Dominant investors' behaviours	Profit-oriented	Profit-oriented	Growth-oriented	Growth-oriented
Ownership and control relationship	Separated	Separated	Associated	Associated
EXECUTIVE COMPENSATION				
Compensation consultant	Yes	Yes	Yes	No
Incentives	Long- and short-term	Long- and short-term	Long- and short-term	Short-term only (i.e. salary and bonus)

Source: (Al-Ghamdi and Rhodes, 2015; Fallatah and Dickins, 2012; The World Bank, 2009)

2.6 EXECUTIVE COMPENSATION POLICIES

Even though executive compensation levels in Saudi Arabia have increased dramatically during the last decade, no research has investigated the reasons behind this boom. A quick statistical glance at the trends among the best compensated executives between 2008 and 2015 demonstrates that compensation per executive has increased by more than 100% on average in most listed firms, while the growth of managerial pay in some companies has tripled, such as the Mobily company (Arqaam, 2014).

Unlike the options available to boards of directors in Western contexts, the setting of executive remuneration in Saudi Arabia is restricted to a few methods, on regulatory grounds. That is to say, there is no legislation that allows firms to repurchase their own stock from the market.

2.6.1 Components of Executive Pay

The Saudi corporate governance code states that executive pay can be designed to include one or more of the following: monthly base salary, allowances or proportion of profits, periodic or annual bonus related to performance, short- and long-term incentive plans and any other kind of benefits including non-pecuniary ones (CMA, 2010). Each of these incentive methods is discussed in detail in the following subsections.

- **Base salary**

Base salary is the preferred method of compensation from an employees' perspective (Murphy, 1999), because it guarantees minimum income regardless of the employee's performance. Moreover, it is characterised by being free from the risk of fluctuation when compared with other constituents of pay. In Saudi Arabia, base salary in general is the most dominant component of executive. This may be attributed to the fact that most listed firms are controlled by families; therefore, there is less pressure to link executive pay to performance, as the family has the power to access and monitor managerial activities closely (Banghøj *et al.*, 2010).

- **Annual bonus plans**

An annual bonus is typically granted to employees based on their individual performance, and is set as a percentage of the company's net profit. However, the case for executives can be different as often executives are set periodic or annual bonuses

according to attaining a predetermined objective or special achievement. An annual bonus is typically and primarily determined according to accounting profits (Murphy, 1999). In Saudi Arabia, despite the fact that annual bonus plans are the only available method for boards of directors to link managerial remuneration to firm performance, only a minority of Saudi firms place much attention to this important component.

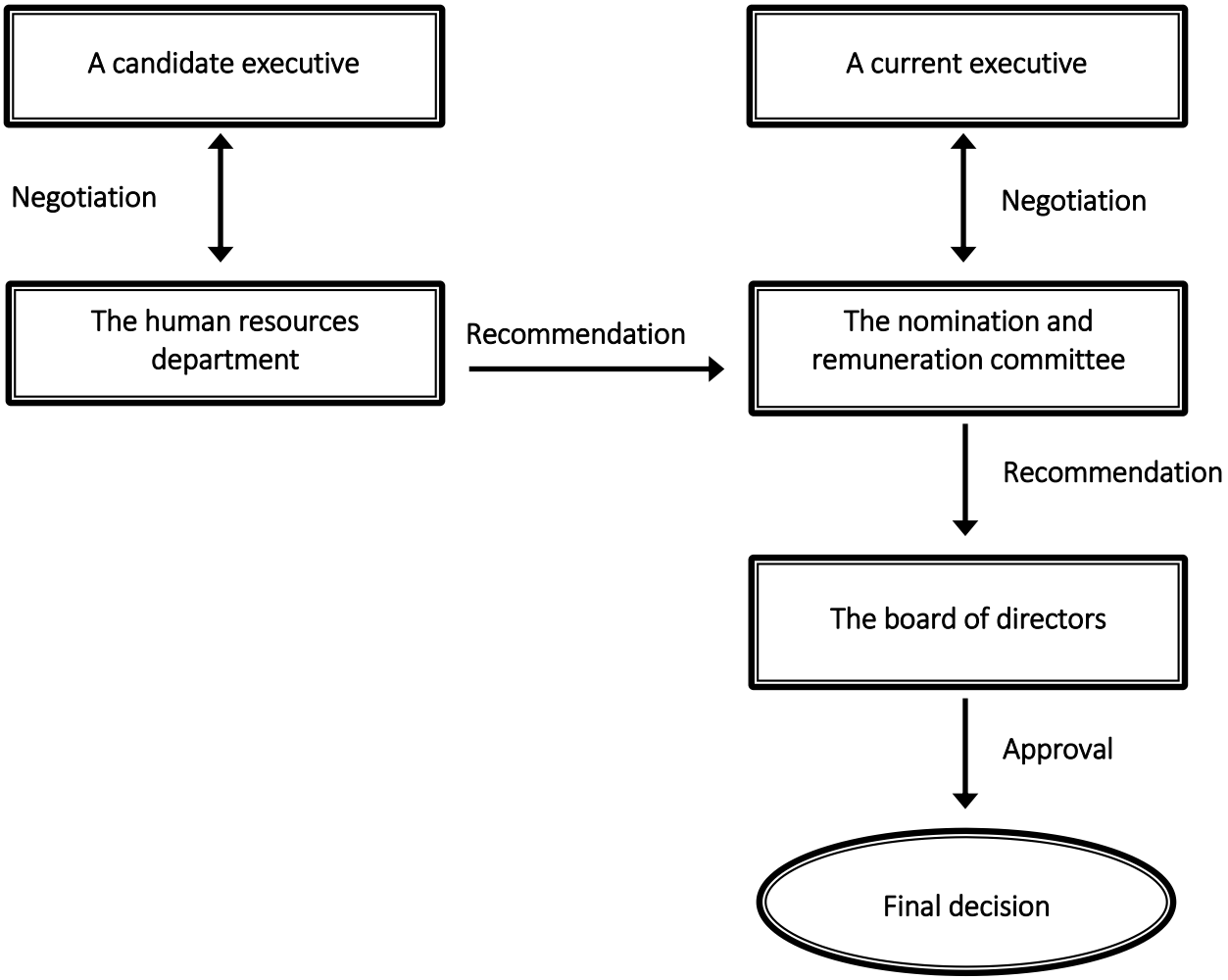
- **Other pecuniary and non- pecuniary packages**

This category comprises all other unclassified components of compensation such as short- and long-term incentive plans and any other kind of benefits, including non-pecuniary ones such as cars, house, travel tickets, etc.

2.6.2 Who Sets Executive Pay?

Murphy (1999) illustrates in detail the process of recruiting expert executives and how they are compensated. The research states that for new executives, a company's human resources department is responsible for offering them suitable compensation packages. If the department agrees with an executive on a particular plan, the decision is then passed to the nomination and remuneration committee to review and make a recommendation thereon. If the committee does not approve the incentive plan, they will return it to the human resources department for revision. However, if the committee approves a proposed plan, they would make a recommendation and raise it with the board of directors, which retains the right of ultimate approval on such decisions. This scenario is related to new executives. However, in the case of current executives, the nomination and remuneration committee takes on the responsibility of negotiating their compensation and incentive plans. In all cases, the board of directors retains the right to approve any packages related to top management. For an illustration of the process of setting executive compensation, see Figure 2.2.

Figure 2.2 : The process of setting executive compensation



Source: Adapted from Murphy (1999)

2.7 OWNERSHIP STRUCTURE

In general, well-structured ownership and the presence of blockholders, especially institutional ones who have experience and capability (Colpan and Yoshikawa, 2012), is thought to help to enhance governance quality and to closely monitor managerial activities to ensure that they act in the best interests of shareholders (Hartzell and Starks, 2003). However, unlike developed countries, where institutional investors are present in most listed firms, different arrangements apply in Saudi Arabia, which is classified as an emerging economy. In Saudi Arabia, the CMA discloses information about all investors who hold 5% or more of the total shares of the company (Tadawul, 2015). Data show that

certain families control nearly 60% of listed firms and the state owns approximately 20% of the market value of the Saudi Stock Exchange (Aleqtisadiah, 2014).

Most research on corporate governance has focused on Western economies with diffused ownership, such as the US and the UK (Al-Najjar, 2017; Conyon, 2014; Core *et al.*, 1999). However, the distinct structure of ownership in Saudi Arabia, which is highly concentrated in the hands of certain families and government bodies, allows for the investigation of corporate governance practices into the principal-principal conflict. This investigation enhances our understanding of the effect of controlling shareholders on corporate governance practices in underdeveloped economies. Thus, the research is expected to add a significant contribution to the existing knowledge of corporate governance practices in emerging economies.

The domination of family ownership in Saudi Arabia can be attributed to several reasons. One important reason is that most family firms were operated privately for a long time before their conversion to joint stock companies through the route of an initial public offering (IPO); thus, those families retain the majority of shares themselves (Alsanosi, 2010). Moreover, since there is no legislation to issue various classes of shares that provide different voting rights, families consider it better to retain the majority of shares in their own hands in order to ensure their ability to control the company (Young *et al.*, 2008).

Since the beginning of the 2000s, the Saudi government has made significant efforts to encourage and convince private establishments to convert to joint stock firms or at least to closed joint-stock companies, as this move would help to expand firms' activities, reduce risks and ensure sustainability, especially for family firms which face succession problems (Tadawul, 2015). This direction has increased since Saudi Arabia became a member of the World Trade Organization in 2005. As a result the number of joint stock companies has more than doubled from 73 in 2000 (Ministry of Commerce, 2001) to 160 in 2014 (Tadawul, 2015).

However, although many private establishments have been converted into joint stock companies during the last decade in Saudi Arabia, a large number of firms have still not changed their ownership structures. For example, the Minister of Commerce has stated that 95% of Saudi private firms are still owned and controlled by families (Alriyadh, 2013). This reluctance to convert can be attributed to the regulatory

requirements imposed by governmental supervisory institutions and to the potential loss of control when other investors are engaged in decision-making.

The domination and presence of certain large family shareholders in most Saudi firms underpins the notion that there is no real separation between management and control in emerging economies such as Saudi Arabia (Rashid, 2013). Hence, the board of directors is expected to be dominated by blockholders and their relatives and friends (Baydoun *et al.*, 2012). Thus, the decision-making process will tend to follow the blockholders' wishes. One might suppose that the high ratio of ownership concentration would be useful for governing managerial activities; however, it negatively affects the management mission. Under this strong control, the management has less discretion and there are complex restrictions on their decisions (Conyon and He, 2011). Moreover, minority shareholders' interests can be neglected by large shareholders (Young *et al.*, 2008). Accordingly, it can be inferred that a principal-principal conflict may arise in KSA.

Furthermore, Saudi royal family members hold blocks of shares in many Saudi firms. This kind of ownership is unique to Saudi Arabia and other monarchical countries in the Gulf Cooperation Council (GCC). The royal family members have strong connections with governmental institutors and suppliers; thus, their investment in a firm gives that firm greater advantages in many aspects of the firm's activities, including sales and financing matters (Al-Hadi *et al.*, 2016). The state is also significantly involved in the control of many firms; usually the largest ones (Baydoun *et al.*, 2012). The presence of state ownership among listed firms could be a substitute for financial institutions, which are forbidden by the Saudi Banking Control Law to own in excess of 10% of company shares (SAMA, 1966).

Accordingly, the domination of families over the stock market is considered as one of the key challenges of corporate governance in Saudi Arabia. Although this domination reduces the gap of interest between shareholders and managers and thereby mitigates principal-agent conflict, it leads to divergence of interests among shareholders themselves and increases principal-principal conflict. That is to say, family controlling shareholders consider the firm as their own heritage and may perceive minority shareholders and their representatives as prying into their own business. This situation leads to a divergence of interests among the two types of investors and increases agency costs that, in certain cases, may exceed the ones caused by principal-agent conflict

(Gomez-Mejia *et al.*, 2003; Young *et al.*, 2008). Such dominant investors have a natural penchant towards the family and seek to benefit them, rather than to care about all other shareholders. This argument is supported by the fact that Saudi Arabia has been assessed as 75% collectivist (The Hofstede Centre, 2014). In addition to this, as *wasta* plays an influential role in the human resource field, there is a high likelihood that such firms may appoint unqualified family-related managers to senior positions and compensate them generously as a duty towards the family members. However, this will be at the expense of minority shareholders who are unable either to access these intangible benefits or obtain higher financial returns due to the poor performance of family-related managers (Young *et al.*, 2008).

In contrast, foreign ownership among listed firms is almost non-existent in the KSA. This is a consequence of the restrictions of Saudi regulations on non-Gulf investors, since foreign investors were forbidden from trading shares in the Saudi Stock Exchange (SSE) before 2013. From 2015, however, the Saudi Council of Ministers has approved a decision allowing foreign investors to trade and own stocks of listed companies providing they do not exceed 20% (Alarabiya, 2013). This decision may change the ownership structure in the Saudi listed firms during the next decade. Even though foreign investors were forbidden from purchasing shares directly in the SSE before 2013, they were allowed to possess up to 49% of the non-traded shares (Alsharq, 2014). In other words, Saudi investors must own the majority of the corporate shares. Investors from the GCC countries are excluded from this restriction, because by law they are implicitly treated as Saudi investors (Alarabiya, 2013; Alriyadh, 2007; Reuters, 2014). Even though this decision is expected to increase the presence of foreign investment in SSE after its implementation, it is of no consequence for this research.

2.8 POLITICAL ECONOMY

The political economy of a context has a significant influence on the norms of corporate governance. The heterogeneous characteristics of political economy between countries explain why there are several models of corporate governance (Pagano and Volpin, 2005). Therefore, the particularities of Saudi political economy should be addressed and considered carefully in order to develop a successful implementable governance system. First, Saudi Arabia is an Islamic state and its constitution and law are derived from and based on *sharia* (Pierce, 2008). Under Islamic law, there are some

restrictions on trade transactions (see section 2.2.1) which provide a unique Islamic framework that all Muslim investors must trade within. Additionally, the political system in the KSA is based on an absolute monarchy where the executive government is the only party that legislates and supervises business policy. Although the *Shura* Council plays a legislating and supervising role, its influence is limited and it lacks sufficient authorisation and independence. Putting these together, i.e. *sharia* law and the absolute monarchy system, it can be seen that the main pillars of the formal institutions that the Anglo-American model has considered when developing the shareholder model of corporate governance are absent in Saudi Arabia.

Furthermore, ownership in Saudi Arabia is highly concentrated in family and state hands. In this context, Young *et al.* (2008) argue that firms with controlling shareholders result in the emergence of principal-principal conflict. Moreover, the demographic structure and customs in Saudi Arabia differ significantly from the majority of countries and are based on a tribal system which is influenced by an orientation to collectivism (The Hofstede Centre, 2014). Such characteristics make *wasta* and political ties key elements in accomplishing business transactions and in shaping business policy (Budhwar and Debrah, 2013; Tlaiss and Kauser, 2011). Therefore, the unique nature of political economy of Saudi Arabia enhances the need for proper governance mechanisms that organise the relationships among all the most influential parties, i.e. family shareholders, state investments' representatives, minority shareholders and executive managers.

2.9 SAUDI VISION 2030

Since the discovery of petroleum on 3 March 1938, Saudi economy has become strongly dependent on oil revenues which account for more nearly 90% of its exports (OPEC, 2016). This despite the fact that the Saudi government has made many attempts to diversify its economy and reduce the reliance on oil (OPEC, 2016). In this context, on 25 April 2016, the cabinet approved and announced a new strategic plan namely 'Saudi Vision 2030' which draws the future of Saudi Arabia after oil era (Bloomberg, 2016b). The main objective of the Saudi Vision 2030 is to diversify the economy away from oil by 2030. In order to achieve the vision's objective, several initiatives and programs have been developed which can be referred to as the executive programs of the vision (Saudi

Vision 2030, 2016). Indeed, this optimistic vision, if successfully implemented, is expected to reshape business policy in Saudi Arabia and the national economy in general.

For instance, one of the vision's programs is the Regulations Review program which aims to revise the current legal framework and all regulations to keep pace with other major developments that will occur in Saudi Arabia (Saudi Vision 2030, 2016). The program was preceded by the release of a new company law in 2015 to replace the old version which was enacted in 1965 (MCI, 2015). The new law acknowledges the importance of corporate governance regulations and strengthens its enforcement. Moreover, in the same year, other new laws that could impact on the business environment were introduced including the non-governmental organizations' law and the law concerning fees on non-developed lands. These imply that Saudi Arabia is restructuring and indeed will be subject to other major reforms of regulations until 2030.

Unlike the previous national plans, the Saudi Vision 2030 has an improved likelihood of success for several reasons. First, the vision is a set of comprehensive initiatives that cover economic, developmental, legal, social, educational, health and security aspects of Saudi Arabia (Saudi Vision 2030, 2016). Therefore, each sector will attempt to achieve its allocated goals in order to avoid being accused of failure. Second, the vision is led directly by the Crown Prince Mohammed bin Salman who is the son of King Salman and the chairman of the Council for Economic and Development Affairs. Hence, the vision is expected to receive considerable focus by the highest authorities, ensuring that the concentration of all government bodies on the achievement of the vision. Finally, the vision has attracted a great deal of attention both domestically and globally with the government empathising the importance of this vision for the country's future. Afterwards, the efforts were followed by practical actions as a sign of seriousness that the vision will be implemented and achieved as intended. For example, in 2016 the government has taken austerity actions to rationalise public expenditure which is part of the vision's executive programs namely the Fiscal Balance program (Saudi Vision 2030, 2016). These actions lead to a temporary cancellation of bonus payments for state employees for the fiscal year 2016, a permanent reduction of 20% and 15% in the salary of ministers and *Shura* Council members respectively (Reuters, 2016). Furthermore, in late 2016 the government announced gradual cuts of subsidies on energy and water from 2017 to 2020 (Bloomberg, 2016a). Concurrently, it will initiate a cash-payment program

to compensate those eligible for subsidies from the middle-class and needy citizens (Saudi Vision 2030, 2016).

2.10 CONCLUSION

This chapter provides a general overview regarding the institutional settings in the KSA. It identifies the principles of *sharia* and shows how they influence the Saudi legal system. Moreover, it highlights the regulations applicable to Saudi corporate governance and provides a comprehensive comparison with the most well-known international corporate governance models.

Relatedly, it can be concluded that institutional settings and corporate governance regulations in Saudi Arabia are still immature, in contrast to the situation in developed economies. Furthermore, the ownership structure and market orientation in Saudi Arabia is close to that of Germany where the stakeholder model of corporate governance has been seen the best fit. However, the KSA adopts the shareholder model, which is primarily designed to govern firms that operate in market-oriented economies, such as the Anglo-American countries.

In addition, Saudi regulators have expended considerable efforts to convert international practices of corporate governance. However, there are key challenges related to the context of the KSA, such as *sharia*, cultural norms (e.g. *wasta*) and ownership concentration, which reduce the possibility of full convergence. However, these constraints should not be considered to be barriers to adopting the international best practices of corporate governance because most aspects of corporate governance are adaptable to and consistent with the Saudi regulations. However, there are a number of domestic norms that should be taken into consideration when setting corporate governance regulations in Saudi Arabia; these include high ownership concentration and the lack of availabity of stock options preventing firms from using this method of compensating top executives. Consequently, Saudi regulators should adjust corporate governance mechanisms to address these domestic issues, otherwise the regulations will not work as intended.

CHAPTER THREE:

CORPORATE GOVERNANCE AND EXECUTIVE COMPENSATION

3.1 INTRODUCTION

Recently, the US model of capitalism has received a great deal of criticism for its inability to constrain executive compensation (Bebchuk *et al.*, 2010; Sun *et al.*, 2010). Reacting to these criticisms, especially in the light of the scandals of Enron and WorldCom earlier this century and the financial crisis in 2008, the US authorities have introduced two major reforms of corporate governance codes, namely the Sarbanes–Oxley Act of 2002 and The Dodd–Frank Act of 2010. At the same time, as a response to international demands many emerging economies have imported and adopted Western agency-based frameworks with no consideration of the cross-country institutional differences (Sun *et al.*, 2010; Young *et al.*, 2008). One example of these economies is the KSA, which is influenced by the 'Anglo-American model' that emphasises the maximisation of shareholders' welfare (Fallatah and Dickins, 2012).

This research is motivated by the boom in executive compensation during the years 2008 and 2015. This increase can be viewed as shareholder expropriation, especially if it is not synchronous with improved company performance. A review of the statistical trends among the highest-compensated executives reveals that executive compensation has increased by more than 100% in most listed firms, while the growth in companies has been significantly lower. In the case of the Saudi Arabian-based Etihad Etisalat Co (Mobily), it was only threefold (Arqaam, 2014).

Importantly, it is worth noting that Mobily has been ranked highest in Saudi Arbia with regard to growth in executive compensation during the period 2010 to 2013 inclusive. However, this led to a massive scandal in late 2014 when manipulation of the financial statements was detected. Consequently, "the company restated profits for 2013 and the first half of 2014" (Smith, 2015), cutting them by USD381 million combined. In January 2015, it posted a shock fourth-quarter loss of USD608 million. This manipulation has seen the accounts switch from a USD1.8 billion profit in 2013 to a USD0.24 billion loss in 2014 (Tadawul, 2015). As a consequence, the CEO Mr. Khalid Al-Kaf was dismissed and by February 2015 Mobily had lost approximately USD13 billion (nearly 65%) of its market value in comparison to May 2014 (Smith, 2015). This case, in addition to other global scandals related to excessive managerial rewards, support the view of Bebchuk and Fried (2003) who argue that executive compensation can be a problem if misused. That is to say, as executive compensation is introduced as a remedy that would reduce

the divergence of interests between shareholders and managers, it may increase agency costs if being granted to managers without a proper link to firm-performance.

In this context, and in order to investigate the effectiveness of the current regulations of corporate governance in controlling executive compensation practices, this research aims to answer two main questions: *a) Do corporate governance mechanisms restrain the opportunism of top managers in Saudi Arabia by reining in their compensation?* and *b) Is the Anglo-American model of corporate governance generalizable in emerging countries?*

The research contributes to the international corporate governance literature in several ways. First, while most countries are adopting the Anglo-American model of corporate governance (Conyon, 2014; Kaplan, 2012; Sapp, 2008; Core *et al.*, 1999), there has been few investigations into the validity and generalizability of adopting this model in emerging economies, which have different institutional characteristics from their West counterparts (Young *et al.*, 2008). Therefore, this research uses a dataset from Saudi Arabia, which has a unique institutional setting. For example, because ownership concentration in Saudi Arabia is high with family-owned and state-owned companies dominating, personal connections (*wasta*) play a significant role in the business field. Another crucial difference is that governance policy in Saudi Arabia is significantly influenced by *sharia* (Islamic law); thus, governance recommendations should take account of these domestic challenges. Second, as the majority of research concentrates on the traditional agency problem between shareholders and managers (Al-Najjar, 2017; Conyon, 2014; Core *et al.*, 1999), this research extends the understanding of agency problems that exist among other parties (controlling and minority shareholders) and provides insights into principal-principal conflict which exists in emerging country contexts. Therefore, new important issues are investigated, such as the influence of a blockholder chairman on pay-setting for top management. Finally, the study adds to the literature related to the role of independent directors and remuneration committee, which are key concerns of international corporate governance best practice, and demonstrate that in practice some firms comply with the governance regulations in form but not in substance.

The remainder of this chapter is as follows; section 2 develops the relevant theoretical base; section 3 reviews critically the literature and highlights the literature

gaps; section 4 describes the research method and formulates the hypotheses; section 5 presents and discusses the empirical results; finally, section 6 provides the research conclusions and limitations.

3.2 THEORETICAL FRAMEWORK

The economy of Saudi Arabia has unique cultural and religious characteristics that differ from other countries, which increases the importance of developing an appropriate theoretical landscape that suits the Saudi context. The process of setting executive compensation in Saudi Arabia is affected by several factors including culture, personal connections, regulations and religion. For example, there is no legalisation in Saudi Arabia that allows firms to re-purchase its own stock in the market as is permitted in developed countries such as the US or the UK. Such restrictions complicate the process of linking executive compensation to firm performance. Furthermore, a brief review of the current code of corporate governance regulations in Saudi Arabia highlights a critical loophole regarding the structure of the nomination and remuneration committees. Unlike in the US where a compensation committee can only be comprised of independent directors, the Saudi code does not prevent executives from being members and even dominating the committee. This significantly compromises the committee's independence and gives executives the ability to control their pay package.

Accordingly, and in order to understand how corporate governance affects executive pay arrangements in depth, the research sheds light on the four most relevant theories that could explain the relationship between corporate governance and executive compensation in Saudi Arabia, namely agency theory, the managerial power model, the optimal contracting model and institutional theory. Although many other models exist, the four theories have been selected due to their relevance to the context of Saudi Arabia. Agency theory is the basis of the Anglo-American model of corporate governance, which Saudi Arabia adopts; thus, the theory helps to build a good understanding of how regulators consider the relationship between shareholders and managers in terms of the protection of interests. Furthermore, two sub-models of agency theory related to executive compensation are also used, namely the managerial power model and the optimal contracting model. The two models provide a better understanding of how executive compensation is designed and determined. The final model, namely institutional theory, has been adopted due to its relevance to the Saudi context and its

importance in explaining the cross-country institutional differences that would have a significant influence on corporate governance norms. Basically, the institutional model looks into the role of both formal and informal institutions in shaping business policy; hence, it complements the whole picture of the relationship between corporate governance and executive compensation.

3.2.1 Agency Theory

Agency theory assumes that managers are self-serving and behave opportunistically in a way that maximises their own utility at the expense of other stakeholders, such as shareholders, by exploiting the firm's resources for their own ends. In contrast, shareholders seek to maximise their wealth through higher profits and increased share prices. These conflicting goals of the two parties are likely to lead to extra costs, known as 'agency costs', which are incurred in order to align the objectives of top management with those of shareholders. Jensen and Meckling (1976) argue that there could be zero agency costs if shareholders take complete control of the company's activities. However, in reality there is a negative relationship with ownership concentration as the more diffuse the ownership is the higher the agency costs become. In other words, the agency costs are subject to the level of separation between ownership and control. In order to reduce agency costs, agency theorists suggest providing well-structured performance-based managerial incentives that include stock options to increase managers' ownership in the firm (Jensen and Warner, 1988; Conyon and He, 2012).

This suggestion might work effectively in Western countries; however, in Saudi Arabia firms are less able to design packages for executives using stock options for regulatory reasons. That is to say, as Saudi firms are not allowed by law to repurchase its own shares; thus, they cannot buy shares and grant them to employees. This, indeed, complicates the objectives of a board of directors in linking executive compensation with long-term firm performance. Therefore, the only available option for Saudi boards to link managerial pay to firm performance is by an annual bonus, which tends not to be linked to long-term performance but is related to past performance. Furthermore, Jensen *et al.* (2004, p. 50) warn that "while remuneration can be a solution to agency problems, it can also be a source of agency problems". For example, managers may extract private benefits at the expense of shareholders through receiving high non-merit compensation.

Furthermore, if incentives are strongly based on accounting measures, this may lead to accounting manipulation or the adoption of certain methods that increase short-term profits (Rashid, 2013).

The traditional agency model (the so-called principal-agent conflict) assumes that ownership concentration is diffuse and managers have considerable discretion and control over decisions-making (Fama and Jensen, 1983b). However, these assumptions are not relevant in the majority of cases in Saudi Arabia where many firms are family controlled. In these firms, which represent nearly 60% of Saudi listed firms, there is no real effective separation of ownership and control. Therefore, managers are less likely to have the discretionary ability to expropriate the firm's resources (Fama and Jensen, 1983b). Thus, the principal-agent model is inadequate to explain the opportunism phenomena in such firms (Young *et al.*, 2008).

In fact, a conflict between controlling and minority shareholders is likely to represent the real situation in family-controlled firms (Young *et al.*, 2008); this is referred to as the principal-principal conflict or Type II agency problem (Jiang and Peng, 2011). In this setting, blockholders may expropriate minority shareholders' wealth by extracting tangible and intangible private benefits (Basu *et al.*, 2007; Shleifer and Vishny, 1986). For instance, controlling families may appoint unqualified family members or close relatives to key positions and overlook better qualified outside managers (Faccio *et al.*, 2001; Gilson, 2006; Ramaswamy *et al.*, 2000; Young *et al.*, 2008). In such situations, family-related managers may set high non-merit-based compensation at the expense of minority shareholders (Rashid, 2013; Su *et al.*, 2010). Thus, small shareholders are unable either to access these intangible benefits or obtain higher financial returns due to the poor performance of family-related managers (Young *et al.*, 2008). Therefore, it can be argued that although concentrated ownership plays a substitutive role for the poor external governance mechanisms and mitigates the Type I agency problem (Fama and Jensen, 1983b; Li *et al.*, 2007; Lin, 2005; Banghøj *et al.*, 2010; Conyon and He, 2012), principal-principal conflict can arise. In certain cases, the agency costs of the principal-principal conflict are higher than those resulting from principal-agent conflict (Gomez-Mejia *et al.*, 2003; Young *et al.*, 2008).

3.2.2 Optimal Contracting Model vs Managerial Power Model

The literature regarding the issue of executive compensation is dominated by two complementary models known as the 'optimal contracting model' and the 'managerial power model' (Murphy, 1999; Bebchuk and Fried, 2004; 2003; Cheng and Firth, 2006; Van Essen *et al.*, 2015; Ntim *et al.*, 2015). Both models have been developed as attempts to understand and explain the practices of executive compensation within organisations. Fundamentally, the two approaches are derived from the agency theory supposition that managers are opportunists with guile and are self-interest maximisers (Jensen and Meckling, 1976). Even though both theories hold the same basic assumption with regard to managerial behaviour, each approach has its own perspective with respect to the ways and processes of setting executive compensation.

The optimal contract model is defined as "one that maximizes the net expected economic value to shareholders after transaction costs (such as contracting costs) and payments to employees" (Core *et al.*, 2003, p. 27). This theory is based on three further assumptions: (1) the board of directors is independent; (2) there is an efficient market of qualified executives; and (3) the shareholders are able to determine contractual terms (Janakiraman *et al.*, 2010). The optimal contract model assumes that the setting of executive compensation is subject to arm's length bargaining between an independent board of directors and managers which unifies agent-principal interests and mitigates the agency costs (Jensen and Murphy, 1990; Ntim *et al.*, 2015). Therefore, the executives cannot influence decisions that relate to their compensation, because directors are completely independent from the top management and are more loyal to shareholders (Ntim *et al.*, 2015). Based on this view, managerial pay should have a significant relationship to firm performance.

However, the explosion in executive pay levels during the 2000s, even after the financial crisis of 2008, was weakly linked to managerial performance (Chen *et al.*, 2010b). The failure of executive compensation to be linked to firm performance rekindled the debate regarding the effectiveness of executive compensation to reduce agency costs (Chen *et al.*, 2010b). For example, a significant volume of research finds weak links between executives' perks packages and firm performance (Murphy, 1999; Ntim *et al.*, 2015; Elsilä *et al.*, 2013; Kabir *et al.*, 2013; Tian, 2013). This irrational boost to managerial compensation during the past two decades demonstrates that the optimal contracting

model is inadequate for interpreting the intricate dimensions of executive compensation practices (Edmans and Gabaix, 2009). Bebchuk and Fried (2003) state that the arm's length model can be applied with executive candidates from outside the company; however, this is not the case when negotiating incumbent executives. They argue that as managers' goals diverge from those of shareholders, the board of directors also suffers from the agency problem. This occurs because the board of directors is linked with top management in a way that influences their independence in order that the former can attain personal objectives such as re-appointment. The affiliation between a board of directors and executives may give a better understanding of why managerial pay grows at a faster rate than company performance.

On the other hand, the managerial power model, which is a complementary approach rather than a substitute for the optimal contracting model, aims to shed light on a further part of the picture of executive compensation arrangements. Managerial power is defined as the extent that top managers can impact decisions that relate to their compensation (Chen *et al.*, 2011). Managers can gain power through different means such as holding a large number of shares (i.e. they have strong voting rights), performing as CEO and chairman at the same time, and participating in nominating and retaining members of the board of directors (Bebchuk and Fried, 2003; Armstrong *et al.*, 2012). If executives are able to set their own compensation, they will be less concerned with firm performance, which therefore exacerbates the agency problem (Bebchuk and Fried, 2004; Van Essen *et al.*, 2015). Bebchuk and Fried (2003) predict that the level of pay-for-performance sensitivity is determined and affected by the ability of an executive to influence his/her compensation package. Findings from East Asia (Li *et al.*, 2007; Chen *et al.*, 2011; Chen *et al.*, 2010b; Conyon and He, 2012) support this model since powerful executives are found to extract higher compensation when the board of directors is weak.

In Saudi Arabia, the corporate governance model is inside-oriented (i.e. internal director control), since ownership concentration is high and there is an absence of effective external governance (Budhwar and Debrah, 2013; Asiri and Alzeera, 2013; Harrison and Moore, 2012; The World Bank, 2009). In addition, the data show that 85% of firms' boards have at least one blockholder director. Thus, in family-controlled firms, managers have less influence and control over boards of directors. Consequently, the executive compensation process is not expected to be subject to managerial power,

unless the manager is part of the family which owns the firm. In such situations, the family-related manager may enjoy favourable treatment from family controlling shareholders and thereby is expected to be able to extract higher non-merit compensation. Similarly, in companies where ownership is diffused and blockholders are absent, managers may have the required level of power to influence their own remuneration. This is because SCGRs allow executives to sit on remuneration and nomination committees (CMA, 2010). Therefore, top managers can participate in and influence the process of nominating new directors, as well as retaining existing directors. This loophole in SCGRs can undermine directors' independence and support excessive compensation for executives. Moreover, due to market inefficiency in relation to qualified executives in the KSA, there is a strong likelihood that the negotiation process regarding executive remuneration in general has many constraints that put significant pressure on directors to provide waivers to candidates; thereby removing the arm's length principle from the negotiation process.

3.2.3 Institutional Theory

In reaction to the gaps in the explanatory nature of agency theory, researchers argue that no single agency-based governance model can be espoused in all contexts and adequately accommodate cross-country differences (La Porta *et al.*, 1998; Lubatkin *et al.*, 2007; Porta *et al.*, 1997; Young *et al.*, 2008). Institutional theory argues that adopting the Western corporate governance model, which is based on principal-agent conflict, in emerging economies would make the situation more costly and problematic (North, 1990; Wright *et al.*, 2005). For example, ownership concentration, which is suggested as an effective mechanism to enhance governance quality in developed economies (Fama and Jensen, 1983b; Jensen and Meckling, 1976), is a root cause of principal-principal conflicts in emerging countries. Therefore, instead of resolving the issue in the Saudi context, it may exacerbate the principal-principal problem (Faccio *et al.*, 2001; Young *et al.*, 2008).

The agency model implicitly assumes that the formal underpinning institutions in relation to corporate governance found in developed countries also exist in emerging economies (Young *et al.*, 2008). However, this is not the case in Saudi Arabia, where the "formal institutions such as laws and regulations regarding accounting requirements, information disclosure, securities trading, and their enforcement are either absent,

inefficient, or do not operate as intended" (Young *et al.*, 2008, p. 198). As the main objective of an enterprise is to survive, economic success is not sufficient to achieve this; besides, firms need to establish legitimacy with the surrounding institutions (Suchman, 1995; Zucker, 1987). Therefore, there is a potential scenario that firms may ostensibly comply with corporate governance requirements as a response to the institutional change, i.e. for legitimating purposes (Dacin *et al.*, 2002).

Furthermore, since external governance in emerging economies is still weak (Peng, 2004; Peng *et al.*, 2003), families prefer to retain controlling shares in order to play a substitutive internal role (Gedajlovic *et al.*, 2004). This, in turn, may explain the high ownership concentration found in Saudi Arabia (The World Bank, 2009). While the board of directors (the most prominent internal mechanism) is often considered to be the 'rubber stamp' for dominant shareholders, minority shareholders' rights are under their thumb and may be expropriated (Young *et al.*, 2008).

Therefore, in the Saudi context, the informal institutional environment tends to play a greater role in addressing corporate governance norms than the formal institutional environment (Peng and Heath, 1996; Young *et al.*, 2008). These informal institutions include "relational ties, business groups, family connections, and government contacts" (Young *et al.*, 2008, p. 198). Consequently, the corporate governance model imported from developed countries may "resemble [it] in form but not in substance" (Peng, 2004; Young *et al.*, 2008). Given the fact that human resource management in KSA is influenced by tribal ties and family connections (Budhwar and Debrah, 2013), there is reason to believe that the controlling shareholders may appoint relatives or close friends to key positions; these, in turn, are able to set high non-merit compensation (Young *et al.*, 2002).

3.3 REVIEW OF LITERATURE

Generally, the literature review shows that most studies have been conducted in the Anglo-Saxon countries (Conyon, 2014; Kaplan, 2012; Sapp, 2008; Core *et al.*, 1999). This is partly due to data availability in these countries. Developed economies enjoy higher quality of information transparency and shareholder protection than do emerging countries, which suffer highly from information asymmetry (Young *et al.*, 2008). Thus, the need for new regulations and disclosure requirements is entirely different for

emerging countries compared to their developed counterparts. Moreover, the adoption of a set of governance regulations that has worked successfully in a developed country context may not produce the same results if implemented in an emerging economy (Young *et al.*, 2008). In this context, to provide a structure for the existing literature review, the two variables, board of directors and ownership structure, are divided into two contextual categories. The first includes empirical studies conducted in developed contexts while the second will look at research carried out in emerging economies.

3.3.1 Board of Directors

The board of directors is considered as the most important mechanism of internal governance (Ramaswamy *et al.*, 2000). In essence, the board members are elected and appointed by shareholders to monitor management actions and to ensure that they act in the best interests of shareholders. However, in order to perform the board functions properly, Fama and Jensen (1983b) suggest that the directors should be free from any collusion with top management and therefore dominated by non-executive directors. This approach should ensure that top executives are paid fairly based on performance criteria rather than on a subjective basis (Jensen and Murphy, 1990). The following sub-sections review studies that investigate the relationship between different characteristics of board of directors (i.e. board independence, role duality, blockholder chairman, and existence of a remuneration committee) and executive compensation.

3.3.1.1 Developed Countries

During the past three decades, a considerable number of studies (Core *et al.*, 1999; Anderson and Bizjak, 2003; Ozdemir and Upneja, 2012; Conyon, 2014) have been conducted in the US. One study that comprehensively examines the role of corporate governance in curbing executive compensation is that of Armstrong *et al.* (2012). This study uses a sample consisting of 2,110 firms from the Russell 3000 index for the year 2006. The findings show that the average CEO compensation in that year was USD4,974,377. Additionally, CEO pay is found to be higher when the directors are busy and the chairman is an insider. This conclusion supports the notion that the decisions of a weak board are critically influenced by top managers (Ozdemir and Upneja, 2012). Contrary to the agency theory assumption that outside directors help to restrain managerial opportunistic behaviours (Jensen and Meckling, 1976), the results of

Armstrong *et al.* (2012) show that independent directors have a positive and significant impact on the total CEO compensation. The study also reports that experienced CEOs earn more compensation than those who are newly appointed. However, having a CEO aged 69 years or more is negatively and significantly related to lower compensation.

Although the study of Armstrong *et al.* (2012) investigates multiple dimensions of corporate governance that impact CEO compensation, it suffers from a methodological limitation. The study uses cross-sectional analysis, as the sample is based only on the year 2006. However, my research extends the timeframe to eight years and utilises panel data analysis which is a more robust approach that can capture the features of both cross-sectional and time series analysis.

Conyon (2014) uses a more recent US dataset from companies listed on the S&P 500 for the period 2008-2012 to examine the effect of non-independent directors (affiliated) on executive compensation. The author selects this specific period to observe the influence of the Dodd-Frank Act (2010) on executive compensation practices. Contrary to expectations, the findings show that the compensation level increased since 2010, even though the level of independent directors on the remuneration committees reached nearly 98%. Conyon (2014) attributes this growth to the fact that the compensation levels were quite low before the Dodd-Frank Act (2010) as a consequence of the 2008 financial crisis. The results also show that the proportion of affiliated directors is associated with lower executive compensation. Furthermore, the findings confirm that a larger board is associated with higher remuneration. This finding matches those of Petra and Dorata (2008) and Ozkan (2007) who find similar relationship between board size and CEO compensation.

Using a sample from the same context as Conyon (2014), Fahlenbrach (2009) examines the role of corporate governance in hindering excessive CEO compensation and whether or not there is a linkage between CEO compensation and firm performance. The results reveal that CEOs cash compensation was equal to approximately 30% of the total compensation. This implies that 70% of the total compensation comprises other variable forms that could include equity-based compensation such as stock options and restricted stock which suggest a strong link between executives' pay and firm performance. In terms of compensation determinants, the study shows that when the CEO simultaneously chairs the board, he/she receives higher compensation. This finding is consistent with Sapp

(2008) who observes a positive and significant correlation between CEO duality and executive pay level in Canada. Surprisingly, Fahlenbrach (2009) also finds board independence was positively and significantly correlated with higher compensation; while the results showed a negative impact on pay-for-performance sensitivity.

This latter outcome may lack accuracy since the study defines board independence as total non-executive directors divided by board size. However, not all non-executive directors are independent from managerial affiliation; for example, 'gray' directors are those who can have a conflict of interest. Fahlenbrach (2009) attributes the use of this approach to the database because it only categorises directors into executive and non-executive directors. However, my research is less likely to encounter such a limitation, because Saudi regulations require firms to classify directorship status into three types, namely executive, non-executive (affiliated), and independent. Thus, this study is expected to deliver more accurate results in relation to the aspect of board independence and total compensation.

Chhaochharia and Grinstein (2009) investigates the consequences of applying the Sarbanes–Oxley Act (2002) regarding board independence and its sub-committees. Their sample consists of 865 firms from the S&P 1500 for the years 2000-2005. The findings show that CEO compensation decreased after the announcement of the Act; specifically, compensation in firms that were non-compliant with the new regulations before 2002 dropped by 17.5% more than those in firms that already had a majority of independent directors on the board and sub-committees (Chhaochharia and Grinstein, 2009, p. 246). This outcome is not surprising due to the outrage following the scandals of large US companies such as Enron (2001) and WorldCom (2002) (Janakiraman *et al.*, 2010). The form of the compensation also changed; for example, the use of bonuses increased from an average of 12% in 2000 to an average of 22% in 2005, relative to the total compensation, while options' incentives decreased from 64% in 2000 to 32% in 2005 (Chhaochharia and Grinstein, 2009, p. 240). Therefore, the corporate governance reform of Sarbanes–Oxley Act (2002) reduced CEO compensation in general and reinforced the linkage of remuneration with short-term firm performance (bonus compensation).

A more recent study from the US is Andrews *et al.* (2017). This study investigates the implication of the change in the SEC disclosure requirements on the frequency of executive perquisites. Using a sample from the S&P 1500 listed firms in the period

immediately after the SEC change, i.e. 2006, the study finds that companies with weak corporate governance are more likely to award perquisites to executives. However, as the scope of the study is limited to the period immediately after the SEC was initiated the expanded disclosures, the findings lack generalizability.

In the context of the UK, Ozkan (2007) examines the relationship between different components of CEO remuneration and board characteristics such as board size and proportion of non-executive directors. Analysing 414 publically traded firms between the years 2003 and 2004, the results reveal that board size has a positive and significant relationship with CEO pay. Furthermore, having a larger proportion of non-executive directors is found to be associated with higher CEO rewards. This indicates that insider non-executive directors are affiliated with management. Thus, they are less likely to design well-structured compensation, unlike independent (outsider) directors, who are expected to be free from such predispositions and able to make decisions objectively. However, Ozkan (2007) does not investigate other important characteristics of board of directors such as CEO duality, board independence, and the role of the compensation committee, which are considered to have a direct impact on the decisions related to CEO pay. To avoid such limitations, my research includes these variables to comprehensively capture the board impact on executive remuneration.

Furthermore, Alagla (2012) investigates the determinants of CEO compensation in the UK. His study is based on 237 non-financial FTSE 350 firms for the period 2004-2008. It finds that both non-executive and independent directors are related to higher CEO compensation. This unexpected result is inconsistent with agency theory, which suggests that external directors are less connected with managers and are thus better able to monitor executives' actions. It supports the finding reported by Ozkan (2007), who observes a positive association between non-executive directors and CEO remuneration in the UK. However, in terms of remuneration committee, the study observes a negative and significant relationship between the committee independence and managerial incentives. The finding supports Chhaochharia and Grinstein (2009), who find that when the committee has a higher independence, managers are less likely to receive high compensation. Consistent with the perspective of stewardship theory perspective, which assumes that when managers are given trust they act in the best interest of shareholders

(Donaldson and Davis, 1991), the results demonstrate that CEO duality significantly reduces all short-term compensation.

A more recent study from the UK is Al-Najjar (2017). This study analyses the impact of board of directors on CEO pay based on a sample of travel and leisure firms in the FTSE 350. The outcomes show that board independence is significantly associated with higher CEO incentives. This conclusion is consistent with Alagla (2012) who observes a similar relationship in the UK context. Moreover, board size is found to have a negative and significant impact on CEO remuneration. However, this finding conflicts with other studies (Méndez *et al.*, 2011; Chalmers *et al.*, 2006; Randøy and Nielsen, 2002), which document that larger boards are more likely to be influenced by top management and therefore associated with higher executive compensation. It is worth noting that the study sample is limited to UK travel and leisure firms; hence, it lacks generalizability.

Based on a sample of 271 German companies for the period 1989-1993, Edwards *et al.* (2009) investigates the association between management and supervisory board sizes on the one hand and managerial compensation on the other. The results show that the average compensation per executive during that period was approximately €280,000 (Edwards *et al.*, 2009, p. 11). Moreover, executives are found to be more highly paid when the supervisory board contains a large number of members. This finding supports the argument that large boards weaken the monitoring function (Ozdemir and Upneja, 2012). It is also consistent with Petra and Dorata (2008) and Ozkan (2007). In contrast, management board size is found to have a negative and significant effect on executive remuneration. One possible reason for this is that large management boards require more compensation that shareholders are usually unwilling to pay. However, this study uses an old sample that does not reflect the impact of German corporate governance reforms in the 2000s. Moreover, it is limited to boards' size and does not investigate other board characteristics. My study uses a most recent dataset, 2008-2015, and considers other key characteristics of board of directors.

In the context of Greece, Chalevas (2011) investigates the interaction between a set of corporate governance mechanisms and firm characteristics on the one hand, and executive cash compensation on the other. The sample is based on unbalanced data consisting of 386 firm year observations for 2000 to 2003. As the Greek corporate governance code was introduced in 2002 (Chalevas, 2011), the author aims to assess the

consequences of applying corporate governance requirements and to compare them with pre-2002 practices. Consistent with the Greek corporate governance code, which states that firms should compensate their managers in line with their performance, the study observes a high degree of pay-for-performance sensitivity since 2002. However, the results reveal no evidence of a relationship between board size, CEO duality, or the existence of a compensation committee and managers' rewards.

However, the study has certain methodological limitations. For example, it applies cross-sectional analysis for each year separately and does not use panel data analysis, which captures both cross-sectional and time-series effects. Furthermore, the author does not conduct a separate investigation into the bonus element of managerial compensation, which is believed to be granted as a reward for managerial performance. My research should not suffer from such limitations because it utilises panel data analysis and analyses the different components of executive compensation, especially bonuses.

Using a sample of 77 Spanish firms between 2005-2009, Méndez *et al.* (2011) examine the role of independent directors and the size of board of directors in determining executive compensation. The statistics reveal that the average compensation per executive was approximately €1,000,000. In addition, board independence is observed to be positively associated with managerial pay, although the coefficient was statistically insignificant. Méndez *et al.* (2011) interpret this finding by pointing out that no real independence exists among boards of Spanish firms since executives normally participate in the process of choosing independent directors. The study also shows a positive and significant relationship between board size and level of executive reward. This finding confirms the notion that large boards suffer from a lack of coordination and consensus among their members, which leads to a low level of governance quality and, thus, the emergence of the free-rider problem (Ozdemir and Upneja, 2012).

Randøy and Nielsen (2002) use a European dataset to analyse the relationship between some corporate governance mechanisms and CEO compensation. Their sample consists of 104 Swedish firms and 120 Norwegian firms that traded publicly in 1998. The results show that the average CEO total compensation was nearly USD310,000 and USD178,000 in Sweden and Norway respectively. In terms of variable compensation, only 42% of Swedish firms granted bonus packages to their CEOs, while the average

percentage of bonus to total compensation was only 23% (Randøy and Nielsen, 2002, p. 64). However, there was no disclosed information about bonus packages with respect to Norway. Consistent with agency theory, the findings show that the size of the board of directors has a positive and significant impact on the level of executive. This result also supports the findings of Core *et al.* (1999) who observe that larger boards are associated with higher CEO compensation in the US. Furthermore, Randøy and Nielsen (2002) demonstrate that having foreign directors will bid up managerial compensation. The authors argue that most foreign members in Swedish and Norwegian boards are usually from the US where CEOs receive the highest compensation in the world. Hence, they perceive the levels of compensation in Norway and Sweden low.

However, the study of Randøy and Nielsen (2002) suffers from a number of limitations. First, their sample covers only one year, 1998. Therefore, their results could change if their sample was based on a longer period. Second, the sample is quite old and does not reflect the updated reforms of corporate governance codes. For instance, the first corporate governance codes were introduced in 2001 and 2004 in Sweden and Norway respectively (NSA, 2004; SSA, 2001). However, my research, as mentioned earlier, extends the timeframe to eight years which allow the use of panel data analysis that capture features of both time series and cross-sectional effects. The timeframe also captures the impact of the latest Saudi corporate governance regulations (CMA, 2010).

Utilising a set of 125 large and medium-sized private firms in Denmark in 2007, Banghøj *et al.* (2010) examine the association between corporate governance mechanisms and CEO characteristics, and total CEO cash remuneration. Questionnaires were used to collect the information on CEO compensation. Denmark has a two-tier board structure and, according to the Danish corporate governance code, CEOs are not allowed to chair the supervisory board but can be members of it (Banghøj *et al.*, 2010). Accordingly, the authors use the presence of the CEO on the board as an alternative proxy of CEO duality to measure CEO dominance and influence over the board of directors. Even though 34% of Danish private firms' CEOs sit on supervisory boards (Banghøj *et al.*, 2010, p. 497), the findings show that CEOs' membership of supervisory boards does not increase their pay level. Consistent with the argument that a large number of directors weakens the monitoring function of the board (Jensen, 1993), the results reveal that

board size is positively correlated with CEO remuneration. However, the findings show no linkage between CEO compensation and firm performance.

Similar to Randøy and Nielsen (2002), Banghøj *et al.* (2010) also has sampling limitations. One of the limitations is that the timeframe of the sample is based only on one year, 2007, preventing the use of panel data analysis. Additionally, the study investigates only private firms, which differ from publically traded firms; i.e. private firms have high ownership concentration and most of them are family-controlled. Thus, there is less need for governance regulations (Banghøj *et al.*, 2010).

In Canada, Sapp (2008) is one of the most comprehensive studies to investigate the effect of various corporate governance mechanisms (including board of directors, compensation committee, ownership structure, and CEO characteristics) on CEO and other executives' compensation. Using 400 firms during the period 2000-2005, the results show that the overall compensation in Canada followed an upward trend and there was a tendency to base compensation on performance. Even though having more directors who sit on other boards was related to more variable structure of compensation, it found to be associated with higher CEO pay level. On the other hand, the number of independent directors is found to have a negative impact on managerial incentives. This outcome is consistent with agency theory that outsider directors are less likely to be influenced by top managers; thus, they can effectively monitor management and ensure that their interests are aligned with shareholders. In support of the managerial power model which argues that when an executive has power, he/she is more likely to influence decisions related to his/her compensation, the results show that CEO duality has a positive and significant impact on CEO compensation level. In terms of the remuneration committee, the research surprisingly finds that independent directors who serve in the compensation committee are more likely to award executive managers higher compensation. This positive correlation between independent directors and executive compensation contradicts agency theory, which argues that independent directors are less loyal to management and can control their moral hazard (Jensen and Meckling, 1976).

Another comprehensive study, conducted in Australia by Chalmers *et al.* (2006), investigates the effect of corporate governance and economic characteristics on five structures of CEO compensation. The sample is based on 200 large Australian listed firms

that traded during the period 1999 to 2000. The findings reveal that external directors have a positive and significant association only on fixed compensation, while 'gray' directors are found to be correlated with higher CEO bonuses and options. Consistent with Banghøj *et al.* (2010) and Conyon (2014), large board size is reported to weaken the board as there was a positive and significant impact on both CEO fixed and bonus compensation. CEO duality was found to be negatively related to volume of shares issued. This indicates that when CEOs have power, they utilise their influence to receive other remuneration components rather than shares which are exposed to the risk of price volatility.

Meanwhile, in New Zealand Reddy *et al.* (2015) analyse the relationship between corporate governance quality and CEO compensation. Based on a sample of non-financial firms between 2005 and 2010, the authors find that larger boards lead to higher levels of compensation granted to CEOs. This finding supports previous conclusions that when the board consists of large number of directors, decisions related to managerial perks are more likely to be influenced by CEOs (Méndez *et al.*, 2011; Chalmers *et al.*, 2006; Randøy and Nielsen, 2002). However, the author does not find any significant relationship between board independence and CEO remuneration.

In East Asia, Colpan and Yoshikawa (2012) investigate the role of several corporate governance mechanisms in suppressing executive remuneration. Using a sample of 200 large Japanese manufacturing firms for the years 1997 to 2007, the findings show that directors who are appointed by firms have a positive impact on executive remuneration, while independent directors and bank-appointed directors are found to be uncorrelated with executive pay. This finding is consistent with that of Sakawa *et al.* (2012) who utilise a more recent Japanese sample in 2010, and find that bank-appointed directors have no impact on executive bonuses or stock options. Higher firm performance, specifically profitability, is found to be linked with executives' short-term incentives (Sakawa *et al.*, 2012; Colpan and Yoshikawa, 2012). Additionally, Colpan and Yoshikawa (2012) find that larger firms are correlated with higher executive remuneration. However, this finding is not consistent with that of Sakawa *et al.* (2012) who find a negative relationship between the two variables.

Based on a sample of 336 listed firms in Hong Kong for the period 1994 to 2002, Cheng and Firth (2006) examine the relationship between board independence and

different executive compensation forms. The descriptive results show that more than 50% of firms do not have blockholders (Cheng and Firth, 2006, p. 554). Due to the disclosure requirements in Hong Kong, firms only provide information about executive compensation without naming the recipients (HKECL, 2003). Therefore, the study uses three different approaches to measure executive compensation: highest remunerated director, average executive compensation, and the top five paid executives. The findings show that independent directors reinforce the link between compensation and firm performance. However, there is no evidence that board independence enhances governance quality", i.e. the results showed no relationship between board independence and all the compensation variables used in this study. The researchers attribute the disappointing result to the domination and power of executive directors in Hong Kong firms.

It is obvious from the findings that different characteristics of board of directors have different impacts on executive compensation in developed countries. For example, CEO duality in some contexts is found to be an opportunity to extract higher managerial perks (Fahlenbrach, 2009; Sapp, 2008; Chalmers *et al.*, 2006); however, in other countries, including the UK, there is evidence that role duality increases stewardship of management and leads to lower executive compensation (Alagla, 2012). Furthermore, the findings of some research show that when there are more independent directors, top managers are more likely to be compensated generously (Alagla, 2012; Armstrong *et al.*, 2012; Méndez *et al.*, 2011; Ozkan, 2007). However, this finding is not conclusive since Cheng and Firth (2006) do not find evidence that outsider members have any relationship with managerial incentives in Hong Kong. Similarly in relation to the remuneration committee, Alagla (2012) report a negative and significant impact between the independent members of the committee and executive compensation, while Sapp (2008) observes the opposite. However, Chalevas (2011) find no evidence of a correlation. Therefore, it can be concluded from this discussion that the impact of the board of directors on executive compensation is unclear and its effectiveness is subject to contextual and institutional characteristics (Reddy *et al.*, 2015).

3.3.1.2 Emerging Countries

A number of studies have been carried out on the topic in different emerging economies, with a predominance of East Asian contexts (Chen *et al.*, 2010b; Conyon and He, 2012; Lin *et al.*, 2011).

Using a sample of 1,175 Taiwanese high-tech businesses for the years 2004 to 2006, Lin *et al.* (2011) investigates the role of the board of directors in enhancing control through preventing excessive executive rewards. The research finds that board control is not significantly associated with pay-setting. They attribute this result to the low proportion of shares owned by directors and question if outside directors have real independence. This finding is inconsistent with Lin (2005), who also conduct a study in Taiwan and find a negative and significant association between board control and CEO compensation. One possible cause of these contradictory findings could be attributable to the fact that Lin (2005) use CEO compensation as a dependent variable, while Lin *et al.* (2011) utilise average executive remuneration. In addition, these different results might be a consequence of compliance with Taiwanese corporate governance which was introduced in 2002, because the study of Lin (2005) is based on a sample for the period 1997 to 1999, while the sample of Lin *et al.* (2011) covers the years 2004 to 2006. Furthermore, Lin *et al.* (2011) find a positive link between firm performance and executive pay. This finding matches the those of Conyon (2014); however, Edwards *et al.* (2009) do not find any link between firm performance and CEO pay.

However, the two studies of Lin *et al.* (2011) and Lin (2005) have a methodological drawback. For instance, they do not transform values that were highly right skewed (e.g. compensation, assets, sales) to their natural logarithm. Therefore, their results might suffer from high heteroscedasticity problems (Ozdemir and Upneja, 2012). To avoid such methodological problems, my research transforms all large positive values to their natural logarithm.

China is the dominant focus among emerging countries in relation to examining the relationship between corporate governance and executive compensation, because data regarding executive compensation has been available to the public since the end of the 1990s (Conyon and He, 2012; Lin *et al.*, 2011). Chen *et al.* (2010b) investigate the effect of a set of corporate governance mechanisms on executive compensation and analyse if the compensations was linked to firm performance. Their sample is based on 502 Chinese

listed firms for the years 2001 to 2006. They find that when a CEO chairs the board executives are more likely to receive higher remuneration. However, this finding does not match the conclusions by Conyon and He (2011), who find no evidence of such a relationship, though their sample timeframe is similar to Chen *et al.* (2010b). Additionally, Chen *et al.* (2010b) find that return on equity (ROE) is significantly and positively linked with executive pay level, which indicates that firm performance is a central criterion in determining executive rewards in China. However, the existence of a compensation committee is found to increase the executive compensation level. This surprising finding matches those of Conyon and He (2011) and Conyon and He (2012). The existence of a compensation committee is supposed to enhance the monitoring function of governance; however, Chen *et al.* (2010b) attribute this unexpected result to the use of external benchmarks.

Another comprehensive study conducted in China is that by Conyon and He (2012). This study uses a larger sample that consists of 2,104 firms for the period 2000 to 2010 to investigate the association between different corporate governance variables and CEO remuneration. Their results show that when a CEO simultaneously holds the position of board chairman, he/she earns higher compensation. Moreover, the study demonstrates that a larger board is significantly correlated with higher CEO pay. The basic idea behind this result is that when a board has more members, there will be a potential problem of free-riding and more coordination difficulties among directors (Yermack, 1996; Jensen, 1993); thus the monitoring role upon CEO compensation is less effective. This finding is consistent with Western studies, for example Core *et al.* (1999) and Conyon (2014). The results also show that both return on assets (ROA) and stock returns have a positive and significant impact on CEO pay level, which complies with the Chinese corporate governance code that encourages a link between executive compensation and performance (CSRC and SETC, 2001), This result is similar to Chen *et al.* (2011) and Conyon and He (2011). However, the study shows no relationship between supervisory board size and board independence on the one hand, and CEO compensation on the other.

Utilising a sample of 1,458 Chinese firms during the years 1999 to 2009, Chen *et al.* (2011) analyse if corporate governance is able to constrain excessive managerial perks. They find that CEO duality and executives who are members of political parties are associated with higher remuneration. This outcome supports the argument proposed by

the managerial power approach, that when managers have more power they can influence board decisions (Chen *et al.*, 2011). Moreover, board independence shows a positive impact on executive pay. This can be attributed to managerial control over independent directors which makes their role less effective. Larger boards are also found to be associated with higher executive rewards. This conclusion is consistent with other findings in China, e.g. Conyon and He (2012).

In Africa, specifically South Africa, Ntim *et al.* (2015) analyse 291 non-financial firms that traded in the years 2003 to 2007 and observe a positive and significant association between board size and executive compensation. This outcome supports the conclusions of Conyon and He (2012) and Shah *et al.* (2009). In addition, a strong link is found between top managers' pay and firm performance. In contrast, the results show no effect between other corporate governance characteristics, such as board meetings, non-executive directors, CEO duality, and executive remuneration. However, although, Ntim *et al.* (2015) capture the role of non-executive directors, they do not test the role of independent non-executive directors. The reason is because disclosure limitations in South Africa make it more difficult to distinguish between independent and affiliated directors. However, my study overcomes this limitation, because Saudi firms are obliged to classify non-executive directors into two types: affiliated and independent.

Utilising a sample of 51 IPO-firms from five different West African countries[1] between 2000 and 2001, Hearn (2013) find that when the compensation committee is dominated by gray directors, CEOs are paid lower salaries. However, their presence does not affect the total executive compensation. In contrast, the study shows that independent directors are more willing to pay executives higher remuneration. Although this finding matches some prior studies (Chhaochharia and Grinstein, 2009; Armstrong *et al.*, 2012), it is inconsistent from an agency theory viewpoint, which argues that director independence is an effective mechanism to mitigate agency costs by restricting executive compensation (Fama and Jensen, 1983b). Finally, the results do not find any relationship between board size and managerial pay. However, the study fof Hearn (2013) suffers from some obvious drawbacks. For instance, it uses a very small sample from five different countries. What is more, it does not control for the country effects, because each country has a unique culture and different governance code (Renders *et al.*,

[1] Nigeria, Ghana, Niger, Cameroon, and Ivory Coast.

2010). Another limitation is that the sample is a mixed sample from both financial and non-financial firms, but these sectors differ from each other in several important aspects, such as different regulations and accounting standards (Wang and Shailer, 2015).

Recently, Irani and Gerayeli (2017) conducted a study to investigates the relationship between various aspect of corporate governance and CEO compensation. The study analyses a sample of 95 Iranian firms for the period 2010-2014 and finds that board independence has no effect on CEO compensation. It only observes a negatively significant relationship between managerial and institutional ownership and CEO compensation. However, this study suffers from certain methodological problems. For example, it defines executive compensation as "the compensation of board to loss or gain of company" (Irani and Gerayeli, 2017, p. 288). However, corporate boards may be comprised by other non-executive directors making the employed proxy less reliable. Furthermore, this proxy reflects the compensation as a ratio to total firm income. Thus, it measures the sensitivity of pay-for-performance rather than compensation as an amount.

Ramaswamy *et al.* (2000) examines the relationship between corporate governance and CEO remuneration. Their study was based on 150 Indian manufacturing firms for the years 1992 and 1993. Even though insider directors were found to be positively correlated to CEO pay levels, and CEO duality was found to be negatively correlated to CEO pay levels, the relationships were statically insignificant. The findings also reveal that older CEOs were awarded higher compensation; however, a CEO who served longer in a firm received lower remuneration. These results indicate that recruiting a new, experienced and older CEO is more costly than retaining a current younger CEO. Ramaswamy *et al.* (2000) attribute these findings to cultural influence, as in India an older person is seen as wiser. However, Ramaswamy *et al.* (2000) lacks generalizability since it is based on a limited sample that only captures manufacturing sector. Moreover, it uses a very old sample, while in contrast, my study will use a wide-ranging sample that covers all non-financial firms operating in Saudi Arabia during the period 2008 to 2015.

In Pakistan, Shah *et al.* (2009) uses a sample of 114 non-financial firms for the period 2002 to 2006 and observes that larger sized boards were significantly associated with larger CEO compensation. This finding supports the notion that when a board

consists of a large number of directors, free-riding problems among directors emerge (Davis, 1991). The positive relationship matches finding in Western-based research (Core *et al.*, 1999; Ozkan, 2007; Sapp, 2008). Furthermore, consistent with an agency theory perspective, the study showed that independent directors are an effective tool through which to improve the quality of board control i.e. it negatively influences the level of CEO remuneration. Unlike developed economies, such as the US and the UK, where CEO compensation is usually linked to performance (Ozkan, 2011; Conyon, 2014), the results show that Pakistani decision-makers do not use firm performance criteria to assess executive compensation. The study did not find any significant correlation between CEO duality (32% of Pakistani firms have CEO duality) and CEO pay.

In the context of Bangladesh, Rashid (2013) investigates the relationship between a set of corporate governance mechanisms and executive remuneration. Based on 94 non-financial firms for the period 2000 to 2009, the study findings reveal that higher numbers of independent directors correlate with higher executive compensation. This outcome supports other research in emerging markets (Hearn, 2013; Chen *et al.*, 2011). Thus, the role and effectiveness of independent directors in protecting shareholders' wealth, in emerging economies, might not be as effective as in developed countries. Moreover, both CEO duality and board size show no significant impact on executive pay level. These findings are inconsistent with agency theory which hypothesizes that these mechanisms are substitutive instruments of the absence of shareholder direct control (Jensen and Meckling, 1976).

3.3.1.2.1 Saudi Arabia

To the author's best knowledge, Fallatah (2015) is the only research to investigate the relationship between corporate governance and executive compensation in the Saudi context. Based on a sample of non-financial firms in the period 2008 to 2012, Fallatah (2015) finds that in general board control has no clear impact on executive's remuneration decisions. However, the study observes a significant sensitivity in pay-for-performance, implying that top executives are paid according to their performance.

Although the study by Fallatah (2015) appears to be similar to this research, there are differences in terms of the method, theoretical development and contribution to knowledge. For example, while the sample of Fallatah (2015) covers the years 2008 to 2012, my longitudinal study includes a further three years to 2015. Furthermore, my

study analyses more variables in relation to the board of directors and ownership structure that have not been examined previously in Saudi Arabia, such as the characteristics of board chairperson and director ownership. Moreover, given that Fallatah (2015) employs only principal-agent model, my research develops more relevant contextual theoretical models that increase the understanding of the principal-principal conflict and the institutional settings in Saudi Arabia. Furthermore, Fallatah (2015) has several problematic issues related to the definitions of the variables and data reliability. For instance, there is inconsistency within the paper with respect to the definitions of large shareholders' ownership and government ownership. That is to say, although the paper defines ownership of large shareholders as the total shares held by an individual or institution to the total issued shares (i.e. a ratio), elsewhere the paper defines it as a dummy variable (i.e. binary) that equals one if there is an individual or institutional investor that owns more than 5% of the firm's total shares and zero otherwise. The same scenario occurs with the variable of government ownership. The data reliability of Fallatah's research is another critical issue. For example, Fallatah (2015) surprisingly shows that 66% of firms experience CEO duality (i.e. a single individual occupies both positions of CEO and board chairman concurrently) which is not consistent with the actual situation in the Saudi market, as my data shows only 15% of firms have CEO duality. Furthermore, the descriptive statistics in Fallatah's research reveals that the mean of firm leverage is 42.42%, while the maximum firm leverage is 13.82%! Indeed, the inconsistency of the research method within the paper and the unreasonable data reduces the validity and reliability of Fallatah's findings.

Accordingly, it can be concluded that board of directors in general have less control over managerial compensation in emerging economies (Lin *et al.*, 2011; Lin, 2005). The independence of board of directors (Rashid, 2013; Chen *et al.*, 2011) is found to be ineffective and associated with higher managerial perks. Furthermore, while some research (Conyon and He, 2012; Chen *et al.*, 2011; Chen *et al.*, 2010b) report a positive and significant relationship between CEO duality and executive remuneration, others (Ntim *et al.*, 2015; Conyon and He, 2012; Shah *et al.*, 2009) did not find evidence of such association between the two variables. These findings demonstrate that the role of board of directors is immature in emerging economies in contrast to developed counterparts. Moreover, remuneration committees do not function as intended since they are found to increase executive compensation (Conyon and He, 2012; Chen *et al.*, 2011; Conyon and

He, 2011). This indicates that emerging economies require customised rather than generic governance settings that consider the context of the institutional challenges such as the control of blockholders and the weakness of external governance.

3.3.2 Ownership Structure

Ownership concentration can reduce information asymmetry between top management and large shareholders (Schiehll and Bellavance, 2009). Moreover, large shareholders are assumed to have the ability to access their firm and the incentive to monitor managerial actions (Ramaswamy *et al.*, 2000). On the basis of these assumptions, many empirical studies examine the association between different types of ownership (such as institutional, state and family ownership) and executive compensation (Sakawa *et al.*, 2012; Chalevas, 2011; Méndez *et al.*, 2011). The following subsections review the key studies that investigate this relationship.

3.3.2.1 Developed Countries

Based on a US sample, Janakiraman *et al.* (2010) analyse the association between ownership structure and executive compensation. The results show that the presence of top institutional investors supports the linkage of executive compensation with firm performance in small manager-owned companies more than in large manager-owned companies. In addition, the presence of top-five investors was found to have a negative and significant impact on the level of managerial pay in small manager-owned companies but a positive and significant impact on the level of managerial pay in large manager-owned companies. These findings are consistent with the managerial power perspective, which argues that firms that are controlled by managers experience a reduction in the monitoring function that institutional investors are assumed to practise (Janakiraman *et al.*, 2010). To find out if these findings are driven by the clientele effect (Hartzell and Starks, 2003), the authors divided the sample into pre- & post-SOX (2002). They found that, after 2002, managerial ownership was negatively related to executive compensation even in large manager-owned companies. Janakiraman *et al.* (2010) attribute this change to the outrage constraint that occurred after the scandal of Enron 2001.

Fahlenbrach (2009) investigates the effect of institutional investors on CEO compensation and its sensitivity to firm performance in the US. The author found that both institutional and pension fund ownerships are associated with lower pay-for-

performance sensitivity. In addition, top institutional investors were shown to have a negative impact on the level of CEO remuneration. These findings are consistent with the substitution hypothesis, which assumes that firms with stronger monitoring quality provide less compensation relative to performance; i.e. when firms have weaker governance, they tend to link CEO compensation to firm performance in order to mitigate the conflict of interests between managers and shareholders. However, there is no evidence of any such relationship existing between pension funds ownership and compensation level.

In the UK, Ozkan (2007) investigates the role and effect of different ownership structures on CEO remuneration. She observes that both institutional investors and blockholders can play an important role in preventing excessive CEO perks. In addition, director ownership was found to be correlated to lower CEO pay. This finding matches other Western results in Méndez *et al.* (2011) on Spain and Sapp (2008) on Canada. Ozkan (2007) also documents that, when CEOs own more shares, they receive less equity-based compensation; i.e. they prefer cash remuneration to equity-based compensation, which is vulnerable to the risk of share price volatility. This conclusion is supported by Alagla (2012), who finds a negative association between CEO ownership and equity-based compensation on the one hand and a positive relationship between CEO ownership and short-term remuneration on the other hand.

Similarly, Alagla (2012) used a sample of 237 UK firms over the period 2004 to 2008 and found that, when the chairman holds more equity, the CEO gains a lower level of compensation. In contrast, CEO ownership is observed to be correlated to higher CEO salary and short-term compensation. This finding is inconsistent with Ozkan (2007), who observed a negative correlation between CEO equity and his/her pay level. In terms of institutional ownership, it is found to have a negative influence on CEO bonus; however, there is no evidence that it might influence other components of CEO compensation.

In the context of Spain, Méndez et al. (2011) find a negative link between executive ownership and their remuneration. This is consistent with the assumption that managerial ownership aligns managers' interests with those of shareholders (Jensen and Meckling, 1976). It is also consistent with other empirical findings reported by Ozkan (2007) and Sakawa et al. (2012) who also observe that when executives own more equity, they demand for less compensation. This can be attributed to the fact that they will

receive dividends for their shares; thus, they are less concern about their managerial compensation.

Chalevas (2011) demonstrates that institutional blockholders rein in the excessive perks of top managers. The research uses a sample of Greek firms to investigate the role of corporate governance mechanisms before and after the enforcement of the Greek corporate governance law in 2002. The findings show that the corporate governance requirements weaken executive power and help institutional investors to practise their monitoring function over pay-setting without pressure from managers. This finding is in line with Ozkan (2007), Lin et al. (2011), and Fahlenbrach (2009) who find that institutional investors play an effective role in constraining managerial perks. Although institutional ownership is found to be significantly correlated with lower executive compensation, the results show that neither individual investors nor the number of blockholders have any impact on executive remuneration level. Moreover, the results provide no evidence that managerial ownership is associated with lower total compensation.

Using a sample of 104 Swedish and 120 Norwegian firms, Randøy and Nielsen (2002) find a negative and significant relationship between CEO ownership and their compensation; i.e. when CEOs own more shares, they tend to receive less compensation. This finding matches those of Méndez et al. (2011) and Sakawa et al. (2012) who find a similar relationship. It also supports agency theory perspective, which argues that, when managers hold more stock, their interests are aligned with those of the shareholders (Jensen and Meckling, 1976).

In the context of Denmark, Banghøj *et al.* (2010) use a sample of 125 private firms to examine whether any relationship exists between ownership structure and CEO remuneration. Even though 36% of executives held shares in their companies, managerial ownership was found to have no relationship with CEO pay. Moreover, ownership concentration, which is high among Danish private firms, at approximately 70% (Banghøj et al., 2010, p. 497), had no significant impact on CEO remuneration. The absence of blockholder effects can be attributed to the fact that the sample only captured private firms which are usually controlled by certain families. Hence, if this ownership increases or decreases, these firms are still controlled by families.

Sapp (2008) uses a Canadian sample and found that CEO ownership is related to higher level of pay but has a weaker link with performance. This finding is consistent with the managerial power standpoint which argues that when managers have effective power, they will exploit it to increase their own compensation. The finding also supports other empirical studies (Li et al., 2007; Chen et al., 2010; Chen et al., 2011) which found that when executives own more shares, they are more likely to receive higher remuneration. Regarding director ownership, the results show that both CEOs and other executives receive lower remuneration when directors own more shares. This outcome is consistent with those of Ozkan (2007) and Ntim et al. (2013) who observe a similar relationship between director ownership and executive pay level. This outcome is because of the directors' incentives to protect their equity from opportunistic managers.

Reddy *et al.* (2015) analyse the relationship between ownership structure and CEO compensation. Based on a sample of 390 New Zealand company-year observations for the period 2005 to 2010, the study found evidence that institutional investors are associated with higher CEO perks. This finding is not consistent with agency theorists who argue that institutional investment helps to improve the quality of corporate governance and thereby control managerial incentives (Hartzell and Starks, 2003; David *et al.*, 1998). Furthermore, it contradicts the findings of others studies (Chalevas, 2011; Fahlenbrach, 2009). However, the research did not find an association between director ownership or blockholders, and CEO pay.

In Japan, Sakawa *et al.* (2012) found that bank ownership (average ownership 26%) had a positive impact on bonus and stock options incentives. Even though a lender can play a principal role in monitoring management decisions (Triantis and Daniels, 1995), unlike in Japan, Saudi banks are not allowed to own more than 10% of another joint-stock company (SAMA, 1966). Thus, they are less likely to take part in companies' boards. Additionally, foreign ownership is found to be associated with higher executive short-and long-term incentives. This finding is consistent with Colpan and Yoshikawa (2012) and Randøy and Nielsen (2002) who also find a positive relationship between foreign investors and executive bonuses. This correlation can be attributed to the fact that most of these foreign investors are from the US and the UK, who are familiar with high executive compensation (Randøy and Nielsen, 2002).

In Hong Kong, Cheng and Firth (2006) note that having blockholders is an effective tool for enhancing governance quality as it reduces executive compensation. This result is consistent with the conclusion of Ozkan (2007) who finds that blockholders are associated with lower CEO pay level in the UK. The study also reports a negative and significant relationship between non-executive director ownership and managerial remuneration. This finding supports the view of agency theory, which maintains that director ownership strengthens the monitoring function and consequently constrains managerial excess. However, this study concentrates the different types of blockholders (such as state and institutions) in one variable, even though the nature and purposes of those owners may differ. For instance, individual investors and pension funds are profit-seekers, whereas government investment can have purposes other than the maximisation of wealth.

This review highlights that certain types of ownership, in particular institutional and director (Chalevas, 2011; Fahlenbrach, 2009; Sapp, 2008) and in certain countries such as Japan bank and foreign investment (Sakawa *et al.*, 2012), predominate the literature related to developed countries. In contrast, state and individual ownership are found to have no significant presence in mature economies. In terms of the impact of ownership structure, there is almost a consensus that director ownership plays an effective governance role in developed economies in a way that enhances the control over managerial incentives (Méndez *et al.*, 2011; Sapp, 2008; Ozkan, 2007). The presence of blockholders is also found to have a negative impact on executive perks (Sakawa *et al.*, 2012; Ozkan, 2007), although (Chalevas, 2011) did not find this effect in Greece. Additionally, the literature reveals that institutional investors can take part in governance function by preventing top managers from extracting high non-merit compensation (Chalevas, 2011; Ozkan, 2007).

3.3.2.2 Emerging Countries

In Taiwan, Lin *et al.* (2011) finds that institutional ownership reinforces governance quality and negatively affects the level of managerial pay. However, this finding is not supported by Lin (2005) who does not find any significant association between the two variables. This might be due to the difference in the timeframes, as the latter study uses a sample before the enforcement of the first Taiwanese corporate governance code (2002), while the former uses a sample after the code was applied.

Additionally, neither study found a relationship between ownership concentration and executive remuneration.

In far east Asia, specifically in China, Conyon and He (2012) find that blockholders mitigate agency problems by reducing CEO compensation. In contrast, the presence of foreign investors is found to be associated with higher CEO compensation. This evidence is in line with findings of Li *et al.* (2007) and Chen *et al.* (2011). However, Conyon and He (2012) do not find a significant relationship between state ownership and CEO remuneration. This finding supports that of Li *et al.* (2007).

In contrast, Chen *et al.* (2011) find that when government has a high stake in a company, managers of that company are less likely to be rewarded generously. This negative correlation implies that when Chinese authorities hold more shares in a certain firm, they put more effort into monitoring executive actions and, therefore, prevent excessive perks for executives. Moreover, the study shows executive ownership to have a positive and significant effect on remuneration. This relationship is not consistent with an agency theory perspective, which points out that when executives own more stock their interests are aligned with those of the shareholders (Jensen and Meckling, 1976). However, the finding supports the perspective of managerial power model which argues that when executives hold more stock, they have the power to control the board and influence decisions related to their compensation (Lambert *et al.*, 1993).

Recently, Jaiswall and Bhattacharyya (2016), who use a sample of 770 Indian firms between 2002 and 2013, find a negative and significant association between the number of blockholders and CEO remuneration. Furthermore, institutional ownership was found to be associated with higher CEO compensation, This finding is not consistent with the view posited by agency model that the presence of institutional investors enhances the monitoring function of the board (Hartzell and Starks, 2003). In the same context, Ramaswamy *et al.* (2000) observe that individual blockholder ownership can be an effective tool in limiting managerial excesses in terms of executive compensation. This outcome is in line with Core *et al.* (1999) and Ozkan (2007).

Ntim *et al.* (2015) use a sample of 291 South African publicly traded firms and find that institutional ownership enhances governance quality by reducing executive pay levels. This finding supports the notion that institutional ownership can be a substitutive tool for weak governance (Chalevas, 2011), because they have more incentive and ability

to monitor decisions related to executive remuneration. Supporting of findings of Sapp (2008) and Ozkan (2007), Ntim *et al.* (2015) finds that when directors hold more equity in a company, managers of that company earn lower level of remuneration. However, in West African economies, Hearn (2013) shows that both state and director ownerships have a positive effect on CEO salary, while, in terms of total CEO compensation, only family ownership was found to be associated with higher compensation.

3.3.2.2.1 Saudi Arabia

In the Saudi context, to the researcher's best knowledge, Fallatah (2015) is the only study that investigates the relationship between ownership factors and executive compensation. Based on a sample of non-financial firms in the period 2008 to 2012, Fallatah (2015) does not find any significant relationship between state ownership or other large shareholders and executive remuneration. Although the study by Fallatah (2015) appears to be similar to this research, there are differences in terms of the method, theoretical development and contribution to knowledge. For example, while the sample of Fallatah (2015) covers the years 2008 to 2012, this longitudinal study includes a further three years to 2015. Furthermore, the present study analyses more variables in relation to the ownership structure that have not been examined previously in Saudi Arabia, such as director ownership. Moreover, given that Fallatah (2015) employs only the principal-agent model, the present research develops more relevant contextual theoretical models that increase the understanding of the principal-principal conflict and the institutional settings in Saudi Arabia. With respect to research methods, the research of Fallatah (2015) suffers from a number of methodological drawbacks that may affect the accuracy of the findings. First, the study measured state ownership as a dummy variable that equals one if the company has any government investment and zero otherwise. However, this approach does not consider the variation in the state investments within and across organisations. In other words, there is no difference whether the state owns 1% or 99%, while in practice different percentages could lead to different implications according to the level of control given by the shareholding. However, my research measures state ownership as percentage rather than using a binary variable. Second, Fallatah (2015) also defines large shareholders as a dummy variable that equals one if the company has an individual or institutional investor that owns more than 5% and zero otherwise. This definition does not differentiate between

the behaviours of individual and institutional investors towards the decisions of managerial perks. Thus, my study uses more specific definitions and classifies investors separately into three types: individuals, state and pension funds.

Accordingly, as highlighted, companies in emerging economies can have different ownership structures from their counterparts in developed countries. The evidence demonstrates that companies in emerging economies are dominated by certain investors, specifically state and family (Conyon and He, 2012; Chen *et al.*, 2010a; Lin, 2005). The divergence in ownership structure has implications for business policy as each type of investors can have different objectives for the company. Therefore, corporate governance regulations should consider these institutional differences between emerging and developed economies and customise mechanisms that fit the domestic context. For example, while best practice of corporate governance in developed economies suggest ownership concentration as a remedy for principal-agent conflict, this suggestion may not work in emerging countries because it leads to a conflict between the principals themselves with an absence of effective formal institutions.

Furthermore, even the findings that are thought to be conclusive in the literature pertaining to developed countries, are found not to so in some emerging countries. For instance, while the negative and significant impact of director ownership on executive remuneration is almost universally accepted by academics in developed countries (Méndez *et al.*, 2011; Sapp, 2008; Ozkan, 2007), Hearn (2013) reported that in five West African countries and state director ownership increases managerial compensation. Moreover, state ownership, which can be significant in emerging economies, is found to have a significant influence on compensation policy in developing economies (Young and Tsai, 2008; Chen *et al.*, 2011). In contrast, the situation in developed economies is totally different since state investment in those markets is virtually absent. Consequently, as mentioned earlier the important differences between emerging and developed economies in terms of ownership structure must be considered when designing governance mechanisms; otherwise the regulations will not work effectively.

In conclusion, although the debate on corporate governance's ability to constrain executive compensation has received intensive consideration by researchers over the past three decades (Conyon, 2014; Conyon and He, 2012; Core *et al.*, 1999; Fama and Jensen, 1983b), the findings are inconclusive. This indicates that the existing literature

still has a number of gaps. For example, the role and effect of the chairman, who is considered to be more powerful than other directors and who has the right to cast an additional vote in some countries, have only been investigated on two dimensions, i.e. CEO/chairman role duality and the chairman independence. However, none of the studies has examined the role of chairmen as blockholders in decision pertaining to executive remuneration. Moreover, although studies analyse the relationship between multi-directorships of board members and executive compensation (Armstrong *et al.*, 2012; Sapp, 2008), none has yet considered the impact of chairman multi-directorships on decisions relating to executive compensation.

Additionally, most research is conducted in developed countries, while emerging countries receive less attention, partly due to disclosure limitations. Although a number of studies have been carried out in various developing economies (Ntim *et al.*, 2015; Rashid, 2013; Conyon and He, 2012; Lin *et al.*, 2011), to the best of my knowledge, the research of Fallatah (2015) is the only study that investigates the relationship between corporate governance and executive compensation in the Arab world, and specifically in Saudi Arabia. Furthermore, my study uses a more comprehensive set of corporate governance mechanisms and investigates additional dimensions that are not captured by (Fallatah, 2015). For example, while the research of Fallatah (2015) is centred around the traditional agency model (principal-agent), my study develops a more relevant contextual-based theoretical framework that reflects a deeper understanding of the domestic institutional settings of Saudi Arabia, which creates setting for principal-principal conflict. Accordingly, my study adds a valuable contribution to the current literature by filling these gaps. By doing so, the research extends the understanding of the association between corporate governance and pay-setting, particularly in contexts that suffer from principal-principal conflict. Table 3.1 presents summary of main research to date.

Table 3.1: Summary of Key Research

Study	Dependent Variable(s)	Independent Variable(s)	Sample characteristics	Analysis Technique	Main Findings
Reddy *et al.* (2015)	-Total CEO compensation -Total CEO cash compensation	1. Board size 2. Board independence 3. Role duality 4. Institutional ownership 5. Blockholders 6. Director ownership	A sample of 390 New Zealand firm-year observations over the period 2005 to 2010	- GLS	1) Institutional investors and board size have positive and significant impacts on CEO compensation. 2) There is no relationship between director ownership, blockholders, or board independence and executive compensation.
Al-Najjar (2017).	-Total CEO compensation	1. Board size 2. Board independence 3. Board meetings	A sample of 237 UK non-financial firms from FTSE 350 for the period 2004 to 2008	- Fixed effects	1) There is a negative and significant relationship between board size and CEO pay 2) Independent directors are more likely to pay CEOs' higher compensation. 3) No association is found between board meetings and CEO compensation.
Fallatah (2015)	-CEO compensation	1. Board size 2. Board independence 3. Role duality 4. State ownership 5. Large blockholders	A sample of Saudi non-financial listed firms for the period 2008 to 2012	- Fixed effects - 2SLS	1) Generally, board characteristics and ownership structure are not significantly associated with decisions related to executive compensation. 2) There is a high sensitivity of pay-for-performance
Sapp (2008)	-Total compensation -Total cash compensation -Total variable compensation	1. Director tenure 2. Board independence 3. Multiple directorships 4. Family-related directors 5. Directors ownership 6. Controlling shareholder 7. Compensation committee independence 8. CEOs sit on compensation committee 9. Financial expertise members on Compensation committee	A sample of 400 Canadian firms for the period 2000 to 2005	- Random effects - Fixed effects	1) A weak board is associated with higher executive compensation. 2) Director ownership has a negative effect on executive pay; however, CEO ownership is positively and negatively related to executive remuneration. 3) Independent directors are less likely to reward other executives high compensation. 4) CEO duality, compensation committee independence, multi-listings in both Canada and the US have positive and significant relationships with CEO compensation. 5) There is no evidence that relationships exist between CEO compensation and independent directors or controlling shareholders.
Jaiswall and Bhattacharyya (2016)	- Total CEO compensation	1. Board meetings 2. Board size 3. Board independence 4. Multi-directorships of independent directors 5. Institutional ownership 6. Blockholders	A sample of 770 Indian firms for the period 2002 to 2013	- OLS - Fixed effects	1) Institutional investors increase CEO compensation, while the number of blockholder is associated with lower CEO pay. 2) If independent directors have multi-directorships, CEOs are more likely to earn higher compensation. 3) There are no relationships between board meetings, size, or independence and CEO pay.

Cheng and Firth (2006)	-Total CEO pay -Executive directors pay -Top five executives pay -Bonus per executive	1. Non-executive director ownership 2. Blockholder ownership 3. Board independence 4. Independent director ownership	A sample of 336 firms listed in Hong Kong for the period 1994 to 2002	- Fixed effects	1) Both non-executive directors who own more shares and large blockholders are more likely to pay executives less compensation. 2) There is no evidence that either independent directors or independent director ownership affects the level of executive remuneration. 3) Independent directors invoke greater pressure to link compensation to firm performance.
Méndez *et al.* (2011)	-Total compensation -Variable compensation -Variation of total compensation	1. Board independence 2. Compensation committee independence 3. Board size 4. Compensation committee size 5. Ownership concentration 6. Ownership of board non-executive directors 7. Ownership of board executive directors	A sample of 77 Spanish firms for the period 2005 to 2009	- OLS	1) Board independence has a positive impact on executive compensation, whereas independent directors on compensation committee are related with lower managerial remuneration. 2) Larger sizes of both board and compensation committee tend to weaken the governance quality by providing more compensation to executive. 3) Ownership of executive directors who serve either on board or on remuneration committee is associated with lower compensation. 4) Large shareholders and non-executive director ownership have negative but insignificant effect on executive rewards. 5) Change in shareholder wealth is one of the main drivers of executive compensation in Spain.
Randøy and Nielsen (2002)	-Total compensation	1. Board size 2. Foreign board membership 3. CEO tenure 4. CEO ownership	A sample of 224 listed firms, which 120 are from Norway and 104 are from Sweden for 1998	- OLS	1) Large board of directors and foreign directors found to be related with higher CEO pay. 2) CEO ownership has a negative and significant relationship with CEO compensation. 3) There is no evidence that CEO tenure has any impact on the CEO compensation. 4) Large firms are more likely to grant CEOs higher rewards.
Edwards *et al.* (2009)	-Total compensation per manager	1. Management board size 2. Supervisory board size 3. Ownership concentration	A sample of 271 firms listed in Germany for the period 1989 to 1993.	- OLS - LAV	1) Supervisory board size has a positive and significant effect on managerial compensation. 2) Management board size is associated with lower levels of executive pay. 3) There is a positive and significant linkage between firm performance (ROE) and executive remuneration. 4) The findings show that ownership structure has little impact on the sensitivity of pay-for-performance.
Armstrong *et al.* (2012)	-Total CEO compensation	1. Board size 2. Board independence 3. Board old 4. Board busy 5. Chairman independence 6. Directors appointed by the CEO 7. Activist shareholders	A sample of 2,110 firms listed in the US for the year of 2006.	- OLS - Fixed effects	1) Independent and busy directors have a positive and significant impact on CEO compensation. 2) An independent chairman constrains CEO pay. 3) New and older CEOs are related with lower compensation. 4) There is no evidence of any relationship between board size, board old, stock price, or founder CEO and CEO remuneration.

Conyon (2014)	-Total compensation -Total realised compensation	1. Board size 2. Non-independent directors on board 3. Non-independent directors on compensation committee	Various sample of S&P500, S&P Mid-Cap and S&P Small-Cap firms listed in the US for the period of 2008 to 2012.	- OLS - Fixed effect	1) There is no evidence that non-independent directors are associated with higher executive compensation. 2) A large board weakens the governance quality with regard to executive compensation. 3) Executive compensation is largely based on firm performance (shareholder returns and ROA). 4) Executive remuneration is elastic to firm sales by about 35%. 5) Female executives receive less compensation than males. 6) Executive age is positively associated with executive compensation.
Chhaochharia and Grinstein (2009)	-Total CEO compensation -Equity based compensation -Non-equity based compensation	1. Independence of board of directors 2. Independence of compensation committee 3. Independence of nominating committee	A sample of 865 US firms from S&P 1500 for the period 2000 to 2005	- Fixed effects	1) CEO compensation decreases after the promulgation of the Sarbanes–Oxley Act (2002). 2) Board of directors, compensation committees, and nomination committees which consist of majority of independent directors have a negative and significant impact on CEO compensation. 3) After 2002, CEO compensation has been significantly linked to firm performance.
Janakiraman *et al.* (2010)	-Total cash compensation -Total direct compensation	1. Top-five managerial ownership 2. Top-five institutional ownership	A sample of 1,350 US firms for the period 1993 to 2008	- Multivariate linear regression	1) Top-five institutional investors are negatively associated with executive compensation in small managerial ownership companies. 2) Top-five institutional investors are positively associated with executive compensation in large managerial ownership companies. 3) Top-five institutional investors have a positive effect on pay-for-performance sensitivity in small managerial ownership companies. 4) Top-five institutional investors have a negative effect on pay-for-performance
Fahlenbrach (2009)	-Total CEO compensation -CEO Ownership	1. Board size 2. CEO duality 3. Board independence 4. Institutional ownership 5. Pension fund ownership 6. CEO tenure	A sample of 11,029 US firm-year observations over the period 1993 to 2004	- Fixed effects	1) CEO duality and CEO tenure positively and significantly affect CEO compensation. 2) Institutional ownership, pension funds ownership, board size, and board independence are associated with lower pay-for-performance sensitivity. 3) Firms that have high institutional ownership concentration are associated with lower CEO pay. 4) Managers who occupy both positions of CEO and chairman are correlated with higher remuneration.
Chalevas (2011)	-Total cash compensation per executive	1. Board size 2. CEO duality 3. Existence of compensation committee 4. Managerial ownership 5. Institutional ownership 6. Individual ownership 7. Blockholder number 8. Existence of audit committee	A sample of 386 Greek firm-year observations over the period 2000-2003	- OLS - 2SLS	1) The enforcement of corporate governance code creates a linkage between executive compensation and firm performance. 2) Institutional ownership and existence of independent audit committee have a negative and significant effect on executive remuneration. 3) Firm size and firm growth positively impact managerial pay. 4) There is no evidence that board size, CEO duality, existence of compensation committee, managerial ownership, or blockholder number have correlation with executive remuneration.
Banghøj *et al.* (2010)	- Total cash compensation	1. The presence of CEO on board 2. Board size 3. Insider directors 4. Ownership concentration 5. Executive ownership	A sample of 125 large and mid-size Danish private firms for 2007	- 2SLS - 3SLS	1) There is positive and significant relationship between board size, CEO education, and firm size and total CEO cash compensation. 2) There is no evidence that insider directors, ownership concentration, or managerial ownership influence CEO remuneration level. 3) Pay-for-performance sensitivity is found to be weak among Danish private firms.

Sakawa *et al.* (2012)	-Total of incentives (bonuses and stock options) -Cash bonuses -Stock options	1. Executive ownership 2. Bank ownership 3. Foreign ownership 4. Outside director 5. Bank directors 6. Executive tenure	A sample of 200 large Japanese firms for 2010	- Tabit model	1) Executive ownership and executive tenure have a negative and significant effect on executive incentives. 2) Outside directors are associated with higher stock options. 3) Bank ownership, foreign ownership, and ROA positively and significantly impact both executive total and short-term incentives.
Colpan and Yoshikawa (2012)	-Total bonus per executive	1. Bank-appointed directors 2. Corporate-appointed directors 3. Foreign ownership 4. Independent directors	A sample of 200 large Japanese firms for the period 1997 to 2007	- Fixed effects	1) Corporate-appointed directors, foreign ownership, ROE, firm size, CEO age, and CEO succession show positive and significant relationship with executive bonuses. 2) There is no evidence that bank-appointed directors or independent directors have any impact on executive bonus. 3) Foreign investors are found to be profit seekers, while corporates are found to be growth seekers.
Chalmers *et al.* (2006)	-Fixed CEO compensation -CEO bonuses -CEO options -CEO shares issued -Total CEO compensation	1. CEO duality 2. Board size 3. Outside directors 4. Gray directors 5. Existence of compensation committee 6. CEO ownership 7. CEO option holdings 8. Outside director ownership 9. Number of blockholders	A sample of 200 large Australian firms for the period 1999 to 2002	- OLS	1) CEO duality has a negative and significant effect on CEO shares issued. 2) Board size is associated with higher CEO fixed and bonus compensation. 3) Outside directors have no impact on any components of CEO compensation except for a negative influence on the fixed aspect. 4) There is evidence that CEO ownership can mitigate the agency problem by reducing executive remuneration. 5) Larger and more profitable firms are correlated with higher compensation. 6) There is no evidence that outside director ownership or number of blockholders influence the level of executive pay.
Lin *et al.* (2011)	-Total executives' compensation	1. Board of directors 2. Institutional ownership 3. Blockholders 4. Firm performance	A sample of 1,175 Taiwanese high-tech businesses for the period 2004 to 2006	-Multi-index variable liner structure relationship (LISREL)	1) Institutional ownership is negatively and significantly correlated to executive remuneration. 2) Firm performance and firm size show a positive impact on managerial pay. 3) Neither board of directors nor ownership concentration have any effect on executive rewards.
Lin (2005)	-CEO cash compensation	1. Board of directors 2. Blockholders 3. Firm performance 4. CEO power	A sample of 485 Taiwanese firms for the period 1997 to 1999	- Multi-index variable liner structure relationship (LISREL)	1) Board control is negatively and significantly related to CEO pay. 2) Firm size shows a positive impact on CEO remuneration. 3) These are no relationships between blockholders, CEO power, or firm performance, and CEO compensation.
Li *et al.* (2007)	-CEO cash compensation	1. CEO duality 2. Board size 3. Supervisory board size 4. Outside directors 5. CEO ownership 6. Legal person ownership 7. State ownership 8. Foreign ownership	A sample of 206 Chinese firms for the period 2000 to 2001	- OLS - IRLS	1) Independent directors, CEO ownership, and foreign ownership are associated with higher executive pay. 2) Firm size positively and significantly influences executive remuneration. 3) There is no relationship between CEO duality, board size, supervisory board size, legal person ownership, state ownership, or firm performance and executive compensation.

Conyon and He (2011)	-Executive cash compensation -Change in pay	1. Ownership concentration 2. Board independence 3. Board size 4. CEO duality 5. Existence of a compensation committee	A sample of 1342 Chinese firms for the period 2001 to 2005	- OLS - Random effects - Fixed effects	1) Existence of compensation committee has a positive impact on executive pay. 2) Existence of ownership concentration has negative impact on executive pay. 3) ROA, firm size, and growth opportunity are the main derivers of executive compensation. 4) There is no significant correlation between board size, independent directors, or CEO duality and executive pay.
Conyon and He (2012)	-CEO cash compensation	1. CEO duality 2. Board size 3. Supervisory board size 4. Independence of board of directors 5. Existence of a compensation committee 6. State ownership 7. Foreign ownership 8. Blockholder ownership	A sample of 2104 Chinese firms for the period 2000 to 2010	- OLS - Fixed effects	1) Board size and existence of compensating committee are related to excessive remuneration. 2) Foreign ownership has a positive impact on CEO compensation. 3) Blockholders have a negative impact on CEO compensation. 4) ROA, stock return, and firm size are associated with higher CEO pay. 5) There are no significant relationships between supervisory board size, independent directors, or state ownership and CEO remuneration.
Chen *et al.* (2010b)	-Executive cash compensation	1. CEO duality 2. CEO ownership 3. CEO is the largest shareholder 4. Board independence 5. Supervisory board size 6. Blockholders 7. Existence of a compensation committee 8. Foreign ownership (dummy)	A sample of 502 Chinese firms for the period 2001 to 2006	- Fixed effects	1) Managerial power (CEO duality, high executive ownership) is associated with higher executive pay. 2) Foreign investors and existence of compensation committee have a positive impact on executive remuneration. 3) Blockholders have a negative effect on executive pay level.
Chen *et al.* (2011)	-Executive cash compensation	1. Executive ownership 2. State ownership 3. Foreign ownership 4. Party (political power) 5. Board size 6. Board Independence 7. CEO duality	A sample of 1458 Chinese firms for the period 1999 to 2009	- OLS - Fixed effects	1) Executive and foreign ownership have a positive impact on executive compensation. 2) State ownership has a negative impact on executive compensation. 3) Political executive, CEO duality, and executive gender are associated with higher remuneration. 4) Board size and independent directors positively and significantly affect executive pay. 5) Executive compensation is positively and significantly linked to firm performance (ROA, EPS, and Tobin's Q).
Shah *et al.* (2009)	-CEO total compensation	1. Board size 2. Board independence 3. CEO duality 4. Shareholder activism 5. Audit committee independence 6. Institutional ownership 7. Ownership concentration 8. Ownership structure	A sample of 114 non-financial Pakistani firms for the period 2002 to 2006	- GLS	1) There is a positive relationship between board size and CEO compensation. 2) There is a negative relationship between board independence and CEO compensation. 3) Ownership concentration has a positive effect on CEO remuneration. 4) There is no relationship between, CEO duality, institutional ownership from one hand, and CEO pay for other.

Ntim *et al.* (2015)	-CEO cash compensation -CEO non-cash compensation -CEO total compensation -Executive cash compensation -Executive non-cash compensation -Total executive compensation	1. Board size 2. Board meetings 3. Non-executive directors 4. Blockholders 5. Institutional ownership 6. Director ownership 7. Compensation committee independence 8. CEO duality	A sample of 291 non-financial South African firms for the period 2003 to 2007	- Fixed effects - 3SLS	1) Board size has a positive impact on executive compensation. 2) Both institutional and director ownership have a negative and significant effect on executive remuneration. 3) There is no evidence of any relationships between board meetings, non-executive directors, CEO duality, or blockholders and executive pay level.
Hearn (2013)	-Executive base salary -Total executive compensation	1. Gray committee 2. Board size 3. Board independence 4. Director ownership 5. State ownership 6. Family ownership	A sample of 51 firms from five different West African countries for the period 2000 to 2011	- OLS	1) Gray committee, state ownership, and director ownership have positive impacts on executive salary. 2) Board independence positively and significantly affects both managerial salary and total compensation. 3) Firm ownership is associated with higher executive remuneration.
Rashid (2013)	-Total cash compensation	1. CEO duality 2. Board size 3. Board independence 4. Director ownership 5. Institutional ownership 6. Executive pay	A sample of 94 non-financial Bangladeshi firms for the period 2000 to 2009	- OLS - Fixed effects	1) There is a positive and significant relationship between independent directors and executive pay level. 2) The results showed no evidence that board size, CEO duality, institutional ownership, or director ownership have any effect on executive compensation.
Ramaswamy *et al.* (2000)	-Total CEO compensation	1. Insider directors 2. CEO duality 3. Family ownership 4. State ownership 5. Public ownership 6. Institutional ownership 7. CEO age 8. CEO tenure	A sample of 150 manufacturing Indian firms for the period 1992 to 1993	- OLS	1) There are negative and significant relationships between family ownership, public ownership, and institutional ownership and CEO compensation. 2) An older CEO is associated with higher compensation, while CEO tenure shows a negative correlation with CEO remuneration. 3) No correlation exists between insider directors, CEO duality, or state ownership and CEO pay.
Alagla (2012)	-CEO salary -CEO Bonus -CEO short-term compensation -CEO total compensation	1. Board size 2. Non-executive directors 3. Independent directors 4. CEO duality 5. Chairman independence 6. Compensation committee size 7. Compensation committee independence 8. Other CEOs on Compensation committee 9. CEO ownership 10. Chairman ownership 11. Institutional ownership	A sample of 237 UK non-financial firms from FTSE 350 for the period 2004 to 2008	- GLS - Fixed effects - OLS	1) There is a positive relationship between board size, non-executive directors, independent directors for one hand and CEO compensation from other. 2) CEO duality, compensation committee size, compensation committee independence have a negative and significant effect on CEO remuneration. 3) Other CEOs on compensation committee positively influence short-term and total CEO compensation. 4) Compensation committee pay and CEO ownership have a positive and significant impact on CEO pay level. 5) Chairman equity found to be associated with lower CEO rewards. 6) Institutional ownership has a negative impact only on CEO bonus

Ozkan (2007)	-CEO cash compensation -CEO equity-based compensation -CEO total compensation	1. Board size 2. Non-executive directors 3. Four largest institutional ownership 4. Total Institutional ownership 5. Block-holder ownership 6. Directors ownership 7. CEO ownership	A sample of 414 UK firms for the years 2003 to 2004	- OLS - Tobit regression	1) Both board size and non-executive directors have a positive relationship with CEO compensation. 2) Institutional ownership and blockholders are negatively associated with CEO pay level. 3) CEO ownership is related to lower CEO equity-based compensation. 4) Director ownership has a negative and significant impact on CEO remuneration.
Firth *et al.* (2007)	-CEO cash compensation	1. State ownership 2. Outsider blockholders 3. Foreign share 4. Non-executive directors 5. Board size 6. CEO duality 7. Stock returns	A sample of 549 Chinese firms for the years 1998 to 2000	- OLS	1) State ownership and outsider blockholders have a negative and significant effect on CEO cash compensation. 2) Foreign investors are associated with higher CEO compensation. 3) A larger board is more likely to reduce CEO remuneration. 4) There is a positive link between firm performance and CEO pay.
Elston and Goldberg (2003)	-Executive salary	1. Ownership concentration 2. Corporate ownership 3. Foreign ownership 4. Bank ownership 5. Family ownership	A sample of 100 German firms for the period 1970 to 1986	- Fixed effects - GMM	1) All ownership structures (including corporate, foreign, bank, family, and ownership concentration) have a negative and significant impact on executive salary. 2) Firms with lager sales reward executives with higher salaries. 3) There is no link between firm performance and executive salary.
Basu *et al.* (2007)	-Total cash compensation	1. Outside directors 2. Board size 3. Family-controlled firms 4. Managerial ownership 5. Main bank 6. Keiretsu membership	A sample of 174 large Japanese firms for the period 1992 to 1996	- Cross-sectional regression - Pooled regression	1) Outside directors have a negative impact on executive compensation. 2) Both family controlled-firms and managerial ownership were associated with higher executive pay. 3) There is a positive link between executive compensation and firm performance. 4) Older and more experienced executives receive higher remuneration. 5) There is no relationship between board size and compensation level.

3.4 RESEARCH METHOD

3.4.1 Hypotheses Development

3.4.1.1 Composition of Board of Directors

The board of directors is considered by some to be the most effective instrument, of all the internal corporate governance mechanisms, for safeguarding shareholders' interests Ramaswamy *et al.* (2000). The importance of the board of directors emanates from the agency theory viewpoint which argues that managerial activities must be controlled and monitored (Lin, 2005; Fama and Jensen, 1983b). However, others, such as stewardship theory proponents, argue that the role of the board of directors is wider than solely monitoring top management (Davis *et al.*, 1997). The responsibilities of the board also include coordinating and connecting the views of shareholders and management. It is also a supportive tool helping management to set strategic plans.

According to corporate law and corporate governance regulations, one major responsibility of the board of directors is to design appropriate managerial incentives to align shareholders' and executives' interests (Lin, 2005). This mission is usually delegated to the remuneration committee, which negotiates compensation issues with top executives and puts forward recommendations to the board of directors for approval (Conyon, 2014). As the composition of the board and its committees is influential, corporate governance recommendations typically distinguish between insider (executive) and outsider (non-executive) directors (Chen *et al.*, 2011). This is because non-executive directors are expected to be more loyal to shareholders and less influenced by the management team, hence providing a better monitoring performance.

Although many theorists believe that board size is also an indication of governance quality (Muth and Donaldson, 1998; Yermack, 1996; Jensen, 1993; Core *et al.*, 1999; Ozkan, 2007; Sapp, 2008), in the KSA the board size is specified at between three and eleven members. This contrasts with other countries such as the UK, the US, Germany and Japan, where the board size is left to discretion of the company. Therefore, all firms in Saudi Arabia have small boards of directors. Consequently, it is pointless to include this variable in the research, while other less researched variables, such as the role of board chairman, deserve inclusion.

a) Board Independence

Given the fact that corporate board structure in KSA is based on a one-tier system that is similar to the system commonly used in Anglo-Saxon countries, there is the potential for interlocking connections between executive and non-executive directors (Core *et al.*, 1999). However, not all non-executive directors are necessarily independent, because some non-executive directors can have indirect interests or business relationships with the company or the managerial team (Chen *et al.*, 2011; Conyon and Peck, 1998; Core *et al.*, 1999). In this context, SCGRs distinguishes between the non-executive directors who are affiliated with top managers and independent directors who have no affiliations with the managers. Thus, firms have to classify board members into three categories, namely executive, non-executive and independent (CMA, 2010). A number of studies also follow distinguish between non-executive directors and independent directors by using different denotations such as non-independent directors, affiliated directors or 'gray' directors (Conyon, 2014; Core *et al.*, 1999; Bebchuk and Fried, 2004).

In the literature, board independence is widely used as a proxy for board effectiveness (Ntim *et al.*, 2015; Jensen *et al.*, 2004; Core *et al.*, 1999; Jensen and Murphy, 1990). Fama and Jensen (1983b) argue that independent directors are free from CEO influence; thus, their judgements about CEO performance are unbiased and neutral. Although independent directors have no direct financial interests in the company, they have other motivations, such as curbing managerial opportunism in order to create a good reputation in the labour market (Fama and Jensen, 1983b; Ozerturk, 2005). By doing so, they may increase their own reputation and enhance their opportunities to find positions on other corporate boards, which results in greater personal benefits. Consequently, those who propose that the board of directors be preponderantly composed of independent directors axiomatically expect a negative relationship between board independence and executive compensation.

However, some critics argue that widening the number of outsider members to the board of directors may have adverse and undesirable consequences (Finkelstein and Hambrick, 1997; Conyon, 2014; Li *et al.*, 2007). Finkelstein and Hambrick (1997) point out that independent members have no interest in the firm's equity; thus, they have no adequate motivation to strictly monitor top management activities. Furthermore, Li *et al.*

(2007) add that outsider directors may have limited knowledge of and expertise in the firm's activities; hence, they will be unable to perform their monitoring role properly. Additionally, as discussed previously, not all independent directors enjoy real and full independence; there are various factors that may affect directors' attitudes. For instance, directors may be former employees of the company and have a close relationships with the incumbent managers; the CEO may have taken part in the appointment of independent directors, who may reciprocate the favour by setting higher managerial pay; or directors may have hidden associations with senior managers (Conyon and Peck, 1998; Conyon, 2014; Core *et al.*, 1999). Accordingly, those who critique the presence of independent directors predict a low quality of governance and, hence, higher managerial remuneration.

Theoretically, there are two counter-models, one of which supports the role of board independence with regard to executive compensation, while the other criticises this role. The first model is 'optimal contracting', which postulates that independent directors ensure that the negotiation process of executive compensation between the board of directors and top executives is subject to the arms-length principle (Core *et al.*, 2003; Janakiraman *et al.*, 2010; Ntim *et al.*, 2015). Therefore, the higher the number of independent directors, the lower the executive pay. However, the other model, 'managerial power', takes an opposing view. It argues that the negotiation process of executive remuneration is subject to the ability of managers to influence their compensation decisions (Bebchuk and Fried, 2004). According to this model, independent directors are more easily captured and controlled by powerful managers, particularly if those executives are able to participate in the decisions on directorship re-nomination (Ozerturk, 2005). In this case, independent directors would prefer to go along with executive pay arrangements rather than challenge them, especially as there are practically no repercussions for independent directors if they approve such payments (Chalevas, 2011). Consequently, greater board independence may strengthen the managerial dominance over the board's decisions, which will lead to higher executive pay.

Empirically, numerous researchers have examined the effect of board and remuneration committee independence on executive compensation and have obtained mixed findings, albeit with predominantly positive associations. In the US and Canada,

Chhaochharia and Grinstein (2009) and Sapp (2008) found that independent directors negatively and significantly impact managerial pay, although other studies in Anglo-Saxon contexts (Ozdemir and Upneja, 2012; Armstrong *et al.*, 2012; Fahlenbrach, 2009; Chalmers *et al.*, 2006; Ozkan, 2007) found adverse outcomes, i.e. higher board independence leads to higher executive pay. Furthermore, a few studies have observed that board independence plays no significant role on managerial compensation in the US (Conyon, 2014; Petra and Dorata, 2008), in the UK (Conyon and Peck, 1998), and in Canada (Schiehll and Bellavance, 2009).

In emerging and East Asian countries where large shareholders predominantly control corporate decisions and serve on the board, the role of independent directors appears to be ineffective. For example, studies carried out in Japan (Sakawa *et al.*, 2012), China (Chen *et al.*, 2011; Li *et al.*, 2007), Bangladesh (Rashid, 2013) and West Africa (Hearn, 2013) find a positive relationship between outsider directors and managerial remuneration. In contrast, two studies, one in Japan (Basu *et al.*, 2007) and one in South Africa (Ntim *et al.*, 2015), found independent directors to be an effective mechanism for curbing executive compensation, while many other researchers found no association between independent members and managerial pay decisions (Cheng and Firth, 2006; Chen *et al.*, 2010b; Firth *et al.*, 2007; Conyon and He, 2011; 2012; Colpan and Yoshikawa, 2012).

Nevertheless, although outsider-independent directors are conceptually perceived as an effective instrument for constraining managerial opportunistic activities (Jensen and Meckling, 1976), there is evidence that independent directors have less impact and effectiveness "in contexts where large family-owned conglomerates control significant sectors of the economy" (Ramaswamy *et al.*, 2000, p. 175). Saudi Arabia is a prime example where certain families control approximately 57% of listed firms and generally own 95% of the private sector (Alriyadh, 2013). Moreover, nearly 85% of Saudi corporate boards have at least one blockholder director; therefore, there is no real separation between ownership and control. Although, in KSA, executive directors are allowed to sit on the nomination committee and participate in the process of nominating board members, independent directors know that their renewal decisions are in the hands of blockholders who control the decision-making. Thus, they would prefer to support

decisions approved by large shareholders rather than collude with top management (Ozdemir and Upneja, 2012).

However, this dominance of powerful families over decision-making may also limit the effectiveness of outsider directors' efforts to protect minority shareholders' interests for various reasons. First, independent directors have less motivation to perform their stewardship role in the presence of a powerful dominant blockholder. Additionally in accordance with institutional theory, in such a context there is potential for independent directors being ostensibly elected solely to fulfil the SGCR requirements and legitimate the firm's existence (Young *et al.*, 2008). On the basis of these arguments, it can be argued that independent directors play no effective role in constraining executive compensation in KSA. Consequently, the research formulates the following hypothesis:

H1: There is a positively significant relationship between board independence and executive compensation.

b) Role Duality

One important dimension of board composition that is widely discussed by researchers is CEO duality (Ramaswamy *et al.*, 2000; Li *et al.*, 2007; Ntim *et al.*, 2015; Conyon and He, 2011; Shah *et al.*, 2009; Firth *et al.*, 2007; Chalevas, 2011; Conyon and Peck, 1998). CEO duality refers to the situation where the CEO holds the position of board chairman simultaneously (Core *et al.*, 1999). This combination of positions in the hands of a single person increases the power of the CEO not only over the management but also over the board of directors. Power can be defined here as "the capacity of individual actors to exert their will" (Shah *et al.*, 2009, p. 151). Therefore, the CEO will serve as an executive manager and a supervisor of managerial activities simultaneously. Recently, CEO/chairman duality has received considerable attention from researchers and has been utilised as a reliable measurement for CEO power (Ntim *et al.*, 2015; Conyon and He, 2012; Rashid, 2013).

This duality of roles leads agency theorists to believe that granting excessive power to management will probably increase the agency costs through the implementation of higher managerial pay (Jensen, 1993; Core *et al.*, 1999). Moreover, Jensen (1993) argues that the self-pecuniary goals of the CEO conflict with the duties of the chairperson of the board of directors, who is in charge of assessing and paying top executives. Therefore,

executive remuneration level is determined according to the power of the CEO over pay decisions (Ramaswamy *et al.*, 2000).

The rationale behind the assumption that CEO duality will strengthen CEO control over the board of directors can be attributed to several factors. First, when the CEO serves as chairperson, he/she will be able to communicate directly and frequently with other directors of the board (Ozdemir and Upneja, 2012). Hence, board independence may be severely impaired (Finkelstein and D'aveni, 1994; Chalevas, 2011). Furthermore, role duality will constrain the board of directors from performing their primary duty, which is to hold the management to account. For example, Goyal and Park (2002) observe very low sensitivity between CEO turnover and firm performance when the CEO acts as the chairperson of the board of directors at the same time. Thus, having two different people in the roles should increase the objectivity of CEO compensation (Ramaswamy *et al.*, 2000).

However, proponents of stewardship theory challenge the pessimistic view of the agency model with regard to CEO behaviour (Davis *et al.*, 1997; Donaldson and Davis, 1991; Muth and Donaldson, 1998). Some scholars argue that leaders can perform their stewardship role correctly, if they have been granted trust, proper authority and discretion (Muth and Donaldson, 1998). They believe that the orientation of the manager's utility is collective rather than individual, because the success of the firm equates to his/her own success (Donaldson and Davis, 1991). In other words, if the company achieves a superior performance, the CEO will indeed earn more rewards in recognition of his/her efforts. Structurally, therefore, the CEO can be granted the required authority if he/she also chairs the board of directors (Lin, 2005; Muth and Donaldson, 1998).

The outcomes of most empirical studies confirm the view of agency theory towards CEO duality; i.e. when the CEO also serves as the board chairman, he/she will extract higher compensation (Ozdemir and Upneja, 2012; Fahlenbrach, 2009; Sapp, 2008; Chen *et al.*, 2011; Chen *et al.*, 2010b; Conyon and He, 2012; Core *et al.*, 1999). Moreover, Petra and Dorata (2008) observe a low ratio of performance pay to total CEO compensation when the CEO also chairs the board. Other studies, however, find no significant association between the two variables (Ramaswamy *et al.*, 2000; Li *et al.*, 2007; Ntim *et*

al., 2015; Conyon and He, 2011; Shah *et al.*, 2009; Firth *et al.*, 2007; Chalevas, 2011; Conyon and Peck, 1998).

In contrast, the stewardship model does not appear to explain the reality of executive compensation. For example, only two studies found a negative and significant relationship between CEO/chairman duality and CEO compensation. The first study (Chalmers *et al.*, 2006) observes that when the CEO has higher power, he/she earns lower compensation in the form of shares. However, this finding can be interpreted in a different way; i.e. because the CEO was able to influence his/her pay decisions, he/she preferred to receive lower compensation related to firm performance. Thus, the result may support the agency theory argument. Meanwhile, the other study (Rashid, 2013) finds that CEO duality negatively and significantly affects CEO remuneration. This can be attributed to the fact that Bangladesh (the location of the study) is a developing country where families have absolute control over firms; thus, CEOs who also chair the boards are usually family members who have blocks of shares and seek organisational profits rather than self-utility through higher compensation.

The situation in Saudi Arabia is fairly similar to that of Bangladesh; i.e. family members are present in most firms' boards and managements. Despite the fact that SRCG mandates that firms diversify the positions of CEO and board chairperson, 15% of board chairpersons perform executive functions and hold positions in other names rather than CEO. Hence, this study uses an alternative method to measure executive power, i.e. the combination of the position of chairperson with any other executive post. As most chairpersons are family members, their power is increased. Therefore, it can be argued that, practically speaking, there is no separation between ownership and control in the KSA. In addition, blockholders can maximise their wealth much more effectively by achieving higher organisational profits than by earning higher executive compensation (Ozkan, 2007; Cheng and Firth, 2006). Accordingly, the study develops the following hypothesis:

H2: There is a negatively significant relationship between role duality and executive compensation.

c) Blockholder Chairman

The position of board chair is of paramount importance, not only for its prestigious features but also for its influential role (Nada and Andrew, 2007; Ding *et al.*, 2015). That is to say, it grants its occupier the power and authority to set meetings' agendas and supervise the processes of hiring, firing, and compensating top executives (Jensen, 1993; Petra and Dorata, 2008). Moreover, the chairperson's position is considered to be more powerful than those of other directors as it carries the legal right to cast an additional vote in certain countries, such as Germany and The Netherlands (Commission, 2013; Douma, 1997). For these advantages, large shareholders usually compete for chairing board of directors.

The author failed to find any empirical study that examines the relationship between a blockholder chairman and managerial pay. However, Alagla (2012), who uses a UK sample, finds that the greater the proportion of chairperson ownership, the lower the CEO remuneration. In other words, when the chairperson holds more shares and, hence, greater power, his/her monitoring effectiveness over CEO compensation increases. Moreover, Conyon and He (2004) found a negative and significant relationship between the presence of a blockholder on the remuneration committee and CEO pay level in the US.

In Saudi Arabia, where power distance is scored at 95% by The Hofstede Centre (2014), the chairperson receives high levels of respect by all parties including the board of directors, management, the public, and other stakeholders. Hence, large shareholders normally utilise their voting rights and influence to win this prestigious and powerful position. This attitude is supported by the fact that 70% of Saudi corporate boards are chaired by blockholders. The combination of occupying such a position and holding a block of voting rights increases the chairman's control over all other parties including the executive team. Therefore, if the chairman holds both dimensions of power, his influence and contribution in restricting executive compensation are expected to be greater. Accordingly, the research formulates the following hypothesis:

H3: If the board of directors is chaired by a blockholder, top managers will receive significantly lower compensation.

d) Chairman Multi-Directorships

Due to the importance of the chairperson's position, it is worth studying other characteristics in depth such as chairman directorships on other company boards. The debate regarding this matter has revealed two opposing perspectives. Fama and Jensen (1983b) argue that when a director holds multi-memberships of other corporate boards, he/she will gain more knowledge and experience. In so doing, his/her monitoring performance will be greatly improved; therefore, this will lead to a reduction in the level of executive compensation. Moreover, sitting on other companies' boards gives the director more opportunities to use benchmarking criteria for managerial compensation. In contrast, Ozdemir and Upneja (2012) argue that serving on other corporate boards leads to reduced supervisory efficiency. Their argument matches that of Petra and Dorata (2008) who also believe that multi-directorships will reduce the time and effort allocated to each company.

Although no single study has examined the relationship between chairman multi-directorships and executive compensation, some researchers have investigated the multi-directorships held by board members, including the chairman. For example, Core *et al.* (1999), who uses a US sample, finds that when outside directors have seats on four or more boards, the CEO receives higher perks packages. This outcome is also supported by the findings of other studies (Armstrong *et al.*, 2012; Ozdemir and Upneja, 2012; Sapp, 2008). In Saudi Arabia where the majority of corporate boards are chaired by large shareholders, approximately 70% of board chairmen are members of other companies' boards. This may signify that large shareholders have strong connections and influence on other companies. However, with respect to executive compensation practices, these large multi-directorships held by chairmen are expected to positively affect the supervisory function of the board, thereby reducing executive remuneration level. Consequently, this study formulates the following hypothesis:

H4: There is a negatively significant relationship between chairmen with multi-directorships and executive compensation.

e) Existence of a Remuneration Committee

Executive compensation is considered as a remedy for the conflict of interests between managers and shareholders (Jensen *et al.*, 2004); however, the design and

implementation of compensation policies can be also a source of conflict if not being well-designed (Méndez *et al.*, 2011). To avoid conflict, good corporate governance regulations recommend that boards of directors transfer the responsibility for pay-setting to a remuneration committee comprised wholly or mainly of independent members (Girma *et al.*, 2007; Méndez *et al.*, 2011). According to the optimal contracting model, the negotiation process between board of directors and top executives is assumed to be rational and unbiased (Chen *et al.*, 2010b). In this sense, the influence of managers over their own compensation decisions is tenuous. Therefore, the remuneration committee is expected to enhance the design and effectiveness of managerial incentives and thereby close the gap of interests between managers and shareholders (Chen *et al.*, 2010b).

However, in Saudi Arabia, there is no requirement for the independence of the remuneration committee. Furthermore, CEOs and other senior executive are allowed to participate in the remuneration committee. From the view of managerial power model, the presence of affiliated directors or executive members leads to higher levels of executive pay and, in general, poorly structured incentive packages (Bebchuk and Fried, 2009). In contrast, institutional theory argues that companies in emerging economies often are dominated by large shareholders and operate in weak institutional settings. Hence, there is a likelihood that a remuneration committee is only established to meet regulatory requirements, while in practice the board of directors is solely responsible for decisions related to executive pay (Young *et al.*, 2008). Empirically, most studies investigate the impact of the presence of a remuneration committee on pay-setting have been conducted in East Asia and find that remuneration committees in fact increase executive compensation (Conyon and He, 2012; 2011; Chen *et al.*, 2010b). Therefore, the study develops the following hypothesis:

H5: There is a positively significant relationship between the existence of a remuneration committee and executive compensation.

3.4.1.2 Ownership Structure:

a) Director Ownership

Agency theory argues that management interests need to be aligned with those of the shareholders; moreover, the interests of the board of directors should be matched with those of the shareholders in order to ensure their focus on firm performance and

their real independence from management (Muth and Donaldson, 1998). In this context, Minow and Bingham (1995, p. 497)cited by Muth and Donaldson (1998), state that "nothing makes directors think like shareholders more than being shareholders". Shareholding will transform board members from delegated directors into shareholders; hence, they are expected to fulfil their supervisory commitment in a more effective way. However, a significant holding of company shares by the board members may cause principal-principal conflict, especially in emerging economies (Young *et al.*, 2008), i.e. a conflict of interests between large shareholders and minority ones. Furthermore, Jensen and Ruback (1983) argue that when director ownership exceeds a certain proportion, there is a risk of them colluding with management to take decisions that may not maximise corporate value. In other words, these decisions may benefit only the large shareholders, such as decisions related to mergers or takeovers (Ozdemir and Upneja, 2012).

Several empirical studies support the role that director ownership can play in enhancing governance quality by limiting executive perks. These studies observe a negative and significant association between the level of equity held by board members and managerial pay (Méndez *et al.*, 2011; Sapp, 2008; Ntim *et al.*, 2015; Ozkan, 2011). However, other research fails to find any significant impact either from share ownership of the entire board (Rashid, 2013; Hearn, 2013) or share ownership by outsider directors (Cheng and Firth, 2006; Chalmers *et al.*, 2006; Core *et al.*, 1999) on executive compensation arrangements. Consequently, based on the previous findings and due to fact that most Saudi corporations have a large shareholder on the board, the following hypothesis is developed:

H6: There is a negatively significant relationship between director ownership and executive compensation.

b) Pension Fund Ownership

One of the effective mechanisms believed to reduce agency costs is institutional equity. This type of ownership has recently received a great deal of attention with regard to its role in resolving agency problems resulting from the separation of ownership and control (Rashid, 2013; Lin *et al.*, 2011; Chalevas, 2011; Ozkan, 2007). The rationale behind the reduction in agency problems is related to the size of the stake that institutional bodies usually hold in a company (Ozkan, 2007). Institutional investors tend

to own more equity than individuals. Thus, they have greater incentives to monitor executive actions, especially those related to their compensation. This argument may be true, because the benefits that institutional investors gain from performing the supervisory function are more likely to exceed the costs incurred (Shleifer and Vishny, 1986).

Furthermore, Colpan and Yoshikawa (2012) argue that institutional investors may have objectives such as growth rather than earning immediate profits. In other words, institutional investors can be classified as growth-seekers rather than profit-seekers. Therefore, they would prefer to link executive compensation to long-term rather than short-term performance (David *et al.*, 1998). Moreover, Qi *et al.* (2000) posit that institutional investors have experts who are able to supervise managerial actions more effectively than individual investors. Recently, many empirical studies have investigated the relationship between institutional ownership and managerial pay level and most find support for the above argument. For example, Ntim *et al.* (2015) find that when institutional ownership increases, executive managers earn less remuneration. Other studies find similar results (Ozkan, 2007; Lin *et al.*, 2011; Chalevas, 2011; Fahlenbrach, 2009; Ramaswamy *et al.*, 2000). However, other researchers find no significant association between the level of institutional shareholding and managerial compensation in emerging countries such as Bangladesh and Pakistan (Rashid, 2013; Shah *et al.*, 2009).

The term 'institutional ownership' in academic research usually refers to the equity held by financial institutions such as banks and insurance companies or by mutual funds (Colpan and Yoshikawa, 2012; Brickley *et al.*, 1988); however, this study uses the term 'institutional ownership' to refer to shares owned by public pension funds only. This unique classification is used because the Saudi Banking Control Law prevents financial institutions from owning in excess of 10% of a company's shares (SAMA, 1966). Therefore, unlike other countries, the presence of financial institutions in the SSE is rare; and even if they do participate, they do not have a controlling share. In contrast, public pension funds hold more equity in the SSE. Public pension funds are considered 'pressure-resistant' investors because they have no direct business relationship with the management (Colpan and Yoshikawa, 2012). Accordingly and based on the empirical results of prior studies, this research formulates the following hypothesis:

H7: There is a negatively significant relationship between pension fund ownership and executive compensation.

c) State Ownership

State investment in the Saudi Stock Market is high in comparison with advanced countries; indeed, the state owns approximately 20% of the market value (Aleqtisadiah, 2014). Because the state is an important player in the Saudi market, this allows it to influence market trends and attitudes. Even though the heads of public pension funds are appointed by the central government in Saudi Arabia, the investments of pension funds espouse different objectives and motives from those of the state in many aspects (Li *et al.*, 2007). For example, the state controls a number of giant corporations that are believed to provide essential facilities, such as telecommunications companies or for economic and security purposes such as companies operating in the energy sectors. Therefore, their primary investment goals are not profitability or growth, unlike pension funds. Moreover, the state attempts to play an indirect substitutive role of market-maker to stabilise the stock market, which is different from pension funds which aim to maximise the funds' welfare.

However, Li *et al.* (2007) argue that top executives in state-influenced companies may waste much time in pleasing government officials rather than concentrating their efforts on achieving the firm's goals. This may negatively affect minority interests and hence lead to the emergence of the principal-principal conflict (agency problem type II) (Conyon and He, 2012). Furthermore, the authors add that state representatives on firms' boards have difficulty in distinguishing between their functional duties as investors' representatives and their administrative role as government officials.

Most studies (Conyon and He, 2012; Li *et al.*, 2007; Ramaswamy *et al.*, 2000; Chen *et al.*, 2011; Firth *et al.*, 2007; Hearn, 2013) that examine the role of state ownership are conducted in emerging countries, because the structure of ownership in developed contexts is usually based around institutional and foreign investments (Khan, 2006; Li, 1994). Various academic research in China, where the state has a dominant share of the stock market, finds that state ownership is negatively and significantly associated with managerial rewards (Firth *et al.*, 2007; Chen *et al.*, 2011). However, Hearn (2013) observes that when state ownership increases, managers earn higher compensation.

Nevertheless, others find no relationship between state investment and executive remuneration (Conyon and He, 2012; Li *et al.*, 2007; Ramaswamy *et al.*, 2000).

In the KSA, due to the regulatory restrictions that ban financial institutions from investing in the SSE, state ownership may play a substitutive monitoring role that is carried out by financial bodies in other markets. Moreover, the Saudi government attempts to be a role model for other large investors in protecting minority interests from any malicious decisions made by management, such as unmerited excessive compensation. Consequently, this study formulates a hypothesis as follows:

H8: There is a negatively significant relationship between state ownership and executive compensation.

3.4.2 Sample Selection and Data Collection

This section provides details about the sources of data used in the research and the sample's time frame. Because there is no electronic database available for the information of Saudi firms such as in the developed countries such as the US and the UK, the collecting Saudi data is time-consuming. Therefore, all data were collected manually from company annual reports through the Tadawul database (www.tadawul.com.sa).

The context of Saudi Arabia is chosen for several reasons. First, the political regime in Saudi Arabia is stable; hence, there is no concern about the effect of political instability on the results. Second, since one of the study's objectives is to analyse the role of blockholders on the practices of executive compensation, the ownership structure in Saudi Arabia enable us to achieve this goal. Last, data are accessible, because the transparency of information in Saudi Arabia is much higher than other emerging monarchical countries.

The initial sample contains all 160 listed firms in the SSE in 15 different industries as at December 2015 (www.tadawul.com.sa) and starts in the financial year 2008. This period has been chosen for two key reasons. First, data are available and accessible following the enforcement of corporate governance regulations and their disclosure requirements began in 2008. Moreover, this period provides the most recent investigation in the literature with respect to the determinants of executive compensation, which helps to fill the gap and improve the understanding of pay setting practices.

However, due to the characteristics of heterogeneity between financial and non-financial firms and being subject to different regulatory requirements (Wang and Shailer, 2015), the study uses only non-financial firms. This method is supported by previous studies (Sakawa *et al.*, 2012; Rashid, 2013; Méndez *et al.*, 2011; Ntim *et al.*, 2015; Shah *et al.*, 2009). Therefore, after excluding financial firms, the total examinable sample is 114 firms over the eight-year period of 2008-2015. In addition, a number of firm-year observations have been excluded because: 13 were missing disclosure, 56 firms were not yet listed, and 24 firms were facing bankrupt issues. Consequently, the final unbalanced sample is 819 firm-year observations.

3.4.2.1 Analytical Procedures

This section discusses in detail the statistical methods applied by the thesis to investigate the study's hypotheses. The econometric methods in this discipline can be classified into two main types; parametric and non-parametric estimations (Gujarati, 2003). The best choice of which should be utilised depends on the type, nature, and other characteristics of the data (Alagla, 2012). However, before discussing the econometric methods, a number of issues related to the data should be highlighted.

First, due to the lack of transparency and disclosure practices in some Saudi firms, there were some missing data, particularly relating to corporate governance and executive compensation. In order to eliminate issues with statistical tests, 13 observations which contained missing information were excluded from the total sample.

Second, in order to mitigate the potential bias that outliers may cause in the regression analysis (Sapp, 2008; Randøy and Nielsen, 2002; Edwards *et al.*, 2009), the study has winsorised the "data by replacing the top and bottom 2.5% of observations with the values of the 2.5th and 97.5th percentiles" following the method of Sapp (2008). Moreover, the use of appropriate estimation techniques, such as random or fixed effects regressions with a robust standard error, help to overcome the problem of outliers (Iskander, 2008), thereby delivering more accurate and reliable results.

Finally, the CMA has suspended the shares in three security companies from trading in the SSE for issues related to bankruptcy and fraud. The three companies are Al-Baha Investment and Development Company, Bishah Agriculture Development Company, and Etihad Atheeb Telecommunication Company. Therefore, this study also

eliminated these companies from the total sample as their figures and performance are abnormal and their particular circumstances may significantly affect the findings. This elimination led to the exclusion of 24 observations. Accordingly, after all these exclusions, the study has a final sample of 819 firm-year observations.

Although parametric tests are believed to deliver more accurate and robust outcomes than non-parametric tests (Judge *et al.*, 1985), Gujarati (2003) argues that parametric estimations cannot be employed unless the data meet four assumptions namely normality, linearity, homoscedasticity and independence of error terms. Accordingly, violating one of these assumptions would lead to inaccurate and misleading results; in which case, applying non-parametric tests can be an alternative to overcome such limitations (Balian, 1982). The four assumptions of parametric tests are explained as follows:

1. ***Normality:*** to use parametric tests, data is assumed to be normally distributed. The normality assumption can be tested through different methods, the most common of which are by skewness and kurtosis. Gujarati (2003) states that data can be normally distributed if the values of skewness and kurtosis are within ±1.96 and ±3 respectively.
2. ***Linearity:*** the model under this supposition assumes that the relationship between an independent variable (X) and the dependent variable (Y) is linear. Therefore, any violation to this assumption will under-estimate the true relationship (Ayyangar, 2007).
3. ***Homoscedasticity:*** this assumption requires that the variance of errors is equal across all levels of the independent variables (X). Otherwise, there is an indication of heteroscedasticity, which means the findings will be seriously distorted (Berry and Feldman, 1985).
4. ***Independence of Error Terms:*** error terms of all explanatory variables must be independent from each other and serially uncorrelated. Otherwise, there will be a problem of autocorrelation (Gujarati, 2003).

Moreover, it is necessary to ensure that the data does not statistically suffer from a multicollinearity problem. Multicollinearity refers to the phenomenon when there is an approximate linear relationship between two or more of the independent variables in the same multiple regression model (Kennedy, 2003). In other words, two or more of

explanatory regressors are highly correlated to each other. Consequently, the model might give inappropriate results (Brooks, 2014).

3.4.2.2 Diagnostic Analysis of OLS Assumptions and Analytical Procedures

Following the ordinary least squares (OLS) assumptions discussed above and in order to decide which estimation methods should be used to investigate the study's hypotheses, a number of tests were conducted. According to the results which are discussed below, the data does not meet the required criteria of the parametric tests; thereby parametric techniques are deemed not to be an appropriate method for the study data. Therefore, non-parametric tests are applied to examine the relationships among the study variables.

First, the assumption of normality has been primarily tested by utilising the tests of skewness and kurtosis. The findings reveal that most of the variables are right skewed (further detail can be found in the following chapter) and therefore they are not normally distributed. For further robustness checks, other normality tests were applied including through a graphical methods histogram and Q-Q plot, as well as numerical methods such as Shapiro-Wilk test (Maldajian and El Khoury, 2014). All tests demonstrate that most of the study variables do not meet the normality assumption.

With regards to the assumption of homoscedasticity, the most common method, namely 'Breusch-Pagan Test', was used (Alagla, 2012; Maldajian and El Khoury, 2014). The results indicate that the heteroscedasticity problem was present. Thus, in order to mitigate such problems, it is statistically suggested to transform the dependent variables to their natural logarithm (Ozdemir and Upneja, 2012). Data transformation is a possible solution to overcome the problems of violating the assumptions of parametric tests. Therefore, following previous studies in executive compensation (Conyon, 2014; Rashid, 2013; Ntim *et al.*, 2015; Hearn, 2013; Armstrong *et al.*, 2012; Chen *et al.*, 2010b; Fahlenbrach, 2009; Edwards *et al.*, 2009; Sapp, 2008; Basu *et al.*, 2007; Randøy and Nielsen, 2002), this study transforms the values of all the variables of executive compensation, firm size, and firm age to their natural logarithm.

After doing so, the data was retested against the assumptions of parametric tests, which resolved the heteroscedasticity problem. However, assumptions such as normality were still violated. According to Greene (2008) and (Baltagi, 2008), OLS estimation

becomes inefficient and should not be used if the normality assumption is not met; otherwise, the findings will be biased and misleading. Consequently and in order to overcome such bias and problems, this study will employ non-parametric tests following other key studies (Elston and Goldberg, 2003; Chen *et al.*, 2010b; Conyon and He, 2011; Ntim *et al.*, 2015).

Furthermore, two well-known approaches were applied to detect if any multicollinearity problem exists in the model, namely the variance inflation factors (VIF) and Spearman's rank correlation. The results reveal that no serious multicollinearity exists among the explanatory variables (further details can be found in the following chapter).

Finally and in order to decide which regression techniques are the most appropriate for the study models, the following sub-section will identify and discuss the differences between two basic methods of panel data usually utilised to test the relationships within or between observations. The two approaches are commonly known in such area of research as the least squares dummy variable (fixed effect) and the generalized least squares (random effect) (Baltagi, 2008).

- **Fixed-Effect vs Random-Effect**

Fixed effect regression is an appropriate approach to deal with panel data when there is a belief that the impact of the variables varies over the time. Fixed effect examines the relationship variables within a particular observation such as country, company, etc. Under fixed effect regression, each observation has its own characteristics that may or may not affect or bias other the outcome variables; thus, fixed effect controls for any omitted variables or unobserved heterogeneous characteristics among variables over the time. Moreover, fixed effect assumes that if the omitted regressor does not change over time, then the changes in the dependent variable can be attributed to other effects rather these fixed effects (Conyon, 2014).

In contrast, random effect, which also works effectively with panel data, assumes that the variation across observations is random and uncorrelated to other explanatory variables within the same model (Greene, 2008). Random effect is more suitable if there is reason to believe that the model in general has not omitted any influential predictor variable. The most appropriate technique for a particular model can be determined

according to the Hausman's test (1978) which is one of the most powerful suggested tests with regard to fixed effect and random effect estimates (McKnight and Weir, 2009). This test basically checks if there is a correlation between the errors (u) and the predictors; the null hypothesis means that there is no correlation.

The outcomes shown in Table 3.11 (in the section of data discussion) demonstrate that fixed effect regression is the most appropriate technique to investigate the study hypotheses for all variables except the **BONUS** variable. The dependent variable **BONUS** has censored data and unique characteristics. Since many firms did not provide details of the bonus packages for their managers over the observed years 2008-2015, the data has zeros that exceed 20% of the total observations. Therefore, as this dependent variable is limited, it needs a special regression technique that can overcome such limitations.

The Tobit regression approach is a powerful test that deals with censored data such as the **BONUS** variable. This model was proposed by Tobin (1958) and aims to estimate the relationship between a non-negative dependent variable and an explanatory variables over time. By using this method, the model can specify lower and/or upper censoring values; thereby, it assumes that the lower is the minimum value and the upper is the maximum value. In the **BONUS** case, the Tobit model censors zero values and estimates more accurate unbiased coefficients (Anderson and Bizjak, 2003). The use of Tobit regression is consistent with prior studies that encountered similar limited dependent variables, such as option packages (Anderson and Bizjak, 2003; Sakawa *et al.*, 2012; Ozkan, 2007).

Given the above discussion, the study uses the fixed effect model for the dependent variables namely **SALARY**, **TOTAL CASH**, and **TOTAL PAY**, whereas, the Tobit model is applied for the **BONUS** variable. For further checks, the study uses several robustness and sensitivity tests.

3.4.3 Measurements of executive compensation

Identifying the various components of executive compensation and measuring them reliably is one of the most methodological challenges in the literature related to executive compensation. In terms of the nature of executive pay, the inconsistent use of terminology for each component of compensation, makes the issue of compensation identification more challenging. For example, while some firms use the term 'bonus' to

refer to short-term compensation that is granted for previous performance, other firms use the term 'short-term incentives' for the same component (Alagla, 2012). Thus, the use of a clear and systematic method of identifying and classifying executive pay components is an essential condition in ensuring accuracy and reliability of executive compensation measurements. Indeed, failure to do this makes comparability with the prior literature difficult.

Previous studies (Ozkan, 2007; Sapp, 2008; Ntim *et al.*, 2015) have used different classifications of executive compensation based on its nature. There are two common classifications in the literature; the first classifies compensation based on time-horizon criteria i.e. short-term and long term incentives, while the second uses pecuniary criteria i.e. cash and non-cash incentives. Accordingly, as the use of long-term incentives in Saudi Arabia are virtually absent (i.e. there is no compensation in the form of stock options) and most Saudi firms disclose the compensation of top executives in the form of salary, bonus, and other compensation, this research adopts the classification that is based on pecuniary criteria (i.e. cash and non-cash pay).

Studies such as (Eichholtz *et al.*, 2008; Conyon and Sadler, 2001; Alagla, 2012) define cash compensation as all pecuniary incentives that are awarded by a firm and received by executives in one fiscal year including salary, bonuses, benefits, allowances, etc. Compared with non-cash or equity-based incentives, cash compensation packages are easily measured and clearly disclosed in the firms' annual reports. In the detailed analysis, this study investigates the impact of corporate governance on three components of cash compensation, namely salary, bonus and total cash compensation. Measurements of salary and bonus are taken from the remuneration report of the relevant firm for a specific fiscal year. Whereas, total cash compensation is measured as the sum of salary, bonus and all other reported cash compensation (i.e. benefits, allowances, perquisites, etc.) that are earned by the senior executives during the year.

Meanwhile, although non-cash pay, such as equity-based compensation or other non-cash incentives, are widely used in the West (Chalmers *et al.*, 2006; Chhaochharia and Grinstein, 2009), this type of compensation is rarely practiced in the Saudi context. Only a few firms provide non-cash compensation and is almost always granted in the form of expenses, such as travel costs and accommodation, or granted in the form of privileges, such as cars and housing. The levels of these compensations are disclosed and

classified separately in the remuneration report as non-cash compensation in the form of a cash equivalent. Therefore, a comparison of cash and non-cash elements is easily achieved, as is the total compensation level. The last variable related to executive compensation is the total compensation, which is the sum of all compensation whether in the form of cash or non-cash compensation, that is received by an executive in a fiscal year.

3.4.4 Models' Specifications

The first empirical model is developed to investigate the hypotheses of the relationship between corporate governance and executive compensation settings. The model contains four dependent variables that allow the effect on various constituents of executive compensation packages, namely **SALARY**, **BONUS**, **TOTAL CASH**, and finally **TOTAL PAY** to be examined (see Table 3.2). The study is not investigating other types of compensation such as options, because such rewards are not legal under Saudi law. Based on the results of Hausman tests, the research formulates the fixed-effect models of the dependent variables **SALARY**, **TOTAL CASH**, and **TOTAL PAY** as follows:

$$\boldsymbol{ln\_PAY_{it}} = \boldsymbol{\beta_0} + \boldsymbol{\beta_{it}} \boldsymbol{X_{it}} + \boldsymbol{u_i}$$

Where;

$\boldsymbol{\beta_0}$ = Intercept

$\boldsymbol{\beta_{it}}$ = Coefficient of slope parameters

$\boldsymbol{X_{it}}$ = Independent variable i at time t, and

$\boldsymbol{u_i}$ = Error term

While, the **Tobit** model for the **BONUS** component is formed as follows:

$$\boldsymbol{ln\_BONUS_{it}} = \begin{cases} \boldsymbol{ln\_BONUS^{*}_{it}} = \boldsymbol{\beta_0} + \boldsymbol{\beta_{it}} \boldsymbol{X_{it}} + \boldsymbol{u_i} & \boldsymbol{if} \quad \boldsymbol{ln\_BONUS^{*}_{it}} > \mathbf{0} \\ \mathbf{0} & \boldsymbol{if} \quad \boldsymbol{ln\_BONUS^{*}_{it}} \leq \mathbf{0} \end{cases}$$

Where:

$\boldsymbol{ln\_BONUS_{it}}$ is the observed dependent variable and $\boldsymbol{ln\_BONUS^{*}_{it}}$ is a latent dependent variable that is observed for values greater than 0 and censored otherwise.

Table 3.2: Variable Definitions

Variable name	Description
Dependent variables	
ln_PAY it	The natural logarithm of average compensation per executive for firm *i* in year *t*, including three different components (variables): - **TOTAL PAY** (cash & non-cash) - **TOTAL CASH** (salary & bonus) - **SALARY**
ln_BONUS it	The natural logarithm of average **bonus** compensation per executive for firm *i* in year *t*.
Independent variables	
BRDIND	The proportion of independent directors to total board members.
DUAL	A dummy variable that equals 1 if the chairman simultaneously holds an executive position and 0 otherwise.
CHRBLK	A dummy variable that equals 1 if the board chairman is a blockholder and 0 otherwise.
CHRMDs	A dummy variable that equals 1 if the board chairman has membership on board of directors of other firms.
REXIST	A dummy variable that equals 1 if the firm has a remuneration committee and 0 otherwise.
DIROWN	The proportion of ordinary shares owned by the members of board of directors.
PFOWN	The proportion of ordinary shares owned by public pension funds.
STATEOWN	The proportion of ordinary shares owned by the Saudi government.
Control variables	
FSIZE	The natural logarithm of the total assets.
LEV	Total debt divided by total assets.
FAGE	The natural logarithm of total number of years since the firm has been listed on the stock exchange.
ROA	Net profit in year t-1 divided by total assets in year t-1.

3.5 DATA ANALYSIS AND DISCUSSION

3.5.1 Descriptive Statistics

The study utilities the most common descriptive statistics which include the mean, median, minimum, maximum, skewness, and kurtosis. These statistics provide a comprehensive view of the state and direction of the study variables in KSA. Furthermore, the average values (the mean) of the variables for the pooled sample are analysed, taking into consideration the differences between industries and years.

According to Gujarati (2003) and Haniffa and Hudaib (2006), the data can be normally distributed if the values of skewness and kurtosis are within ±1.96 and ±3, respectively. By applying these criteria to the study data, there is evidence that the data does not meet the normality assumption required by parametric tests. For example, Table 3.3 shows that all skewness and kurtosis values of executive compensation variables exceed the value of 1.96 and 3, respectively, even after the transformation of the remuneration variables into their natural logarithm. Furthermore, Table 3.6 also demonstrates that independent variables such as **DUAL, RCEXIST**, **DIROWN**, **PFOWN**, **STATEOWN**, **FSIZE**, and **LEV** do not meet the criteria of skewness as they are highly right skewed. Similarly, most independent variables are found to have values of kurtosis that exceed 3.

3.5.1.1 Descriptive Statistics for Executive Compensation

Table 3.3 displays the descriptive statistics of all the executive remuneration variables (i.e. **TOTAL PAY, TOTAL CASH, SALARY** and **BONUS**). All compensation components are presented in Saudi Arabian Riyals (SAR) which has a fixed exchange rate equal to approximately 0.267 US dollars (USD). As can be seen in Table 3.3, the average of total compensation (**TOTAL PAY**) is SAR1,511,352 (approximately USD403,530) with a median of SAR1,029,433 (USD274,858) and a range from SAR12,000 (USD3,204) to SAR28,100,000 (USD7,502,700). This demonstrates that managers in KSA are rewarded significantly higher compensation than their counterparts in China, who receive nearly USD66,336 (Conyon and He, 2012, p. 580). This can be attributed to the socialist system applied in China which significantly reduces the variance in labour wages.

However, the level of executive remuneration in KSA is significantly lower than in Western countries such as the US, UK and Spain where managers earn nearly USD3.0

million (Conyon, 2014, p. 76), USD2.4 million (Alagla, 2012), and USD1.1 million (Méndez *et al.*, 2011, p. 62) respectively. This significant difference between managerial pay in KSA and the West can be attributed to several factors, such as the existence of a highly competitive labour market, the usage of benchmark standards, living costs levels, and linking incentives to firm performance. Table 3.3 also shows details of other compensation components. As can be seen, the average **TOTAL CASH**, **SALARY,** and **BONUS** compensation are SAR1,498,481, SAR983,414, and SAR515,067, respectively, while the median **TOTAL CASH**, **SALARY,** and **BONUS** compensation are SAR1,029,433, SAR800,275, and SAR170,000, respectively.

Table 3.3: Descriptive Statistics of Executive Compensation Variables

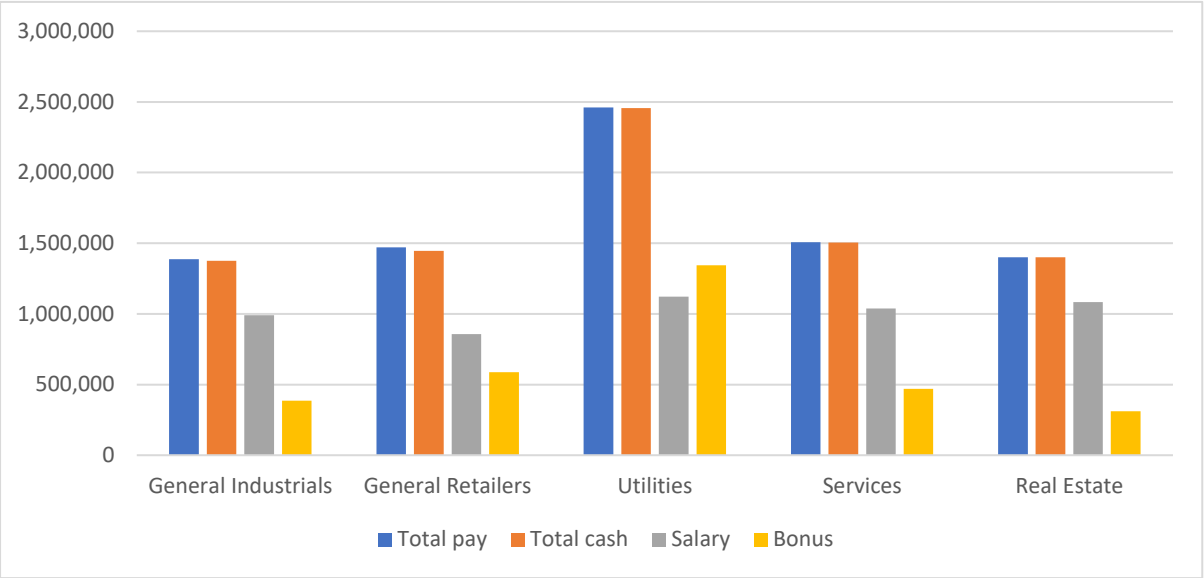
Variable	Mean	Median	Min	Max	Skewness	Kurtosis
TOTAL PAY	1,511,352	1,029,433	12,000	28,100,000	6.53	77.85
TOTAL CASH	1,498,481	1,029,433	12,000	28,100,000	6.65	80.39
SALARY	983,414	800,275	9,000	28,100,000	16.15	370.08
BONUS	515,067	170,000	0	12,900,000	6.30	59.32

Table 3.4 and Figure 3.1 display the mean of executive compensation variables based on the industry type. The study follows the industrial classification reported in Thomson One Banker database which classifies Saudi firms into five main sectors, namely General Industrials, General Retailers, Utilities, Services, and Real Estate. As can be seen, managers in the Utilities sector receive the highest remuneration (**TOTAL PAY**). This sector also appears to use pay-for-performance criteria, because only in this sector do **BONUS** packages exceed the fixed compensation (**SALARY**). A brief glance at the ownership structure in Figure 3.4 reveals that the State investment (**STATEOWN**) is the main dominant investor in the Utilities sector; hence, this might be preserved as an indication that, the greater the state investment, the stronger the link between managerial pay and firm performance.

Table 3.4: Average of Executive Compensation Variables by Sector

Variable	General Industrials	General Retailers	Utilities	Services	Real Estate
TOTAL PAY	1,386,594	1,469,802	2,460,424	1,505,968	1,399,638
TOTAL CASH	1,376,275	1,446,245	2,455,247	1,504,598	1,401,200
SALARY	989,688	857,489	1,122,364	1,038,310	1,083,685
BONUS	385,290	587,546	1,343,997	468,785	310,993

Figure 3.1: Executive Compensation Variables by Sector



On the other hand, the Real Estate sector grants the lowest **BONUS** perks and the second highest **SALARY**. According to Figure 3.4, the Real Estate industry has a low ownership concentration; therefore, this may indicate the management has control over the pay-setting process. Finally, and in general, the other sectors (General Industrials, General Retailers and Services) show similar trends to each other in terms of the magnitude of executive remuneration variables.

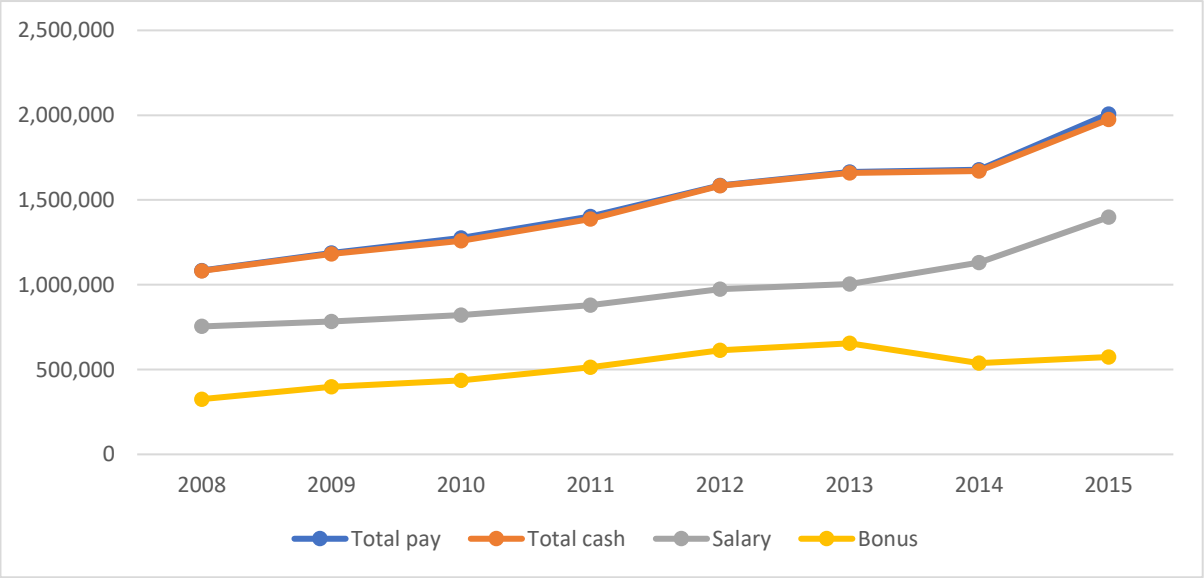
Table 3.5 and Figure 3.2 present the change in the average of executive remuneration variables during the period 2008-2015. Since 2008 all managerial perks packages have gradually trended upwards. For instance, **SALARY** is nearly doubled from SAR754,268 in 2008 to SAR1,398,213 in 2015. Furthermore, bonus perquisites have increased by nearly 76% from 377,547 SAR in 2008 to 664,487 SAR in 2015. Figure 3.2 demonstrates that **BONUS** had almost similar trend to that of **SALARY**. Thus, **BONUS** might be used as another means of increasing executive compensation even without any consideration of firm performance

Table 3.5: Average of Executive Compensation Variables by Year

Year	TOTAL PAY	TOTAL CASH	SALARY	BONUS
2008	1,084,231	1,082,405	754,268	325,693
2009	1,188,071	1,181,591	783,944	397,568
2010	1,276,917	1,258,656	820,435	437,031

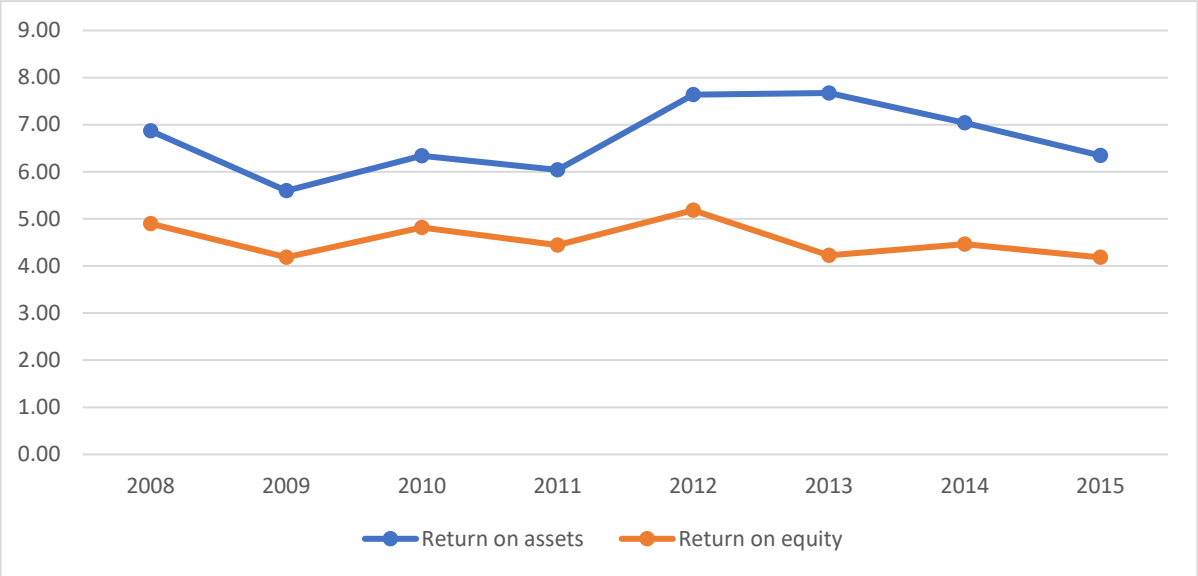
2011	1,403,069	1,388,081	879,909	512,877
2012	1,586,649	1,583,990	973,803	612,806
2013	1,664,908	1,659,918	1,003,428	654,856
2014	1,677,972	1,671,500	1,130,717	538,629
2015	2,007,184	1,974,729	1,398,213	573,286

Figure 3.2: Trend of Executive Compensation Variables (in SAR), 2008-2015



This argument is supported by the data highlighted in Figure 3.3, which shows the performance of firms during the eight years; i.e. there was a fluctuation in firm performance, whereas executive **BONUS** has shown an upward trend during the same period. In contrast, **TOTAL PAY** and **TOTAL CASH** also show a very similar trend and magnitude which means that non-cash compensation is not significant in the Saudi context and that executive compensation is predominantly granted in cash.

Figure 3.3: Firm Performance (%), 2008-2015



3.5.1.2 Descriptive Statistics for Corporate Governance and Ownership Variables

Table 3.6 presents the descriptive statistics for all independent variables of the first empirical study. As can be seen, nearly 46% of Saudi boards' members are independent (**BRDIND**). The finding is consistent with the SCGR which requires at least one third of the seats of boards of directors to be occupied by independent members (CMA, 2010). However, the result is still significantly lower than the situation in developed countries where boards of directors consist mainly of independent members. For example, Armstrong *et al.* (2012) uses a sample from the US in 2006 and found that 71% of boards of directors' members were outsiders. Moreover, Alagla (2012), which is based on a UK sample for the years 2004-2008, states that the independence level of boards of directors is nearly 51%.

Furthermore, only 15% of Saudi firms appear to endorse role duality (**DUAL**). In other words, 85% of board chairpersons are not affiliated with any executive functions. This proportion (15%) is significantly lower than the situation in the US where Petra and Dorata (2008), who use a sample from the US market in 2004, found that 52% of chairpersons act as CEOs simultaneously. These statistical findings provide reliable evidence and support the research argument that the practical governance norms in the Anglo-American contexts are significantly different from the ones that exist in Saudi Arabia. Thus, the findings question the validity of generalising the Anglo-American model

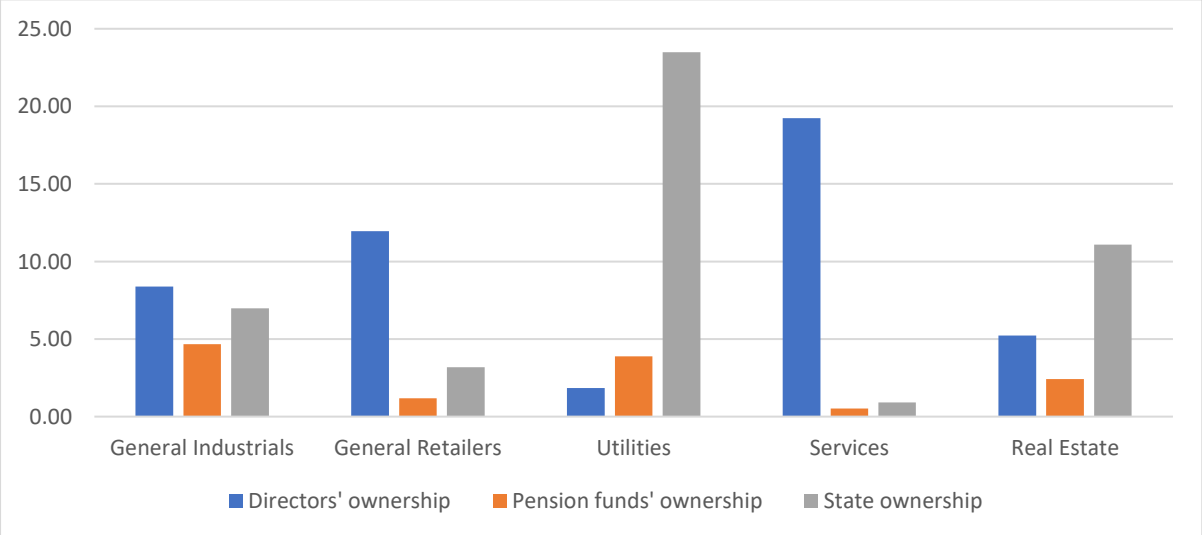
of corporate governance in emerging economies, such as the KSA, which is subject to different institutional and ownership structure.

Table 3.6: Descriptive Statistics of Independent Variables

Variable	Mean	Median	Min	Max	Skewness	Kurtosis
BRDIND %	45.96	42.86	0	100	0.83	3.28
DUAL	0.15	0	0	1	1.99	4.94
CHRBLK	0.69	1	0	1	-0.85	1.72
CHRMDs	0.70	1	0	1	-0.87	1.76
RCEXIST	0.92	1	0	1	-3.11	10.69
DIROWN %	9.18	1.88	0	95.84	2.75	12.30
PFOWN %	3.24	0	0	35.10	2.38	9.30
STATEOWN %	7.44	0	0	81.21	2.56	8.74
FSIZE ('000,000)	12,600	2,110	54	358,000	6.18	44.21
LEV %	37.41	34.95	0.41	463.09	5.64	91.66
FAGE	2.52	2.83	0	4.11	-0.52	2.31
ROA %	6.73	5.66	-67.81	49.27	-0.30	12.20

Regarding the variables related to board chairpersons, Table 3.6 highlights that 69% of board chairmen are blockholders (**CHRBLK**) and 70% serve on other boards (**CHRMDs**). With respect to the ownership structure in the Saudi market, directors (**DIROWN**) are found to be the largest investors since they own over 9% of the Saudi stock market, whereas the ownership of state (**STATEOWN**) and pension funds (**PFOWN**) is 7.4% and 3.2%, respectively.

Figure 3.4: Ownership Variables by Sectors



Across industrial sectors, Table 3.7 highlights that Utilities, Services and Real Estate are the most affected by role duality (**DUAL**) since roughly 25% of their chairpersons are executives. Table 3.7 also confirms that directors (**DIROWN**) are the largest and most dominant investors in three industries, namely General Industrials, General Retailers and Services, whereas state investment (**STATEOWN**) is concentrated in and dominates the Utilities and Real Estate sectors. In contrast, pension fund investments (**PFOWN**) appear to be smaller than those of directors (**DIROWN**) and state (**STATEOWN**), showing a well-structured diversification across market industries.

Table 3.7: Average of Governance and Ownership Variables by Sector

Variable	General Industrials	General Retailers	Utilities	Services	Real Estate
BRDIND %	44.03	48.47	45.32	43.12	52.70
DUAL	0.14	0.08	0.23	0.25	0.23
CHRBLK	0.68	0.71	0.62	0.85	0.67
CHRMDs	0.78	0.71	0.30	0.69	0.64
RCEXIST	0.93	0.91	0.90	0.95	0.91
DIROWN %	8.38	11.95	1.84	19.25	5.23
PFOWN %	4.67	1.18	3.88	0.51	2.42
STATEOWN %	6.97	3.18	23.49	0.90	11.09

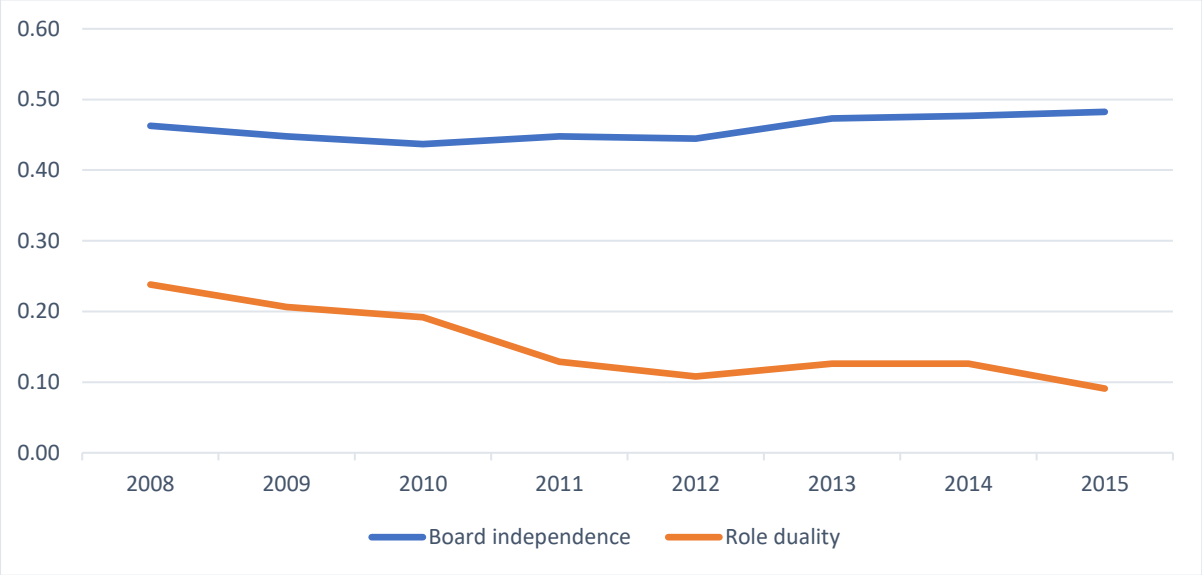
Table 3.8 represents the changes that occurred in the governance and ownership variables during the eight-year period. The independence level of board of directors (**BRDIND**) has increased slightly from 46.3% in 2008 to 48.3% in 2015. The Table also highlights a significant reduction in the number of chairmen who perform executive duties simultaneously (**DUAL**). That is to say, 24% of corporate boards had executive chairpersons in 2008; in contrast, only 9% of firms had them in 2015

Table 3.8: Average of Governance and Ownership Variables, by Year

Variable	2008	2009	2010	2011	2012	2013	2014	2015
BRDIND %	46.28	44.80	43.68	44.76	44.46	47.33	47.68	48.25
DUAL	0.24	0.21	0.19	0.13	0.11	0.13	0.13	0.09
CHRBLK	0.62	0.68	0.70	0.70	0.72	0.71	0.71	0.69
CHRMDs	0.63	0.64	0.69	0.71	0.73	0.73	0.72	0.72
RCEXIST	0.55	0.77	0.95	0.99	1	1	1	1
DIROWN %	10.28	10.87	10.62	10.21	9.08	8.04	7.86	7.25
PFOWN %	2.66	3.21	3.22	3.31	3.42	3.41	3.36	3.20
STATEOWN %	6.96	8.03	7.57	7.61	7.16	7.16	7.21	7.81

Overall, it can be argued that the general attitude of Saudi firms shows a high degree of compliance with the recommendations of SCGR during the years under review. This argument is demonstrated in Table 3.8 and Figure 3.5, which show a gradual increase in the independence of board of directors (**BRDIND**) and a downward trend in the role duality (**DUAL**) over the eight-year period of 2008-2015. Furthermore, there was a strong adherence with respect to the establishment of remuneration committee (**RCEXIST**), while in 2008 only 55% of firms have established a sub-committee related to remuneration matters, in 2015 all firms are found to have the committee.

Figure 3.5: Trends of Board Independence and Role Duality Variables, 2008-2015



3.5.2 Correlation Coefficients

According to Table 3.9, the results of the correlation matrix show that no serious collinearity problem exists between the regressors i.e. all pairwise correlations between explanatory variables are lower than 80% (Gujarati, 2003; Hair *et al.*, 2006). Even though some of the dependent variables are highly correlated with each other, there are no concerns about the collinearity problem, since multicollinearity is relevant only between the independent variables, as the dependent variables are analysed in separate models. Table 3.9 shows that the highest correlation (0.40) is between the firm size (**FSIZE**) and pension fund ownership (**PFOWN**). Firm size (**FSIZE**) is also found to have the highest correlations with other independent variables, although the coefficients are statistically insignificant. Accordingly, it can be concluded that all correlations of independent

variables lie in the acceptable range of pairwise correlation 0<0.80 (Gujarati, 2003; Hair *et al.*, 2006). In this sense, the diagnostic test of Spearman's rank-order correlation demonstrates that the model in general does not suffer from the multicollinearity problem.

However, Belsley *et al.* (2005), Kutner *et al.* (2004), and Kleinbaum *et al.* (2013) argue that the technique of the correlation matrix suffers from a number of limitations. First, the correlation matrix only examines the pairwise correlation between independent variables, although collinearity is highly likely to involve more than two regressors simultaneously. In addition, there is no specific criterion to decide what degree of correlation should be considered too high. In order to overcome such limitations, the authors suggest a more elaborate approach to detect multicollinearity, namely the Variance Inflation Factor (VIF).

The VIF test allows researchers to regress each predictor on all other independent variables and to produce an R^2 value for each. By doing so, the test examines the existence of the multicollinearity problem in each predictor with other regressors jointly rather than only through pairwise correlation. Therefore, this study also employs the VIF test to make further checks on the existence of collinearity. Statistically, it is suggested that if any predictor has a VIF exceeding 10 or a tolerance (1/VIF) below 0.10, the regression model suffers from multicollinearity (Hair *et al.*, 2006; O'brien, 2007).

It can be seen from Table 3.10 that the mean of VIF is 1.40, which lies within the acceptable levels of 0-10 suggested by Hair *et al.* (2006) and O'brien (2007). In line with the findings of the Spearman's correlation test, firm size (**FSIZE**) is found to have the highest VIF (1.89) which is well below the value of 10. Moreover, no single variable tolerance (1/VIF) is below 0.10. Consequently, the outcomes of VIF test confirm the findings of the Spearman's test that multicollinearity does not seriously influence the coefficient estimates of the predictors of the first empirical model

Table 3.9: Correlation Matrix

		[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]	[12]	[13]	[14]	[15]	[16]
[1]	**TOTAL PAY**		0.99*	0.89*	0.46	-0.29*	-0.13*	0.13*	0.06*	0.14*	0.11*	0.17*	0.17*	0.59*	0.25*	-0.19*	0.18*
[2]	**TOTAL CASH**	0.99*		0.89*	0.46*	-0.29*	-0.13*	0.14*	0.06*	0.14*	0.11*	0.17*	0.17*	0.59*	0.25*	-0.20*	-0.18*
[3]	**SALARY**	0.90*	0.90*		0.23*	-0.26*	-0.15*	0.17*	0.09*	0.13*	0	0.15*	0.23*	0.56*	0.22*	-0.17*	0.09*
[4]	**BONUS**	0.75*	0.76*	0.47*		-0.16*	-0.09*	0.10*	0.09*	0.13*	0.14*	0.23*	0.04*	0.30*	0.12*	-0.09*	0.27*
[5]	**BRDIND**	-0.29*	-0.30*	-0.25*	-0.22*		-0.01	-0.30*	0.01	-0.05*	-0.11*	-0.17*	-0.07*	-0.35*	-0.16*	0.26*	-0.09*
[6]	**DUAL**	-0.11*	-0.12*	-0.13*	-0.09*	0.02		-0.03	-0.03	-0.07*	-0.06*	-0.06*	-0.10*	-0.05*	0	-0.01	-0.10*
[7]	**BLKCHR**	0.16*	0.17*	0.22*	0.07*	-0.24*	-0.03		0.08*	0.11*	0.27*	-0.19*	0.06*	0.15*	0.12*	-0.32*	-0.02
[8]	**CHRMDs**	0.10*	0.10*	0.14*	0.05*	0	-0.03	0.08*		0.05*	-0.14*	0.11*	0.04*	0.10*	0.09*	-0.07*	0.12*
[9]	**RCEXIST**	0.16*	0.16*	0.15*	0.14*	-0.02	-0.07*	0.11*	0.05*		0.08*	-0.01	-0.04*	0.03	0.02	-0.04*	-0.01
[10]	**DIROWN**	0.04*	0.04*	-0.04*	0.11*	-0.02	-0.07*	0.22*	-0.01	0.10*		-0.22*	-0.23*	-0.04*	0.02	-0.34*	0.08*
[11]	**PFOWN**	0.25*	0.25*	0.24*	0.26*	-0.12*	-0.04*	-0.16*	0.09*	0	-0.21*		0.22*	0.35*	-0.04*	0.16*	0.26*
[12]	**STATEOWN**	0.11*	0.11*	0.16*	0.04*	-0.04*	-0.06*	-0.06*	0.06*	-0.06*	-0.41*	0.38*		0.51*	0.07*	0.13*	0.04*
[13]	**FSIZE**	0.59*	0.59*	0.62*	0.40*	-0.27*	-0.04*	0.12*	0.15*	0.03	-0.15*	0.48*	0.38*		0.29*	-0.10*	-0.02
[14]	**LEV**	0.40*	0.39*	0.36*	0.30*	-0.21*	0.01	0.13*	0.10*	0.03	0	-0.05*	-0.02	0.40*		-0.20*	-0.17*
[15]	**FAGE**	-0.17*	-0.18*	-0.16*	-0.09*	0.23*	-0.03	-0.30*	-0.07*	-0.03	-0.27*	0.29*	0.27*	-0.04*	-0.30*		-0.01
[16]	**ROA**	0.19*	0.19*	0.06*	0.33*	-0.06*	-0.14*	-0.03	0.08*	0.03	0.28*	0.23*	0.01	-0.07*	-0.24*	0.01	

Spearman rank correlations are reported below the diagonal, and Pearson correlation coefficients are reported above the diagonal.

* denotes significance at 0.05 level

Table 3.10: VIF Test

Variable	VIF	1/VIF
FSIZE	1.89	0.528
STATEOWN	1.53	0.655
PFOWN	1.46	0.685
DIROWN	1.34	0.745
FAGE	1.34	0.746
BRDIND	1.34	0.747
BLKCHR	1.34	0.748
LEV	1.19	0.840
ROA	1.18	0.848
CHRMDs	1.10	0.910
DUAL	1.04	0.965
RCEXIST	1.03	0.974
Mean VIF	1.40	

3.5.3 Discussion of Research Findings

Table 3.11 presents the results of the regression analysis for the variables of corporate governance and ownership structure and their effects on each component of executive remuneration. The R-squares of the models demonstrate that 25%, 24%, and 22% of the variations in the dependent variables **TOTAL PAY**, **TOTAL CASH**, and **SALARY**, respectively, are explained by the variations of the included independent variables. These proportions of explanatory power (R^2) are consistent with many previous studies. For example, the R-squared statistics of Ramaswamy *et al.* (2000), Anderson and Bizjak (2003), Li *et al.* (2007), and Edwards *et al.* (2009) were 36%, 27%, 26% and 17%, respectively. Others also found similar R-squared statistics around 30% (Chen *et al.*, 2010b; Conyon and He, 2011; 2012; Rashid, 2013).

However, these moderate explanatory powers indicate that there are other, omitted variables that influence the practice of setting executive remuneration packages. In the context of the KSA, where personal connections and tribal ties can play a significant role in the process of hiring employees and determining their wages (Budhwar and

Debrah, 2013), such moderate R-squared statistics are not surprising. These behavioural factors, which are beyond the scope of this study, are not statistically measurable.

Consistent with Hypothesis 1, which predicts a positive and significant relationship between the level of independence of board of directors (**BRDIND**) and executive pay, the results in Table 3.11 reveal that the presence of independent directors on the board (**BRDIND**) is significantly associated with all variables of executive compensation except **BONUS** packages. The positive link between outsider directors and managerial pay is in line with several previous findings (Hearn, 2013; Rashid, 2013; Shah *et al.*, 2009). However, these findings are not consistent with those of Chhaochharia and Grinstein (2009) and Fahlenbrach (2009), who report that outsider directors negatively and significantly impact executive perks. Moreover, others find no significant relationship between independence level of board of directors and executive remuneration (Chen *et al.*, 2011; Chen *et al.*, 2010b; Conyon and He, 2012; Sapp, 2008).

Although the agency theories argue that board independence is an effective mechanism for mitigating agency costs by aligning the interests of managers with those of shareholders, this assumption does not seem to explain the causes of or solve all agency problems, particularly in emerging economies. In this context, institutional theory appears to provide more reliable and reasonable interpretations for the attitudes of pay settings in the likes of the KSA (Young *et al.*, 2008) where personal factors and family names are strongly involved in such decisions.

The weak role of independent directors in monitoring management activities, in particular managerial pay, found by this study can be attributed to the control and presence of large shareholders on most Saudi corporate boards. According to institutional theory, a firm might appoint outsider members to the board of directors ostensibly to claim that it is complying with regulations, thereby legitimising its existence among its competitors (Young *et al.*, 2008). In other words, a firm might allow external members to sit on the board of directors solely to satisfy minority shareholders and regulators, while in fact, these members are not involved in the decision-making process.

Another potential interpretation for the ineffectiveness of independent directors is that as these blockholders control the decision-making, outsider members may prefer not to challenge their decisions in order to retain their own jobs and ensure their re-nominations (Ozdemir and Upneja, 2012), since the approval of decisions related to

managerial pay has almost no repercussions for independent directors (Walkner, 2004). In addition, the close supervisory role played by blockholders over managerial activities may make outsider members feel more relaxed and under less pressure to perform their stewardship duties.

With respect to **BONUS** packages, the outcome supports the findings of Chalmers *et al.* (2006), Cheng and Firth (2006), and Colpan and Yoshikawa (2012) who did not find significant relationship between the board independence and bonus compensation. However, Chhaochharia and Grinstein (2009) observe a negative and significant relationship between the level of board independence and bonus perks.

Table 3.11 also shows a negative but not statistically significant relationship between role duality (**DUAL**) on the one hand and all the components of executive pay on the other. Therefore, Hypothesis 2, which expects a significant negative relationship, is not accepted. According to the managerial power model, the determination of executive compensation is subject to the extent of the influence that managers are able to exert over related decisions (Bebchuk and Fried, 2004). However, the findings provide strong support for the stewardship theory, which suggests that combining the positions of CEO and chairman in the hands of a single individual is not harmful for the company (Donaldson and Davis, 1991). The theory posits that the manager as the shareholders' steward acts in the best interests of the company as a whole rather than opportunistically exploiting the company's resources, as alleged by agency theory (Muth and Donaldson, 1998). Empirically, the results are in line with Ntim *et al.* (2015), Conyon and He (2011), Chalevas (2011), and Shah *et al.* (2009), who observe similar relationships; i.e. when an executive serves as board chairperson at the same time, this does not affect his/her pay-related decisions.

However, this evidence does not match the outcomes reported by some other studies which documented that role duality is associated with higher executive compensation (Ozdemir and Upneja, 2012; Conyon and He, 2012; Chen *et al.*, 2011; Fahlenbrach, 2009; Sapp, 2008; Core *et al.*, 1999). In fact, these studies support the standpoint of agency theory, which predicts higher managerial remuneration when the CEO also holds the position of board chairperson.

Table 3.11: Regression Analysis: Corporate Governance and Executive Compensation

	TOTAL PAY		TOTAL CASH		SALARY		BONUS	
	Fixed effect		*Fixed effect*		*Fixed effect*		*Tobit*	
	Coef.	*t-value*	*Coef.*	*t-value*	*Coef.*	*t-value*	*Coef.*	*z-value*
BRDIND	0.003	2.56**	0.004	2.82***	0.004	2.95***	0.014	0.87
DUAL	-0.079	-1.27	-0.086	-1.39	-0.122	-1.88*	-0.383	-0.54
CHRBLK	0.171	2.14**	0.175	2.21**	0.269	3.26***	-0.474	-0.62
CHRMDs	-0.061	-1.13	-0.046	-0.86	-0.070	-1.24	0.465	0.79
RCEXIST	0.113	2.35**	0.108	2.24**	0.072	1.43	1.561	2.59**
DIROWN	-0.004	-1.59	-0.004	-1.45	-0.007	-2.49**	0.049	2.08**
PFOWN	0.040	3.73***	0.041	3.90***	0.039	3.56***	0.102	1.57
STATEOWN	0.003	0.58	0.003	0.57	0.001	0.16	-0.058	-2.16**
FSIZE	0.321	4.93***	0.340	5.26***	0.256	3.79***	1.319	4.38***
LEV	0.002	3.19***	0.002	3.32***	0.002	3.33***	0.018	2.30**
FAGE	0.201	4.32***	0.175	3.79***	0.210	4.35***	0.262	0.75
ROA	0.011	5.01***	0.011	5.12***	0.004	1.97**	0.100	3.90***
Constant	5.852	4.31***	5.469	4.06***	6.950	4.94***	-23.515	-3.62***
Observations	819		819		819		819	
Adj. R2	.25		.24		.22			
F-statistics	18.80***		18.56***		15.95***			
Wald Chi2							65.65***	
Hausman's Chi2	61.04***		58.65***		89.43***			

All variables are defined in Table 3.2
*** p<0.01, ** p<0.05, * p<0.10

It is not surprising to find no significant association between role duality and managerial pay in a context of the KSA since the executives' activities are controlled and monitored by large shareholders who perform a close supervisory role through their presence on the board of directors and its sub-committees. Furthermore, these blockholders frequently appoint their relatives and friends to executive positions; hence, the relationship between the controlling shareholders and these top managers is strong, close, and based on trust. This close relationship may be sufficient to align the interests of top senior executives with those of shareholders in a way that benefits the organisation as a whole.

Relatedly, the study finds that when the position of board chairperson is occupied by a blockholder (**CHRBLK**), top managers are more likely to earn greater pecuniary incentives. Hence, Hypothesis 3, which predicts a negative and significant association between blockholder chairman and managerial pay, is not accepted. Despite the lack of studies examining the role of blockholder chairperson in the enhancement of governance quality, Alagla (2012), who uses another proxy to measure the power of chairperson through his/her voting rights (ownership), obtains a contrary result. That is to say, the author observes that the higher the number of shares held by the chairman, the lower the remuneration earned by the CEO. The study's finding is inconsistent with the supposition of the agency model, which states that the presence and close supervision of large shareholders helps to mitigate the agency costs resulting from the separation between ownership and management.

In the KSA, blockholders, particularly those who carry out the chairperson's functions, do not seem to be performing their supposed monitoring duties effectively. The positive association between blockholder chairman (**CHRBLK**) and executive compensation supports the study's argument that there is principal-principal conflict in emerging countries where certain individuals control the decision-making within the organisation without consideration of minority interests. In other words, blockholder chairmen, who combine both dimensions of powers through voting rights and the chairing of the board of directors, can use their power to influence the decisions on the remuneration of executives, who are often their relatives and close friends, in a way that extracts greater pay.

Inconsistent with Hypothesis 4, the study did not find evidence that chairman multi-directorships (**CHRMDs**) have any significant relationship with managerial perks packages. Although no previous study has investigated the relationship between chairman multi-directorships and the practices of executive compensation, a number of researchers (Armstrong *et al.*, 2012; Core *et al.*, 1999; Ozdemir and Upneja, 2012; Sapp, 2008) use a broader variable that captures the other directorships of the entire board of directors and have obtain a different result. They document that when the members of a board of directors are simultaneously on other corporate boards, their monitoring role is significantly reduced; thus, executives receive greater remuneration.

The regression analysis presented in Table 3.11 supports Hypothesis 5 and provides evidence that the existence of remuneration committee (**RCEXIST**) does not play its supposed role effectively in controlling executive compensation. In contrast, it does significantly increase managerial pay packages. In other words, it exacerbates the agency problem rather than mitigates it. Empirically, this conclusion is consistent with Conyon and He (2012) and Chen *et al.* (2010b) who also found in the Chinese context that the existence of remuneration committee is significantly associated with higher managerial remuneration packages.

This finding can be attributed to different reasons. First, this study finds that the presence of large shareholders on board is related to higher executive remuneration. Therefore, the committee members, who know that their renewal decisions are subject to the satisfaction of the dominant shareholders, might prefer to go along with any decision approved by those controlling shareholders rather than to oppose them since this approach might lead to an undesirable consequence i.e. losing their directorship (Ozdemir and Upneja, 2012). Another potential interpretation is that owner-managers may perceive the remuneration committee as an effective tool to legitimise their high compensation, arguing that the pay plan emanates from a specialised committee following the recommendations of the SCGR. This interpretation is supported by the implied view of institutional theory that there is a strong potential scenario in a context such as the KSA, where family ownership is predominant and their control over decision-making process is evident, of a remuneration committee being ostensibly established solely to fulfil SGCR requirements and legitimate the firm's existence (Young *et al.*, 2008).

Consistent with Hypothesis 6, the results demonstrate that when the members of board of directors hold more equity (**DIROWN**), top executive are paid lower fixed compensation (**SALARY**). In fact, their ownership enhances the link with firm performance since Table 3.11 highlights a positive and significant impact on **BONUS** perks. However, there is no significant relationship between director ownership (**DIROWN**) and **TOTAL PAY** and **TOTAL CASH**, implying that the prime concern of board directors is the components of compensation rather than the total package. This evidence confirms the perspective of agency theorists who argue that when the members of board of directors own more shares, their role will be transformed from delegated directors to shareholders (Minow and Bingham, 1995). Thus, their main objective will be aligned with

shareholders' objectives, i.e. to increase company market value and to yield more dividends (Banghøj *et al.*, 2010; Jensen, 1993). As a result of this alignment of interests, the owner-directors will have greater incentives to protect their own equity through constraining managerial remuneration (Lin, 2005; Zald, 1969; Shleifer and Vishny, 1986; Jensen and Meckling, 1976; Muth and Donaldson, 1998).

Empirically, many studies document similar results (Méndez *et al.*, 2011; Ntim *et al.*, 2015; Ozkan, 2007; Sapp, 2008). That is, they observe a negative and significant relationship between shareholding level of directors and executive perks. However, other research fails to find any significant effect of either ownership of the entire board (Hearn, 2013; Rashid, 2013) or ownership of individual independent directors (Chalmers *et al.*, 2006; Cheng and Firth, 2006; Core *et al.*, 1999) on managerial pay settings.

Surprisingly, Table 3.11 manifests that pension fund investments (**PFOWN**) have a positive and significant impact on all executive compensation except **BONUS** packages. This outcome nullifies Hypothesis 7 which presumes that such ownership should help to significantly diminish managerial pay levels. The interesting finding also does not match the argument of agency-based view which suggests that the presence of institutional investors can improve supervisory functions over managerial activities and therefore, reduce executive compensation (Chalevas, 2011; Fahlenbrach, 2009; Hartzell and Starks, 2003; Lin *et al.*, 2011; Ozkan, 2007; Ramaswamy *et al.*, 2000).

To the author's best knowledge, no previous empirical research observes a positive and significant relationship between pension fund investment and managerial remuneration arrangements. In contrast, most studies find that institutional investment significantly curbs top managers' remuneration (Chalevas, 2011; Fahlenbrach, 2009; Lin *et al.*, 2011; Ntim *et al.*, 2015; Ozkan, 2007; Ramaswamy *et al.*, 2000). However, Rashid (2013) and Shah *et al.* (2009) find no relationship between the two variables in Bangladesh and Pakistan, respectively, which share many common cultural features with the KSA.

The rationale behind the positive impact of pension fund ownership over executive compensation can be attributed to the fact that pension funds are growth-seekers rather than profit-seekers (Colpan and Yoshikawa, 2012; Colpan *et al.*, 2011; David *et al.*, 2010). Basing on this view, those investors may compensate their top employees generously in order to incentivise them to do their best and expand the firm activities. Furthermore, as

public pension funds are controlled and administrated by the Saudi state (GOSI, 2000; PPA, 2004), Conyon and He (2012) argue that state representatives can get confused between their duties as investors' stewards and as state administrators. Accordingly, they may be less concerned about executive compensation, especially as there are practically no repercussions if they approve such payments (Chalevas, 2011).

Even though the Saudi state owns almost 20% of the market value of the SSE (Aleqtisadiah, 2014), the results show that state investment (**STATEOWN**) does not enhance the protection of shareholders' interests through limiting executive perks. That is to say, the findings do not observe any significant relationship between state equity and any components of executive compensation, except a negative and significant association with **BONUS**. Consequently, the study does not accept Hypothesis 8. This finding is in line with Conyon and He (2012), Li *et al.* (2007), and Ramaswamy *et al.* (2000), who conclude that state investment does not influence the practices of managerial pay in Asia. However, Chen *et al.* (2011) and Firth *et al.* (2007) find that state ownership negatively and significantly impacts the level of top managers' remuneration, while, Hearn (2013) reports that when the state holds more shares, top employees are more likely to earn higher remuneration packages.

Conyon and He (2012) attribute the ineffective monitoring role played by the state to the difficulty encountered by state representatives on board of directors who cannot distinguish between their functions as shareholders' representatives and their administrative tasks. Furthermore, the low supervisory performance of state investors might be a consequence of the divergent objectives between the state and regular shareholders (Ramaswamy *et al.*, 2000; Olson, 1973). That is to say, state investment can have other non-profit aims, such as stabilising the stock market and controlling certain sensitive operational sectors for security purposes (Olson, 1973). Therefore, state investors do not always seek to maximise their income; hence, their efforts may not concentrate on improving firm performance and controlling managerial activities. In other words, the state may have other primary objectives rather than monitoring the opportunistic actions of top management with regards to their remuneration packages (Olson, 1973). The latter argument seems to be a reasonable interpretation in the case of the KSA, since the data show that the Saudi state investment is restricted to certain giant corporations in the energy and telecommunication sectors.

With regards to the control variables, Table 3.11 demonstrates that firm size (**FSIZE**) is a key determinant of executive compensation in the KSA and has a positive and significant relationship with all components of managerial pay. This means that executives who serve in larger firms are compensated more generously than their counterparts in smaller firms. The positive relationship between firm size and executive pay can be attributed to the fact that larger firms have more complicated operational activities (Cheng and Firth, 2006; Core *et al.*, 1999). Hence, there is a need to hire more skilled and experienced executives, who demand higher remuneration packages in exchange for their services (Chalevas, 2011; Baker *et al.*, 1988). This conclusion is one of the few for which there is conclusive evidence in the literature (Méndez *et al.*, 2011) since numerous previous studies observes similar findings either in developed or in emerging economies (Conyon, 2014; Hearn, 2013; Armstrong *et al.*, 2012; Colpan and Yoshikawa, 2012; Conyon and He, 2012; Banghøj *et al.*, 2010).

Leverage ratio (**LEV**), which reflects the financial structure of the firm, is widely used with respect to its association with executive pay arrangements (Chalevas, 2011; Banghøj *et al.*, 2010; Firth *et al.*, 2007). The results show that debt ratio (**LEV**) significantly and positively impacts three constituents of executive compensation namely **TOTAL PAY**, **TOTAL CASH**, and **SALARY**. In other words, top managers are found to be rewarded with higher remuneration when the firm has high financial leverage. This evidence does not support the notion of the theory of free cash flow (Jensen, 1986) that corporates with high financial leverage have higher interest payment commitment, thus, they have less ability to pay high remuneration to top managers. Empirically, the outcome is also opposite to the findings of a number of previous studies (Basu *et al.*, 2007; Bryan *et al.*, 2000; Cyert *et al.*, 2002; Firth *et al.*, 2007), which document negative correlations between debt ratio and managerial pay levels. The finding for the KSA can be attributed to several potential reasons. First, as business transactions including access to bank loans in the KSA are highly dependent on personal connections, managers may be highly compensated because of their networks. Another potential interpretation is that as these firms have higher risks, managers may demand higher remuneration against the possibility of higher dismissal risks.

The regression analysis reveals that firm age (**FAGE**) has a positive and significant impact on all components of executive compensation. This outcome supports the

argument that older firms are more efficient and more profitable than their younger counterparts; hence, they are more able and more likely to compensate their executives generously (Rashid, 2013). The result is consistent with Rashid (2013) who uses a sample of Bangladeshi firms and finds that the more the number of years the firm has been listed in the stock exchange, the greater the compensation the executives receive.

Even though some researchers suggest using accounting and market based proxies when measuring firm performance, the study adopts only an accounting measure, namely return on assets (**ROA**) to control for firm performance. This is due to the fact that using market measures depends on market efficiency level (Richard *et al.*, 2009), and the efficiency of the SSE is found to be weak (Asiri and Alzeera, 2013; Harrison and Moore, 2012; Onour, 2009). The Kenexa High Performance Institute (KHPI) states that "using market measures in countries with non-efficient financial markets could give misleading conclusions" (KHPI, 2012). In this context, firms are expected to rely on accounting measures, which have a greater reliability when making decisions related to performance (Banker and Datar, 1989; Sloan, 1993; Murphy, 1999). The regression analysis shows a positive and significant correlation between firm performance (**ROA**) and all components of executive compensation. These results are consistent with the findings reported by previous studies which conclude that firm performance positively and significantly impacts executive compensation (Ntim *et al.*, 2015; Conyon and He, 2012; Colpan and Yoshikawa, 2012; Sakawa *et al.*, 2012).

3.5.4 Robustness Checks

In order to check how robust the findings are, further analyses are carried out. Even though the results of correlation matrix and VIF test show that the models' variables are not affected by multi-collinearity problems, these tests may have limitations. Thus, to ensure the findings are reliable, the research re-runs the main regressions after eliminating any variable that has a likelihood of overlapping with another variable in the same model. In this sense, there is potential overlapping between chairman blockholder variable (**BLKCHR**) and director ownership (**DIROWN**). This is because **BLKCHR** is a dummy variable that equals one if the chairman owns at least 5% of the company's outstanding shares, while at the same time, **DIROWN** is defined as the total shares held by board members including chairman. In this sense, if chairman is a blockholder, axiomatically director ownership will be somewhat high. However, there is also a

possibility that director ownership is high even if the chairman is not a blockholder. Therefore, the elimination of the problematic variable will ascertain if this variable has affected the primary findings.

Table 3.12: Robustness Tests: Corporate Governance and Executive Compensation, excluding the Blockholder Chairman

	TOTAL PAY		**TOTAL CASH**		**SALARY**		**BONUS**	
	Fixed effect		***Fixed effect***		***Fixed effect***		***Tobit***	
	Coef.	*t-value*	*Coef.*	*t-value*	*Coef.*	*t-value*	*Coef.*	*z-value*
BRDIND	0.003	2.16**	0.003	2.41**	0.003	2.31**	0.016	1.04
DUAL	-0.089	-1.43	-0.096	-1.55	-0.137	-2.11**	-0.368	-0.52
CHRBLK	-0.069	-1.27	-0.054	-10	-0.082	-1.45	0.459	0.78
RCEXIST	0.121	2.51**	0.115	2.41**	0.084	1.66*	1.530	2.54**
DIROWN	-0.003	-1.06	-0.002	-0.88	-0.004	-1.67*	0.046	1.99**
PFOWN	0.040	3.71***	0.041	3.88***	0.039	3.53***	0.109	1.7*
STATEOWN	0.001	0.27	0.001	0.25	-0.001	-0.31	-0.058	-2.16**
FSIZE	0.326	4.99***	0.345	5.32***	0.263	3.87***	1.296	4.35***
LEV	0.002	3.14***	0.002	3.27***	0.002	3.24***	0.018	2.3**
FAGE	0.210	4.52***	0.185	4.00***	0.224	4.63***	0.266	0.76
ROA	0.011	4.93***	0.011	5.04***	0.004	1.85*	0.101	3.93***
Constant	5.880	4.32***	5.497	4.07***	6.993	4.94***	-23.426	-3.62***
Observations	819		819		819		819	
Adj. R2	.24		.24		.20			
F-statistics	19.99***		19.69***		16.22***			
Wald Chi2							65.43***	

All variables are defined in Table 3.2

*** p<0.01, ** p<0.05, * p<0.10

Table 3.12 displays the regression results after excluding **BLKCHR**. As can be seen, the findings are qualitatively similar with a slight difference in the significance levels of few results. For example, while the main regression in Table 3.11 shows that **DIROWN** has a negative and significant (p<0.05) association with **SALARY**, the relationship after eliminating **BLKCHR** is still negative but with slight difference in the significance level (p<0.10). Accordingly, it is clear from comparing the results in Table 3.11 and Table 3.12

that the findings are significantly robust and reliable, even after eliminating the potential overlapping problems among the model's variables.

3.5.5 Sensitivity Tests

The main objective of the sensitivity analysis is to investigate how sensitive the findings of the primary test towards other econometrical methods. In this section, two different analyses are employed namely random effect regression (GLS) and pooled OLS regression with robust standard error, since the data are not normally distributed as demonstrated earlier by the descriptive statistics.

3.5.5.1 Random Effect Regression

As discussed in the method section, the results of the Hausman test suggest that the fixed effect regression is the most appropriate approach by which to examine the models, **TOTAL PAY**, **TOTAL CASH**, and **SALARY**. While, **BONUS** is primarily tested using Tobit regression since the data are censored with zeros that exceed one-fifth of the total observations. However, in order to check the findings sensitivity to alternative estimation techniques, random effect regression and pooled OLS regression are employed.

Table 3.13 presents the findings of the random effect regression. The R-squares are almost similar to those of the primary analysis with a slight increase, indicating that the explanatory power of independent variables under both techniques is convergent. The directions of the relationships are similar, except for the variable **STATEOWN,** which has a positive but statistically insignificant relationship with executive compensation variables in the primary analysis, but has a negative and significant association under random effect regression.

Generally, the outcomes are consistent across all models and have the same implications, with a number of differences in the significance levels. For example, **DUAL** is negatively but insignificantly associated with the remuneration variables in the fixed effect regression. However, in the random effect model, all these relationships are found to be statistically significant. The opposite scenario occurs with **PFOWN**. In the primary regression **PFOWN** shows a positive and significant relationship with managerial pay, but under the random effect regression the relationship is found to be insignificant**.** Although, there are very few changes between the results of the two tests, especially in the significance levels, the two regressions in general demonstrate that the findings of the

fixed effect regression are consistent, reliable, and not significantly sensitive to the random effect estimation.

Table 3.13: Sensitivity Analysis (GLS): Corporate Governance and Executive Compensation

	TOTAL PAY		TOTAL CASH		SALARY		BONUS	
	Random effect		*Random effect*		*Random effect*		*Random effect*	
	Coef.	*z-value*	*Coef.*	*z-value*	*Coef.*	*z-value*	*Coef.*	*z-value*
BRDIND	0.003	2.29***	0.003	2.5***	0.003	2.55***	0.011	0.92
DUAL	-0.144	-2.42***	-0.149	-2.52***	-0.192	-3.2***	-0.237	-0.43
CHRBLK	0.127	1.85*	0.134	1.96*	0.229	3.4***	-0.460	-0.78
CHRMDs	-0.033	-0.65	-0.022	-0.44	-0.033	-0.66	0.318	0.69
RCEXIST	0.186	3.88***	0.179	3.77***	0.150	3.04***	1.243	2.63***
DIROWN	-0.002	-0.74	-0.001	-0.61	-0.005	-2.33**	0.039	2.08**
PFOWN	0.008	1.21	0.009	1.36	0.006	0.94	0.084	1.64*
STATEOWN	-0.007	-2.66***	-0.007	-2.64***	-0.006	-2.2**	-0.047	-2.27**
FSIZE	0.348	10.93***	0.347	10.94***	0.274	9.46***	1.125	4.83***
LEV	0.002	3.51***	0.002	3.55***	0.002	3.41***	0.015	2.39**
FAGE	0.102	3.08***	0.090	2.74***	0.087	2.76***	0.220	0.81
ROA	0.011	5.34***	0.011	5.42***	0.005	2.28**	0.083	4.15***
Constant	5.652	8.37***	5.662	8.41***	6.982	11.29***	-17.838	-3.55***
Observations	819		819		819		819	
Adj. R2	.38		.38		.31		.20	
Wald Chi2	268.39***		267.08***		213.15***		75.57***	

All variables are defined in Table 3.2
*** p<0.01, ** p<0.05, * p<0.10

3.5.5.2 Pooled OLS Regression with Robust Standard Error

As shown in the Descriptive Statistics section and due to the nature of the study's data, the assumptions of parametric test have not been met, especially in relation to the prerequisite that data is normally distributed. Therefore, after adopting different diagnostic checks, the results reveal that non-parametric test with fixed effect is the most relevant technique to estimate the empirical models. Despite the fact that both fixed effect and random effect deliver similar results, the study employs OLS regression for further

checks. Table 3.14 shows that the findings of the primary regression are sensitive to the OLS estimation. For example, while the fixed effect regression demonstrates that **PFOWN** and **FAGE** have a positive and significant relationships with executive compensation, the OLS findings show negative and significant associations. Furthermore, while **CHRBLK** has a positive and significant impact on managerial remuneration in the primary regression, the OLS estimate shows a negative but insignificant impact. The opposite scenario occurs with **STATEOWN.** It has a positive association with the compensation constituent in the fixed effect estimate; however, it shows negative and significant relationship under OLS regression.

Table 3.14: Sensitivity Analysis (OLS): Corporate Governance and Executive Compensation

	TOTAL PAY		**TOTAL CASH**		**SALARY**		**BONUS**	
	OLS		***OLS***		***OLS***		***OLS***	
	Coef.	*t-value*	*Coef.*	*t-value*	*Coef.*	*t-value*	*Coef.*	*t-value*
BRDIND	-0.002	-1.14	-0.001	-1.11	-0.001	-0.70	0.007	0.65
DUAL	-0.196	-3.27***	-0.206	-3.44***	-0.228	-4.21***	-0.541	-1.17
CHRBLK	-0.057	-1.08	-0.042	-0.81	0.069	1.46	0.511	1.26
CHRMDs	-0.051	-1.08	-0.048	-1.02	0.002	0.04	0.212	0.57
RCEXIST	0.314	4.01***	0.308	3.94***	0.235	3.32***	1.958	3.24***
DIROWN	0.002	1.17	0.002	1.18	-0.003	-2.29**	0.035	2.93***
PFOWN	-0.009	-2.40**	-0.009	-2.29**	-0.008	-2.25**	0.092	3.03***
STATEOWN	-0.007	-4.83***	-0.007	-4.81***	-0.003	-2.49**	-0.040	-3.53***
FSIZE	0.325	18.56***	0.322	18.43***	0.244	15.46***	0.992	7.34***
LEV	0.003	3.06***	0.003	3.05***	0.001	1.39	0.017	2.48**
FAGE	-0.052	-2.17**	-0.055	-2.29**	-0.055	-2.52**	0.018	0.10
ROA	0.019	8.05***	0.019	8.00***	0.009	4.21***	0.142	7.58***
Constant	6.716	16.84***	6.771	17.01***	8.209	22.81***	-16.024	-5.21***
Observations	819		819		819		819	
Adj. R2	.45		.40		.37		.21	
F-statistics	57.42***		57.36***		41.11***		19.68***	

All variables are defined in Table 3.2
*** p<0.01, ** p<0.05, * p<0.10

The divergence between the findings of the two regressions may be attributed to the fact that the OLS regression does not capture the variation of time in the study's observations (Habbash, 2010) and also OLS treats the different observations as one unit without distinguishing between the different groups of data in contrast to the panel data (Iskander, 2008). Furthermore, since the OLS assumptions are not met, the test may have generated misleading and unreliable results (Baltagi, 2008; Greene, 2008). It can be concluded that even though the pooled OLS regression provided inconsistent results when compared with those of the main regression, the findings of the latter are still reliable and consistent with the other approach that deals effectively with panel data, random effect regression. As discussed earlier, the OLS regression has to meet a number of assumptions, which the data in this research fails to do; therefore, it is inappropriate to rely on its results and these cannot be utilised to assess the findings of the main regression.

3.6 CONCLUSION

This research contributes to the extant knowledge in several ways. One key contribution is that it studies the effectiveness of the agency-based governance model in constraining executive compensation in an emerging economy, Saudi Arabia which has a unique institutional setting. Saudi Arabia is an interesting context since the ownership concentration is high and dominated by state and family investments, its political system is based on an absolute monarchy in which the legal setting is derived from the *sharia*, and its business environment is significantly influenced by *wasta*. These characteristics represent the key divergences between the KSA as an emerging economy and developed economies. Thus, the research enhances the understanding of cross-cultural and institutional settings and proves empirically whether or not models developed in other contexts are generalizable across the globe. Furthermore, while most literature concentrates on the principal-agent model (Al-Najjar, 2017; Conyon, 2014; Core *et al.*, 1999), this research extends the understanding of agency problems that exist among other parties (controlling and minority shareholders) and provides insights into principal-principal conflict which exists to a considerable degree in emerging economies. Finally, the study provides evidence that the absence of effective formal institutions encourages companies to pay lip service to corporate governance regulations (form over substance).

Using data on Saudi listed firms during the period 2008 to 2015, the study finds that when the board of directors is chaired by a blockholder, top executives are more likely to receive more generous compensation. This finding invalidates the assumption of agency model that the participation of large shareholders in the monitoring function reduces managerial expropriation (Fama and Jensen, 1983b). This outcome can be attributed to large shareholders' connivance since the employment culture in Saudi Arabia is influenced by nepotism and cronyism (Budhwar and Debrah, 2013). In other words, those generously paid managers might be relatives or friends of blockholder chairmen. Furthermore, board independence and the remuneration committee, which are key elements in international corporate governance (Ntim *et al.*, 2015; Méndez *et al.*, 2011; Fama and Jensen, 1983b), are found to be ineffective in controlling managerial incentives. On the contrary, they are found to boost executive compensation. This implies that corporate governance regulations in the KSA are followed in form but not in substance for regulatory and legitimating purposes. In contrast, CEO/Chairman role duality is low and negligible in Saudi Arabia and has no significant influence on managerial incentives. This is because Saudi corporate governance regulations prohibit the combination of the positions of CEO and board chairman in a single individual.

With regards to the impact of investor type on decisions related to executive pay, the findings show that board directors are key shareholders in the Saudi market. However, their ownership only has a partial impact on managerial pay. Although their equity holdings show no relationship with total executive compensation, it significantly reduces fixed compensation and expands the use of variable bonus packages. This indicates that when members of board of directors hold stakes in the company, they become more incentivised to protect their own wealth; therefore, they perform their supervisory roles more stringently. Furthermore, pension fund investment, which is akin to institutional investment and is believed to promote governance quality (Colpan and Yoshikawa, 2012; Ozkan, 2007), is surprisingly found to escalate the pecuniary rewards of top management. A potential cause of ineffective role played by pension funds in the KSA is that these institutions are semi-government and their representatives on the companies' boards are government officials who find difficulty in distinguishing between their functions as shareholders' representatives and their administrative tasks (Conyon and He, 2012).

This interpretation is supported by the additional finding that state ownership is not related to executive pay-setting. This, despite the state being a dominant investor in the SSE, the results demonstrate that state equity in general has no significant relationship with the levels of executive remuneration. This poor supervisory role of the state might be a consequence of the divergent objectives between state and regular shareholders (Ramaswamy *et al.*, 2000; Olson, 1973). This is because state investment may have non-profit aims such as stabilising the stock market and controlling certain sensitive operational sectors for security purposes (Olson, 1973). Therefore, such investors do not always seek to maximise their income; hence, their efforts may not focus on improving firm performance or controlling managerial activities. In other words, the state may have other primary duties rather than monitoring the opportunistic actions of top management with regards to their remuneration packages (Olson, 1973).

Accordingly, the research provides evidence that Saudi companies comply to regulatory requirements of corporate governance but with no real conviction. This situation supports the institutions-based view which argues that the adoption of the Western governance model in emerging economies, where formal institutions are weak, will lead to an adherence to governance requirements in form rather than in substance (Young *et al.*, 2008). However, certain informal institutional arrangements such as personal connections (*wasta*) play a more significant role than individual merit in the design of executive compensation. That is to say, the board of directors, which is controlled by blockholders, rather than the remuneration committee, retains the right to reward top managers, who are usually appointed on the basis of nepotism and cronyism (Budhwar and Debrah, 2013). This situation leads to the emergence of principal-principal conflict, which results in minority shareholders' equity being threatened with expropriation. Consequently, it is evident that the Anglo-American model of corporate governance lacks generalizability in emerging economies such as Saudi Arabia and must be contextualised in a way that considers and captures the domestic cultural and institutional settings, otherwise, it will not function as intended.

In practice, the research has significant implications that may assist firms and regulators in their efforts to improve the current practices of corporate governance towards the design of executive compensation. First, the best practice recommendations of corporate governance suggest that ownership concentration and the presence of

controlling shareholders in board of directors would mitigate agency costs (Fama and Jensen, 1983b). However, this research demonstrates that ownership concentration in the hand of certain investors and the presence of blockholders on companies' boards, especially in economies with weak formal institutions, may lead to principal-principal conflict and the incurrence of further agency costs. Consequently, governance regulations should acknowledge and consider potential conflict among shareholders and create tools that ensure the prevention of blockholders' opportunism and strong protection for shareholders' rights, particularly minority shareholders. Second, the findings show that independent directors are ineffective in controlling managerial perks, making the independence of board of directors questionable. This provides an opportunity for parties in charge to re-define the independent member and generate an appropriate periodic assessment for the member. Finally, although firms have shown high compliance with current regulations of corporate governance, executive compensation has followed upward trend even in years of poor company performance. This indicates to regulators and firms that governance regulations are not practised as intended and should stimulate the redesign of compensation packages in line with firm performance.

Although the research outcomes have a high degree of generalizability in emerging economies that share similar political, institutional and cultural characteristics with Saudi Arabia such as other Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar and the United Arab Emirates), there are a number of limitations that should be considered when interpreting the findings. First, the research analyses a limited set of corporate governance mechanisms and their relationship to executive compensation settings. However, other board characteristics such as the audit committee, which are not expected to have a direct influence on executive pay, are not included in the research. Second, the investigation scope is limited to one governance mechanism namely executive compensation, while other governance characteristics and practices are not examined. Third, the research is based on a sample from a single context namely Saudi Arabia and does not use multi-country samples. Finally, it is worth noting that the research utilises a sample of non-financial companies only and does not investigate financial firms since they are subject to different regulations and accounting practices (Wang and Shailer, 2015; Méndez *et al.*, 2011).

CHAPTER FOUR:

POLITICAL CONNECTIONS AND EXECUTIVE COMPENSATION

4.1 INTRODUCTION

Recent research shows that corporate political connections are a global phenomenon with complex economic consequences (Civilize *et al.*, 2015; Guerra Pérez *et al.*; Zhang *et al.*, 2015). That is to say, political relationships are key in shaping the business environment, especially in less-developed countries (Faccio, 2010). The absence of effective property rights and the weakness of formal institutions in such immature economies leads to uncertainty in business sustainability (Zhang *et al.*, 2015). Therefore, and in order to reduce such uncertainties, firms tend to build networks of connections, in particular with governments, which control the lifeline of any economy (Faccio, 2010). In other words, political connections act as a substitute for the weak legal framework. In this sense, firms that fail to build political relationships may encounter barriers to their survival. In contrast their connected-counterparts can obtain preferential advantages (Hoskisson *et al.*, 2000). Furthermore, many studies demonstrate that political ties add value for the company since they provide benefits, such as increasing its value and performance (Civilize *et al.*, 2015; Goldman *et al.*, 2009), investment diversification (Li *et al.*, 2012; Zhang *et al.*, 2015), privileged access to bank financing (Faccio, 2010; Khwaja and Mian, 2005), regulatory protection (Kroszner and Stratmann, 1998) and government bailouts (Faccio *et al.*, 2006). This evidence highlights the importance of the phenomenon of political connections and how they play a key part in the business policy in developing countries.

The previous chapter shows that the adoption of corporate governance regulations in Saudi Arabia, which is a network-oriented economy, was not as effective as when implemented in the West. Hence, this research discusses the role of other informal drivers that influence business policy in Saudi Arabia. In other words, while formal institutions are found to be weak in the Saudi context like other emerging economies (Young *et al.*, 2008), there is a high likelihood that other informal institutions will emerge to play a substitutive role and fill the gap. *Wasta* significantly influences employment culture and levels of wages in Saudi Arabia (Budhwar and Debrah, 2013; Tlaiss and Kauser, 2011). Thus, political connections, which are based on the *wasta* principle, are a key channel to obtain private benefits. Accordingly, this research analyses the relationship between political connections and the practices of executive compensation

in Saudi Arabia. In this setting, the investigation of political connections is derived from a governance framework rather than the economic dimension.

The study is motivated by the boom in executive compensation in Saudi Arabia from 2008 to 2015, which may be an indication of managerial exploitation, especially if it is not synchronous with superior firm performance. The statistical trends among the highest-compensated executives reveal that executive compensation has increased by more than 100% in most listed firms, while the growth in certain firms was threefold, such as the Etihad Etisalat Co (Mobily) (Arqaam, 2014). Even though many studies investigate the value that political connections can add to a firm (Civilize *et al.*, 2015; Zhang *et al.*, 2015; Goldman *et al.*, 2009), to the best of our knowledge, the research of Chizema *et al.* (2015) and Hearn *et al.* (2017) are the only ones that clearly looked at the role of political connections in controlling executive incentives. Accordingly, the research aims to answer this question: *Do political connections enhance governance quality through controlling executive compensation?*

In contrast to Chizema *et al.* (2015) and Hearn *et al.* (2017), this research contributes significantly to the growing body of literature of political connections and managerial pay-settings in several ways. First, the study uses a sample from Saudi Arabia, which has unique characteristics, i.e. an absolute monarchy system, existence of the *Shura* Council, and the domination of businesses through family and state investment. Second, the distinct sample enables a view of the relationship between political connections and managerial pay through the lens of principal-principal conflicts of interest. This provides an understanding of the interaction between controlling shareholders and politically connected members and shows the implications on governance quality, in particular executive compensation. Third, to the best of the researcher's knowledge, no such research has yet been conducted in the Gulf region in general, and in Saudi Arabia in particular. Hence, this study is generalizable to Gulf countries, which have many cultural, institutional, and economic characteristics in common with Saudi Arabia. Last, since the study context is significantly different from most other emerging economies, a new definition of political connections, that suits monarchical countries, is developed. This definition can be used to examine the phenomenon of political connections on different governance and economic characteristics in the GCC countries.

The remainder of this research is structured as follows: section 2 reviews the theories related to the phenomenon of political connections; section 3 reviews critically the literature and shows the literature gap; section 4 develops the research hypotheses and method; and section 5 presents and discusses the empirical results; finally, section 6 provides the research conclusion and limitations.

4.2 THEORETICAL FRAMEWORK

In order to understand how political connectedness influences corporate governance quality and the consequences of its existence on executive compensation, the research uses the aforementioned theories that directly relate to corporate governance and the Saudi context, namely agency theory and institutional theory. In this context, the institutional model explains why and how informal institutions such as political connections emerge and their influence on business policy in general and governance norms in particular. In addition to this, the study also adopts resource dependence theory (RDT) due to its direct relevance to political connections attributes. In fact, the RDT provides a decent understanding of the motivations leading boards of directors to recruit politically connected members and what benefits such members can obtain for the firm. In this context, the RDT, along with the agency and institutional models, helps to build a comprehensive view towards the behaviours of politically connected members in terms of whether they enhance governance quality or increase agency costs. Even though there are other models related to political connections, they consider different issues that are not related to the research scope.

4.2.1 Resource Dependence Theory

RDT came to prominence in 1978 by Pfeffer and Salancik (1978). Since then, it has been extensively employed in organizational theory and strategic management (Boyd, 1990; Hillman *et al.*, 2009; Pfeffer and Salancik, 1978). The theory stands on well-developed research which generally argues that an organisation is susceptible to external contingencies; therefore, its operational effectiveness and continuity depend on external factors (Hillman *et al.*, 2009). Pfeffer and Salancik (1978) state that to understand organisational behaviour, it is essential to acknowledge and recognise the external surrounding environment of that organisation which constrains its strategic decisions.

The central argument of RDT is that the success and continuity of an organisation is primarily subject to environmental uncertainty and dependencies (Pfeffer and Salancik, 1978). To illustrate, each organisation depends on others in providing basic services needed for operational activities e.g. raw material supply, financing, regulatory restrictions and so on. Consequently, the more vital resources that the organisation controls, the more power that the organisations can exercise over others and vice-versa. Based on this assumption, Pfeffer and Salancik (1978) suggest five actions that an enterprise can take to control their vital resources and thereby diminish resource dependence: "a) mergers/vertical integration, (b) JVs [joint ventures] and other interorganizational relationships, (c) boards of directors, (d) political action, and (e) executive succession" (Hillman *et al.*, 2009, p. 2). However, this study concentrates only on the ability of board of directors and political action since these two mechanisms are the most related to political connectedness which is the main focus of this study.

Although the research around boards of directors is predominantly dominated by agency theory (Core *et al.*, 1999; Cubbin and Leech, 1983; Jensen and Meckling, 1976), RDT emphasises that boards of directors are a key mechanism for bringing critical resources to the organisation (Hillman *et al.*, 2009). For example, while agency theories argue that large boards in some environmental conditions are less effective than small boards (Jensen, 1993; Yermack, 1996), RDT sheds light on the role of 'resource-rich' directors in securing vital resources for the firm (Boyd, 1990). In other words, composition of boards should primarily built on directors' type not on numbers of directors (Hillman *et al.*, 2009). From the perspective of RDT, directors are expected to bring four advantages to firms: "(a) information in the form of advice and counsel, (b) access to channels of information between the firm and environmental contingencies, (c) preferential access to resources, and (d) legitimacy" (Hillman *et al.*, 2009, p. 6).

However, organisations find difficulties in diminishing uncertainty and dependence on large institutions such as government (Hillman *et al.*, 2009). Hence, they tend to undertake other means i.e. via recruiting and inviting current or former senior government officers to take a seat on the board of directors (Hillman and Dalziel, 2003). Pfeffer and Salancik (1978, pp. 189-190) state that "the organization, through political mechanisms, attempts to create for itself an environment that is better for its interest"

and that "organizations may use political means to alter the condition of the external economic environment".

Typically, politically connected members are explicitly considered as 'valuable' due to the benefits that they can add to the firm through their significant interlocking connections with government, regardless of whether or not they have experience in the sector (Menozzi and Vannoni, 2014). For example, the organisation may gain preferential access to key resources including, but not limited to, government contracts, tax benefits, lower regulatory constraints, warnings of government policy changes, and government bailout and subsides (Faccio, 2010; Goldman *et al.*, 2009; You and Du, 2012; Wang, 2015; Hillman and Dalziel, 2003; Menozzi and Vannoni, 2014).

Although the literature on RDT emphasises the role of board of directors as resource-access (Pfeffer and Salancik, 1978; Menozzi and Vannoni, 2014; Hillman and Dalziel, 2003), RDT argues that politically connected directors help to reduce the regulatory oversight of government bodies (Guerra Pérez *et al.*, 2015; Faccio, 2010). The absence of government oversight, however, is not an advantage for all stakeholders. For example, related-party transactions are found to be significantly higher when a politically connected member serves on board (Berkman *et al.*, 2010; Sun *et al.*, 2016; Wang, 2015). However, such transactions benefit controlling shareholders, while minority shareholders are the most influenced party.

Faccio (2010) finds political connections to play a more active role in transitional economies than in developed counterparts. In this context, political ties play a significant role in the business environment in Saudi Arabia. The economy of Saudi Arabia is dominated by family and state investments and the relationship between control and ownership is almost total (Rashid, 2013). Thus, according to RDT, small shareholders rely primarily on the resources of larger shareholders. In other words, since RDT measures individual power basing on resource dependency, minority shareholders, who have less voting rights and less involvement in decision-making, are considered as the weakest party in the organisation, especially if top managers are family members (García-Meca, 2015).

Some argue that a politically connected director benefits the company as a whole. However, when conflicts of interests occur among shareholders, the loyalty of that director tilts to blockholders (Conyon and He, 2011), who have the power of appointing

him/her to the board. In this sense, controlling shareholders may exploit director's ties to protect them from legal liability resulting from expropriation of minority shareholders' wealth. For instance, family related managers can extract higher non-merit compensation or establish higher negative related-party transactions (Sun *et al.*, 2016; Wang, 2015).

4.2.2 Agency Theory

Agency theory argues that agency costs are subject to the balance of power between managers and shareholders (Jensen and Meckling, 1976). Additionally, it implicitly assumes that a manager's behaviour is influenced by human nature that is self-interested (Fama and Jensen, 1983b). Therefore, the manager acts opportunistically to maximise his/her utilities. Since the relationship between managers and shareholders is framed by the criterion of power (Finkelstein *et al.*, 2009), political ties may strengthen one of the two sides; for this, political connection matters. Consequently, well politically connected manager may exploit this connection for private benefits. In particular, he/she may use this advantage to extract higher non-merit perks with less consideration to regulatory sanctions (García-Meca, 2015).

However, in Saudi Arabia the situation is different. Most politically connected individuals serve on boards of directors rather than becoming top managers; this feature may be attributed to prestige and leadership reasons. For instance, all boards of directors that have a royal family member, are chaired by a royal family member. Hence, Saudi politically connected members appear to prefer to be a board member rather than to serve in management which is perceived as subordinate by board of directors' 'supreme authority'. Moreover, since ownership is highly concentrated in Saudi Arabia (The World Bank, 2009) and blockholders are present in the majority of boards, there is reason to argue that the presence of the conventional principal-agent conflict is lower in Saudi Arabia than in most other countries (Young *et al.*, 2008). It is also arguable that top managers in Saudi Arabia have less discretion and power than, for example, their counterparts in Western region (Rashid, 2013), unless they are blockholders.

Initially, agency theory argued that concentrated ownership is an effective mechanism to mitigate agency costs (Jensen and Meckling, 1976). However, scholars came to recognise that concentrated ownership transforms the conflict from principal-agent to a conflict among shareholders themselves (principal-principal) (Young *et al.*, 2008). In this situation, blockholders may use their voting rights to control decision-

making and extract resources, assets and profits at the expense of minority shareholders (Sun *et al.*, 2016).

The severity of principal-principal conflict is dependent on two external governance mechanisms: the legal system and market efficiency (Sun *et al.*, 2016). La Porta *et al.* (2000) point out that the strength of legal investor protection can play a crucial instrument in curbing blockholder opportunism. That is to say, the enforcement of effective sanctions acts as a deterrent to blockholders from abusing their power and vice-versa. Second, blockholders can be constrained by efficient markets, because committing any opportunistic activities sends a negative signal to the market, which in turn affects the stock price (Gomes, 2000) and limit opportunities of future equity financing (Durnev and Kim, 2005).

Accordingly, the immature economy of Saudi Arabia may suffer significantly from principal-principal conflict, because it has neither an effective legal regime (Al-Twaijry *et al.*, 2003) nor an efficient stock market (Asiri and Alzeera, 2013). Although, regulatory bodies have imposed mechanisms to curb rent appropriation by controlling shareholders e.g. requiring one third of board members to be independent and enforcing the adoption of cumulative voting system in board elections (CMA, 2010), controlling shareholders and their representatives still comprise the majority of boards. Furthermore, the principal-principal problem is exacerbated if a blockholder is well connected politically. In such a situation, even if the two aforementioned instruments become effective, a politically connected blockholder is less likely to be affected by external sanctions. His/her political ties will protect him/her from any legal consequences and will also open alternative channels for equity financing when needed.

With regards to executive compensation, even though politically connected members are not usually managers, their relatives and close friends are. This phenomenon is demonstrated by the fact that the employment environment in Saudi Arabia is significantly influenced by nepotism and cronyism (*wasta*) (Tlaiss and Kauser, 2011). Therefore, those politically connected blockholders may exercise their stewardship for the benefit of their related and unqualified-managers and set high non-merit compensation. However, this will be at the expense of minority shareholders, since their equity is poorly managed by unqualified managers and their resources are expropriated (Young *et al.*, 2008).

4.2.3 Institutional Theory

Recently, studies related to political connectedness, conducted in emerging and transition economies, have been widely influenced by the institutional-based perspective (Zhang *et al.*, 2015; Chizema *et al.*, 2015; You and Du, 2012). This theory argues that each context has a unique institutional environment. Therefore, an effective mechanism that works properly in one country, might not be applicable to another country (Young *et al.*, 2008). For example, concentrated ownership is suggested as a remedy to diminish agent-principal conflict. However, this instrument is a *root cause* of principal-principal conflict in immature economies, such as Saudi Arabia, which are characterised by weak formal institutions (Faccio *et al.*, 2001; Young *et al.*, 2008).

Basically, when "formal institutions such as laws and regulations regarding accounting requirements, information disclosure, securities trading, and their enforcement are either absent, inefficient, or do not operate as intended" (Young *et al.*, 2008, p. 198), informal institutions play a substitutive role in addressing organisational behaviour (Peng and Heath, 1996). One of these informal instruments is *wasta*, which is an important factor in emerging Arab economies (Young *et al.*, 2008, p. 198). In Saudi Arabia, *wasta* plays a significant role in daily transactions among individuals, government, and business organisations (Tlaiss and Kauser, 2011). In this sense, *wasta* is considered to be one of the key determinants of organisational culture in the KSA.

For legitimacy and survival purposes, firms in emerging economies seek to build strong connections with the external surrounding environment, in particular with government which enables them to gain preferential treatment (Suchman, 1995; Faccio, 2010). To do so, firms tend to attract government investment or to offer directorship seats for directors who have strong connectedness with top government. Such directors are usually current or former senior government officials (Wang, 2015), or related to the ruling party (Sun *et al.*, 2016; Fisman, 2001). From the resource dependence perspective, the power of these directors may balance or outweigh shareholders' power if the firm significantly depends on the resources that these directors have (Pfeffer and Salancik, 1978). Hence, the politically connected directors may not be as influenced by large shareholders as are regular independent directors who are accused of being a 'rubber stamp' for dominant shareholders (Young *et al.*, 2008).

Typically, political members are influenced by the general orientation of the government; therefore they may act to reinforce government expectations with regards to top executive compensation (Chizema *et al.*, 2015). Moreover, since these directors are usually cautious, they are seriously concerned about the political costs that would arise if they collude either with top managers or controlling shareholders for private interests (Goldman *et al.*, 2009). Put differently, the legitimacy of these members and of the political organisations to which they belong will be significantly affected if they are caught engaging in any corruption scandals. However, the situation might be different if that politician holds a block of shares concurrently. In such a scenario, the blockholder politician may act as a normal investor who seeks rent; thereby, his relationship with other small shareholders will be framed by principal-principal theory (Young *et al.*, 2008).

4.3 REVIEW OF LITERATURE

The economic effects of political connections have attracted increasing scholarly attention in recent years (Faccio, 2010; Civilize *et al.*, 2015; Zhang *et al.*, 2015). Numerous academic studies focus on the contribution of political connections to a firm's survival, especially in immature economies characterised by high levels of corruption (Faccio, 2010; Civilize *et al.*, 2015; Zhang *et al.*, 2015). The existing literature reports evidence of certain benefits that political connections can add to the enterprise, such as increasing its value and performance (Civilize *et al.*, 2015; Guerra Pérez *et al.*), investment diversification (Zhang *et al.*, 2015; Li *et al.*, 2012), privileged access to bank financing (Faccio, 2010; Khwaja and Mian, 2005), regulatory protection (Kroszner and Stratmann, 1998) and government bailouts (Faccio *et al.*, 2006). However, few look at the role of political connections in controlling over executive incentives (Chizema *et al.*, 2015; García-Meca, 2015).

Although the body of literature on political connections and their relationship to executive pay is small, executive compensation is found to be significantly affected by firm characteristics such as firm value and performance (Ntim *et al.*, 2015; Conyon and He, 2012) and leverage level (Chalevas, 2011; Banghøj *et al.*, 2010). Hence, it is essential to understand how political connections can affect these factors in order to build a perception of the indirect relationship between political connection and executive compensation (Ding *et al.*, 2015), before analysing the direct relationship between the

two variables. To the best of my knowledge, no research has yet been conducted in the Arab region or in the Gulf countries into the relationship between political ties and managerial pay. Thus, the literature review focuses on global experiences with a spotlight on the emerging economies.

4.3.1 Definition of Political Connections

The literature demonstrates that there is no single conclusive definition of political connections that fits all contexts. The existing definitions vary significantly since they are subject to different contextual and legal characteristics. For example, while the government system in China is significantly influenced by communism and the sole major political party is the Communist Party of China (Sun *et al.*, 2016), the political system in the US is democratic and there are two major political parties, the Republican party and Democratic party (Goldman *et al.*, 2009). Consequently, the variations between the different political systems leads to diverse definitions of political connections. Arguably, the definitions of political connections not only vary across countries but also within the same country. For instance, Ding *et al.* (2014) classify a firm as politically connected f there is Chinese government ownership, while Wang (2015) and Chizema *et al.* (2015) consider a firm to have political ties if one of its board members is a former government officer, a member of the Chinese People's Congress or a member of the Chinese People's Political Consultative Conference.

The dimensional level of impact and specification of political connections also vary from one definition to another. For example, in Hong Kong, Wong (2010) acknowledges a firm as having a political relationship if one of its board members is concurrently serving on the Election Committee. In addition, Khwaja and Mian (2005) consider a person as a politician in Pakistan if he/she ran in an election, regardless of whether they won the election. In contrast, Fisman (2001) classifies an Indonesian corporation as politically connected according to its links with the family of the Indonesian President Suharto. Undoubtedly, there is a significant difference between having strong links to a family that controls a government and having ties to a political committee.

Thus, it can be concluded that, in order to develop a definition of political connections, contextual characteristics require to be taken into consideration, such as the type of political system and the level of authority. Accordingly, this study uses the presence of a royal family member, a *Shura* Council member, or a state representative on

a board of directors as a proxy for determining that an enterprise has political connections. Since the political system in Saudi Arabia is based on absolute monarchy, a royal family member is expected to have a strong link to senior government officers. Undoubtedly, members of the appointed *Shura* Council or state representatives are officially and directly connected to senior government officers through their positions. However, minsters are not included in the definition because the Saudi Law of the Council of Ministers forbids ministers from accepting memberships in private corporate boards (BECM, 1993).

4.3.2 Political Connections and Firm Performance

The literature shows that political connections can benefit the firm and increase its value through various channels (Goldman *et al.*, 2009). For instance, politically connected enterprises might directly obtain favours through an allocation of lucrative government contracts (Goldman *et al.*, 2009). Moreover, governments may tolerate and exempt connected firms from certain regulations (Imai, 2006). Another example is related to the market share; i.e. firms which receive government favour might enjoy a monopolistic environment and be protected from competitors (Civilize *et al.*, 2015), while tariffs are imposed on foreign competitors (Goldman *et al.*, 2009). All these favours might ultimately result in higher firm value and a better performance and thereby increase managerial incentives. This section is a review of studies offering evidence that political connections are valuable for firms' operations.

Goldman *et al.* (2009) investigate the relationship between political connections and firm value in the US. In order to analyse the value of the political connections, they classify the firms into two categories; those related to the Republican Party and those affiliated to the Democratic Party. Their sample is based on the S&P 500 for the period 1996-2000, and they focus on two aspects: the 2000 presidential election and the nomination of politically connected members to the board. The study finds that approximately 31% of firms are politically connected, and after the announcement of the Republican win, the return was significantly positive for firms connected to the Republican Party and significantly negative for those connected to the Democratic Party. Additionally, the announcement of the board nomination for a politically connected member is found to be related to a positive and significant stock-price response.

Using a sample of 115 non-financial Spanish companies for the years 2003-2012, Guerra Pérez *et al.* (2015) corroborated the findings of Goldman *et al.* (2009). They report that board members who have previously held political office significantly increase firm performance. The study, however, uses a single proxy, namely Tobin's Q, to measure firm performance. This limits the robustness of the results and their generalizability. Moreover, it uses a Probit model which is basically designed to deal with binary variables, which represent experiments with a fixed number of possible outcomes e.g. dummy variable (one or zero). However, using Tobin's Q is not valid since its figures have different values that not limited to certain possible outcomes.

In Far East Asia, Wong (2010) examined the relationship between political connections and multi-performance measures in Hong Kong. The study defines political connection as a shareholder or director who sits on the election committee, and it finds that nearly 16% of the election committee's members are affiliated to listed firms. In order to answer the study's main question on whether or not collusion exists between government and business in Hong Kong, the author utilises a sample from the years 1997-2000 and obtains mixed results. For example, while return on equity was found to be higher when a shareholder or director participates in the election committee, there was a negative effect on market-to-book ratio. This might be an indication that political connections only influence firm performance in accounting terms. Arguably, however, the relationship between political connections and firm performance may be a misleading proxy by which to identify if there is collusion between government and business elites. That is to say, the performance may have been improved by other factors such as the experience of politically connected individuals or the amount of information known about future government plans such as new projects or regulations.

Although the above studies were applied in developed contexts which have mature economies and low levels of corruption compared to emerging countries (Faccio, 2010), they highlight that political connections have a significant influence on firm value and performance. Given the fact that the benefits from political connections are limited in developed economies, the results might therefore be expected to be statistically significant were such a study conducted in an emerging country such as Saudi Arabia.

In an emerging context, Civilize *et al.* (2015) conducted a study with a sample of 653 Thai listed companies that were operating between 1987 and 2008. The study

considers a firm to be politically connected if a board member is connected with the prime minister, a cabinet member, or a member of parliament. The findings demonstrate that 65% of Thai firms are politically connected and that politically connected firms are associated with higher stock realised returns than their counterparts.

Faccio (2010) argues that political connections operate strongly in highly corrupt countries. This argument is supported by studies carried out in China (Wang, 2015; Zhang *et al.*, 2015; Ding *et al.*, 2014), which are ranked 83rd of 168 countries in 2015 by Transparency International with regard to corruption (Transparency International, 2015). For example, Ding *et al.* (2014) adopts two proxies (state ownership and management connections) to measure the influence of political connections on firm performance. Their findings show that only state ownership is associated with superior firm performance. This finding is consistent with that of Wang (2015), who uses a different proxy for political connections—independent directors—but documents similar results; i.e. he observes a positive and significant relationship between political connections and firm value. Furthermore, Conyon *et al.* (2015) examine the role of politically connected CEOs and firm performance and report that when the CEO has political connections, the firm produces a better performance. Zhang *et al.* (2015) also examine the association between political connections and firm diversification in China. They provide evidence that, in general, politically connected enterprises have greater diversification opportunities than non-politically connected ones.

In contrast, Faccio (2010), who uses a sample from across 47 countries, produced a different result. It finds that when a firm is politically connected, the accounting performance declines. Faccio (2010) attributes this negative correlation to the possibility that such firms may be managed by politician managers who may lack the skills required to run a successful business. The study by Faccio (2010), however, has two methodological limitations. First, the analysis is based only on OLS regression, which has several statistical drawbacks if certain assumptions are not met (Gujarati, 2003). Second, it uses a cross-sectional analysis rather than panel data, which limits the robustness of the findings.

4.3.3 Political Connections and Access to Credit

Access to external debt financing gives a firm an advantage in its efforts to expand its operations and comprehensively outperform its competitors. However, such access is

a thorny issue for many enterprises. Therefore, firms tend to establish connections with politicians as a mean of opening channels to greater bank credit, especially those controlled by the government (Khwaja and Mian, 2005). Since this relationship occurs actively in emerging countries, the majority of studies (Civilize *et al.*, 2015; Ding *et al.*, 2014; Wang, 2015) examining the relationship between political ties and long-term finance have been conducted in developing economies. They conclusively document that politically connected firms enjoy preferential treatment with respect to accessing credit.

For example, Khwaja and Mian (2005), which utilises a large sample of borrowers from government and private banks between 1996 and 2002 in Pakistan, recording nearly 10,890 firm-year observations, find that firms with political connections receive substantial preferential treatment from government banks. The findings show that connected firms receive 45% higher bank lending than their non-connected counterparts. Interestingly, this preferential treatment was entirely related to government banks, as privately-owned bank lending show no significant association with political ties. This finding confirms the argument that government banks are more prone to captured and influence by politicians than private financial institutions (Wang, 2015).

Sun *et al.* (2016) and Wang (2015) obtain similar results in China. Wang (2015) uses a random sample of 827 non-financial firms operating between 2003 and 2011. The results show that the larger the percentage of politically connected independent directors on the board, the higher degree of access to external financing. This finding is supported by Sun *et al.* (2016), who document that politically connected directors help to obtain higher long-term debt financing in privately owned enterprises, although their study was limited to 1,046 manufacturing firms operating between 2008-2011.

Using a sample of Malaysian top-500 non-finance listed firms for the period 2001-2004, Bliss and Gul (2012) investigate the relationship between politically connected firms and access to bank lending. The authors conclude that when a firm has political ties with government officers, there is a high likelihood of it enjoying firm-specific political favours from banks with respect to credit. Although this study adopted the OLS approach, which has several limitations (Gujarati, 2003), its findings are qualitatively consistent with the literature.

In contrast, Claessens *et al.* (2008) use contributions to election campaigns as an indirect proxy to measure the effect of political connections. In particular, the authors

investigate if firms' contributions to campaigns related to the Brazilian elections of 1998 and 2002 led to future firm-specific favours. The findings show that firms that made campaign contributions to the winning party received preferential treatment from banks during the four years following the election.

However, establishing political connections through election campaign contributions is not compatible with the context of Saudi Arabia, since the political system is an absolute monarchy. Therefore, direct connections is the most appropriate way to establish political relationships with government, i.e. by appointing directors related to the government to the board of directors or by establishing personal connections with government officers. However, the latter tactic is in fact incommensurable.

The conclusive outcome, that political connections increase access to bank financing, is also reinforced by the comprehensive study of Faccio (2010), who examines the impact of political connections on firm leverage in 47 different countries. The conclusion confirms the notion that when the company has stronger political ties, there is a higher likelihood of it gaining extra financing.

4.3.4 Political Connections and Corporate Governance

Although political connections provide favours to certain firms, they also have a negative impact that enables blockholder rent appropriation (Sun *et al.*, 2016). In other words, political ties may strengthen the position of controlling shareholders and provide them with the required authority and legal protection to expropriate the wealth of minority shareholders through various means, e.g. via related-party transactions (Wang, 2015). Recently, this on-going debate has stimulated academics (Sun *et al.*, 2016; Wang, 2015; García-Meca, 2015) to carry out studies in order to address the relationship between political ties and rent-seeking behaviour.

Sun *et al.* (2016) investigate the situation of having politically connected directors on the board and its consequences for shareholders' interests in 1,046 Chinese manufacturing firms operating between 2008 and 2011. The results reveal that political connections increase transactions related to controlling shareholders. However, the study finds no relationship between political ties and firm performance. Linking the two conclusions indicates that the presence of politically connected directors benefits only

the large shareholders at the expense of small investors. In other words, minority shareholders neither gain advantage from superior firm performance nor benefit from party-related transactions, while controlling shareholders maximise their own wealth by channelling the firm's resources to their privately-owned enterprises.

Similarly, but based on a wider sample consisting of 827 Chinese firms from manufacturing and other non-financial sectors for the years 2003-2012, Wang (2015) find that appointing independent directors who have political connections is significantly associated with higher related-party transactions. This finding demonstrates that controlling shareholders pretend to comply with corporate governance requirements related to board independence; however, they actually appoint politically connected members to protect them from the regulators in the event that they engage in rent appropriation behaviour. Therefore, those independent members do not seem to enjoy real independence from large shareholders.

Cheung *et al.* (2010) analyse 187 related-party transactions reported by Chinese firms in 2001-2002. The study adopts a unique definition for political connections, which distinguishes between firms affiliated with central government and their counterparts connected to the local authority. Interestingly, the final results demonstrate that the local government ownership or the presence of their affiliated directors are significantly associated to negative related-party transactions. In contrast, firms affiliated with the central government obtain benefit from related-party transactions. To be more specific, minority shareholders in firms related to local government are expropriated through such transactions; however, their counterparts which have political connections with the central government benefit from positive related-party. The evidence indicates that the objectives and governance quality are different across government institutions. Therefore, each institution may have unique orientations and goals.

With regards to the avoidance of regulations enforcement, Berkman *et al.* (2010) investigate the consequences of three regulatory changes introduced to improve the protection of small shareholders in China. The research observes that the newly enforced regulations benefit minority shareholders only in non-politically connected firms. However, if a firm has ties with government, these regulations are not effective. That is to say, firms that have close relationships with government are found to be less affected by the new regulations and blockholders in these firms still expropriate the wealth of

minority shareholders through related-party transactions. Although the research mainly relies on cross-sectional analysis i.e. only for 1999, the findings show consistency with other findings (Sun *et al.*, 2016; Wang, 2015).

Political connections are also accused of having a negative influence on the composition of boards of directors. For instance, Ding *et al.* (2014) in the context of China between 2004 and 2006 find that politically connected firms are associated with fewer independent directors than their non-connected peers. Moreover, using a Chinese sample of 1,546 firms over the years 2005-2008, You and Du (2012) examine the consequences of poor firm performance for the status of CEOs. The findings show that politically connected CEOs are less likely to be fired in the event of poor performance. This is because politically connected CEOs can use their political ties to prevent termination of their contract resulting from poor firm performance. Both politically connected CEOs and board members who have political ties are significantly associated with a lower compulsory turnover of CEOs.

With respect to the transparency level, (Al-Hadi *et al.*, 2016), which uses a sample of financial listed-firms from the GCC markets, found that the presence of ruling family members on the board of directors is associated with lower disclosure of risk, especially in firms that are experiencing financial distress or high levels of risk. In other words, politically connected members do not enhance transparency which is considered as a key issue in governance. Although this research partly investigates the Saudi context, it is important to note that the scope is limited to the relationship between political connections and risk disclosure. Furthermore, the sample is only based on financial firms which are subject to various supervisory bodies and different disclosure requirements. Lastly, the research adopts a specific definition of political connections that is limited to the ruling family members. In contrast, my study uses a wider definition of political connections that considers other influential parties such as *Shura* Council members and state representatives.

4.3.5 Political Connections and Executive Compensation

Research around the relationship between political ties and corporate governance has increased significantly (Sun *et al.*, 2016; Wang, 2015; Ding *et al.*, 2014), although only a small number of studies investigate their impact on executive incentives (Chizema *et al.*, 2015; Conyon *et al.*, 2015; Ding *et al.*, 2015). This might be attributed to the data

accessibility, because the majority of studies examining the role of political connections are conducted in emerging economies, which are characterised by low transparency, and therefore lower data. Studies find mixed results regarding the influence of political connections according to whether the connected person is an executive or a director on board of directors. If the person is a beneficiary such as CEO, there is a high likelihood that he/she will exercise his/her political ties to influence his/her own compensation, as suggested by managerial power hypothesis (Bebchuk and Fried, 2009). However, if the person who has the political connections is a board member with a supervisory function, the impact might be more desirable. In this section, the study reviews prior evidence related to the association between the political connectedness and managerial incentives.

Conyon *et al.* (2015) conducted a study to address the question if political connections in management level matter when setting their compensation. Using data from 572 Chinese firms operating in the period 2000-2010, the findings show that when CEOs have political ties, their compensation is more likely to be higher in comparison to non-connected counterparts in other firms. In this sense, CEOs exploit their political connections to strengthen their control over decisions related to their own compensation and thereby extract high non-merit rewards. In other words, political connections help CEOs to expropriate shareholders' wealth. However, the study uses a definition of political connections that is not widely accepted, since it considers CEOs who have military experience to be politically connected, neglecting the fact that not all military individuals have political ties, especially enlisted and low ranking officers.

In the same context, Ding *et al.* (2015), who investigate all listed firms in China's two stock exchanges between 2005-2006, document that politically connected managers cannot increase their own compensation if there is a controlling politically connected owner. However, if managers are the only party who enjoy political connections, their remuneration is found to be significantly higher. This indicates that political connections help to balance between the power of agents and principals. In other words, political ties act as a supportive instrument for controlling shareholders to thwart any managerial opportunistic behaviours, even if those managers have political relationships as well. Notably, the study uses board chairman to refer to the executive managers. The authors justify this by arguing that board chairmen always act as executives in China; thereby, their positions are ranked higher than CEOs. However, this classification is not widely

generalizable; e.g. board chairpersons in Saudi Arabia are not allowed to hold the post of CEO or any other key executive positions concurrently (CMA, 2010).

Furthermore, in Spain, García-Meca (2015) investigates if boards of directors in financial institutions are self-interest when designing their own remuneration packages. The investigation is based on a sample consisting of 44 savings banks that operated between 2004 and 2009. It finds that politically connected chairmen are significantly associated with higher board remuneration, suggesting that political connections are not always to the benefit of the enterprise, especially when the matter is related to personal interest of board or management members.

To the best of my knowledge, Chizema *et al.* (2015) and Hearn *et al.* (2017) are the only research that clearly examine the role of political connections from a supervisory perspective in constraining executive compensation. Chizema *et al.* (2015) carried out their study in the context of China and observe the political impact on 964 listed firms for seven years starting from 2008. The study outcomes demonstrate that politically connected directors can be a substitute for weak governance. That is to say, they find that directors with political experience play a significant role in curbing the opportunism of top executives through reducing their compensation packages. Chizema *et al.* (2015) suggest that politically connected members may enhance adherence to the primary government objective, such as achieving a harmonious society. Furthermore, they argue that politically connected directors may act informally as a government representative to ensure that the government expectations are met with regards to executive remuneration.

Similarly, in the context of Saudi Arabia, politically connected directors such as *Shura* Council members and state representatives may informally represent the government's view with respect to the enhancement of corporate governance. Even royal family members are expected to primarily comply with corporate governance regulations in form and in substance for the purposes of legitimacy. If this is the case, it will lead to higher transparency and low opportunistic behaviours.

Hearn *et al.* (2017), who use a sample of 119 initial public offering (IPO) listed firms for the period 2000 to 2014, also find similar results. The authors observe a negative and significant relationship between the presence of social elites on the board of directors and managerial fixed remuneration. However, the research scope is limited to IPO listed

firms in 17 African economies with only a few observations in each context. Furthermore, their main independent variable namely 'social elites on board' is based on a wide definition since it includes parties that do not necessarily have political connections, such as university professors or directors with commercial background. However, my research uses a more specific definition for political connections that ensures political-classified members have direct ties with government.

According to the literature survey, there is evidence that political connections are a two-edged sword (Ding *et al.*, 2015; García-Meca, 2015; Faccio, 2010). That is to say, while they are beneficial for the firm in obtaining vital resources such as access to bank financing (Faccio, 2010; Khwaja and Mian, 2005), they also have a negative impact from the perspective of minority shareholders, since they are found to be associated with higher third-party transactions which only benefit large shareholders (Sun *et al.*, 2016; Wang, 2015). Furthermore, although much research investigates the role and behaviours of political connections on certain firm characteristics (Civilize *et al.*, 2015; Zhang *et al.*, 2015; Bliss and Gul, 2012), only two studies, (Chizema *et al.*, 2015; Hearn *et al.*, 2017) connect this phenomenon with executive pay-settings. Consequently, the literature has some significant gaps. For example, there is no investigation into countries governed by monarchical regime where royal family members are powerful politically connected members. Furthermore, while the research of Chizema *et al.* (2015) and Hearn *et al.* (2017) are centred on the traditional agency model (principal-agent), no research focuses on the influence of political connections in the presence of large shareholders. Accordingly, my study adds a valuable contribution to the literature by filling these gaps. In doing so, the study extends the understanding of the relationship between political connectedness, using a contextual-based definition of political connections, and managerial pay arrangements, particularly in contexts that suffer from principal-principal conflict. Table 4.1 presents summary of main research to date

Table 4.1: Summary of Key Research

Study	Dependent Variable(s)	Independent Variable(s)	Sample characteristics	Analysis Technique	Main Findings
Goldman *et al.* (2009)	- Stock return - Stock price	1. Connections to the Republican Party 2. Connections to the Democratic Party	A sample from S&P 500 firms for the period 1996 to 2000	- N/A	1) Firms connected to the Republican Party (the Democratic Party) have a positive (negative) and significant association with stock return. 2) Stock price of firms connected to the Republican Party (the Democratic Party) showed a positive (negative) response after the result of the US presidential election 2000.
Guerra Pérez *et al.*	- Firm performance	1. Politically connected directors 2. Family related directors 3. Banks related directors	A sample of 115 non-financial Spanish-listed firms for the period 2003 to 2012	- Probit	1) Directors with a former political post have a positive impact on firm performance. 2) Family directors are associated with higher firm performance. 3) There is a negative and significant relationship between banks related directors and firm performance.
Hearn *et al.* (2017)	- Executive salary	1. Social elites on the board	A sample of 119 IPOs from 17 African countries for the period 2000 to 2014	- Fixed effect - Random effect	1) Boards that have social elites significantly increases executive fixed compensation.
Civilize *et al.* (2015)	- Stock returns	1. Political connections	A sample of 653 Thai-listed firms for the period 1987 to 2008	- Fixed effect - 2SLS	1) There is a positive and significant relationship between the presence of politically connected firms and realised stock returns.
Jackowicz *et al.* (2014)	- Operational performance	1. Politically connected directors	A sample of 105 non-financial Polish-listed firms for the period 2001 to 2011	- GMM - GLS	1) Board members with political ties have a negative and significant impact on companies' operational performance
Domadenik *et al.* (2016)	- Firm performance	1. Politically connected directors	A sample of Slovenian-listed firms for the period 2000 to 2010	- OLS - GMM	1) Politically connected directors are significantly associated with lower firm productivity.
Wong (2010)	- Firm performance	1. Politically connected shareholders 2. Politically connected directors	A sample from Hong Kong firms for the period 1997 to 2000	- OLS - Fixed effect - Logit	1) Both shareholders and directors who have political ties are associated with higher accounting firm performance (ROE). 2) However, they have a negative impact on market related firm performance (market to book ratio)
Ding *et al.* (2014)	- Firm performance - Board independence	1. Political connections	A sample from Chinese-listed firms for the period 2004 to 2006	- 2SLS	1) Political connections positively and significantly affect firm performance. 2) Political connections have a negative and significant relationship with independence level of board of directors.

Wang (2015)	- Firm leverage - Firm value - Blockholders appropriation	1. Independent politically connected directors	A sample of 827 non-financial Chinese-listed firms for the period 2003 to 2012	- Fixed effect	1) Private firms benefit from independent politically connected directors via access to external debt financing and more subsidies from the government. 2) The larger fraction of independent politically connected directors, the higher the firm value. 3) Having more independent directors with political ties increase the magnitude of related-party transactions of the controlling shareholders in private firms.
Conyon *et al.* (2015)	- Firm performance - CEO cash compensation	1. Star CEO 2. Politically connected CEO	A sample of 572 Chinese-listed firms for the period 2000 to 2010	- OLS - Fixed effect	1) Firms that have politically connected CEOs perform much better than firms that hiring CEOs with no political ties. 2) When CEOs have political connections, their compensation is more likely to be higher.
Khwaja and Mian (2005)	- Firm leverage	1. Politically connected directors	A sample of Pakistani firms for the period 1996 to 2002	- Fixed effect	1) Politically connected firms receive larger bank credit than non-connected counterparts. 2) Political connections operate in government banks only; however, privately owned banks have no such ties with politicians.
Sun *et al.* (2016)	- Firm leverage - Firm performance - Blockholders appropriation	1. Politically connected directors	A sample of 1046 manufacturing Chinese firms for the period 2008 to 2011	- Fixed effect - 2SLS	1) Political connections are associated with higher long-term debt. 2) There is no significant relationship between political connections and firm performance. 3) The larger fraction of politically connected directors on board, the higher related-party transaction of large shareholders.
Bliss and Gul (2012)	- Firm leverage	1. Political connections	A sample of top 500 non-financial Malaysian-listed firms for the period 2001 to 2004	- OLS	1) Politically connected firms enjoy preferential treatment with regards to access to credit.
Claessens *et al.* (2008)	- Firm performance - Firm leverage	1. Campaign contributions	A sample of 238 firms contributed in the Brazilian elections in 1998 and 2002	- Fixed effect	1) Companies that provided contributions to elected federal deputies had a higher stock returns than firms that did not in the 1998 and 2002 elections. 2) Firms that made campaign contributions to the winner party, received preferential treatments from banks during the four years following the election.
You and Du (2012)	- Firm performance - Forced CEO turnover	1. Politically connected CEO	A sample of 1546 Chinese-listed firms for the period 2005 to 2008	- OLS - Logistic	1) Politically connected CEOs is less likely to be fired even if they show poor performance. 2) Politically connected CEOs are positively and significantly associated with higher future performance only if the firm ROA is lower than the industry median.
García-Meca (2015)	- Board remuneration	1. Politically connected chairman	A sample of 44 Spanish saving banks for the period 2004 to 2009	- N/A	1) There is a positive and significant relationship between politically connected chairman and board remuneration level.
Yeh *et al.* (2013)	- Abnormal returns - Firm leverage	1. Political connections	All Taiwanese-listed firms for the period between 1998 and 2006	- OLS - Logistic	1) Politically connected firms are associated with higher abnormal returns. 2) Politically connected firms are more likely to have preferential bank lending.

Fan *et al.* (2007)	- First-day stock return - Board professionalism	1. politically connected CEO	A sample of 790 IPOs Chinese firms for the period 1993 to 2001	- OLS - Fixed effect - Random effect	1) Firms with politically connected CEOs are significantly related with poor accounting and stock return performance in contrast to their unconnected counterparts. 2) Politically connected CEOs tend to appoint more bureaucrats on board of directors which reduces the board professionalism.
Ding *et al.* (2015)	- Chairman remuneration	1. Politically connected chairman 2. Politically connected owner	All Chinese-listed firms in the two stock exchanges for the years 2005 and 2006	- OLS	1) Politically connected managers have a positive and significant impact on executive compensation if there is no politically connected owner. 2) Political connections make a balance of power between agents and principals.
Chizema *et al.* (2015)	- Top executive pay	1. Politically connected directors	A sample of 964 Chinese-listed firms for the period 2002 to 2008	- GMM	1) Politically connected directors have a negative and significant effect on key executive remuneration.
Berkman *et al.* (2010)	- Blockholders appropriation - Effectiveness of new regulation related to minority shareholders' protection	1. Political connections	A sample of 887 Chinese-listed firms in 1999	- Cross-sectional regression	1) Minority shareholders benefit from the new regulations designed to protect their interests only in non-politically connected firms. 2) Politically connected blockholders expropriate the wealth of minority shareholders via related-party transactions.
Cheung *et al.* (2010)	- Expropriation of minority shareholders	1. Political connections to local government 2. Political connections to central government	A sample of 187 related-party transactions reported by Chinese firms in 2001-2002	- Cross-sectional regression	1) The ownership of local government or the presence of their affiliated directors are significantly associated with negative related-party transactions. 2) Firms affiliated with the central government have got benefit from positive related-party transactions

4.4 RESEARCH METHOD

4.4.1 Hypotheses Development

4.4.1.1 Political Connections

It has been widely recognised that political connections can influence and explain economic outcomes (Chen *et al.*, 2010a; Ding *et al.*, 2015; Faccio, 2010; Khwaja and Mian, 2005; Sun *et al.*, 2016; Wang, 2015). However, as discussed earlier, this phenomenon is difficult to generalize because there is no single generally accepted definition for political connections, due to the cross-country differences of political systems (Guerra Pérez *et al.*, 2015). Hence, in order to develop a valid definition of political connectedness in a particular context, the political regime should be taken into consideration. Following earlier literature (Faccio *et al.*, 2006; Goldman *et al.*, 2009; Guerra Pérez *et al.*, 2015), this study considers the presence of a politician on a board of directors as a proxy for the existence of a political relationship. More specifically, the firm is recognised as politically connected if at least one member of board of directors is a member of the royal family, is a current or a former member of the *Shura* Council, or is a representative of state investments.

With respect to the activity of political connections in Saudi Arabia, Faccio (2010) conducted a cross-country analysis and documents that political connections are significantly active in emerging economies, particularly in the most corrupt countries. The author argues that political relationships emerge as a result of the weak enforcement of laws and thus create a network of power between business elites.

In terms of corruption levels in Saudi Arabia, the country is not considered as one of the most corrupt economies since it is ranked as 48th out of 168 countries in the Corruption Perceptions Index (Transparency International, 2015). Saudi Arabia obtained a score of 52 out of 100 (where 0 is highly corrupt and 100 is very clean), whereas two-thirds of the surveyed countries scored less than 50. According to the Index, Saudi Arabia is less corrupt than other large or emerging economies such as Turkey (66th), Brazil (76th), China (83rd), Indonesia (88th) and Russia (119th). Furthermore, in comparison to developing countries, it is ranked as less corrupt than Croatia (50th) and Italy (61st).

Although Saudi Arabia is not recognised as one of the most corrupt countries, there is a strong likelihood that political connections are heavily influential in business

transactions. This is due to the fact that the demography in Saudi Arabia is mainly based on a tribal structure, in which personal relationships play a significant role in daily life. The report of The Hofstede Centre (2014) supports this argument, since it has assesses Saudi Arabia at 75% collectivist and having a power distance of 95%. Thus, political connectedness is considered to be a substantial element in the power networks among business elites, which would even affect decisions related to the appointment of key executives.

Views on the consequences of political connections in general are mixed. From an optimistic view, RDT perceives political relationships as an important channel that can bring vital resources to an enterprise (Civilize *et al.*, 2015; Faccio, 2010; Goldman *et al.*, 2009; Pfeffer and Salancik, 1978). Therefore, firms are encouraged to build political ties with other parties in order to survive and compete. For instance, Khwaja and Mian (2005) find evidence in Pakistan that politically connected firms enjoy more substantial and preferential treatment from government banks than firms that have no such connections. This favour also exists in China according to Wang (2015) and Sun *et al.* (2016), who observe that companies with higher numbers of politically connected directors are more likely to receive higher external debt financing.

The privileges of political ties are not limited to bank financing; they also extend to other benefits such as improving firm performance (Goldman *et al.*, 2009; Guerra Pérez *et al.*, 2015), increasing market share (Civilize *et al.*, 2015; Claessens *et al.*, 2008), and being exempted from regulations (Imai, 2006). For example, Goldman *et al.* (2009) highlight that after the announcement of the Republican win in the 2000 US presidential election firms connected to the Republican Party experienced significantly positive returns, whereas their counterparts associated with the Democratic Party faced negative returns. Civilize *et al.* (2015) also demonstrate that in Thailand politically connected firms are associated with higher stock realised returns than their counterparts. Moreover, Guerra Pérez *et al.* (2015) report that board members who had previously held political office significantly increased firm performance. (Civilize *et al.*, 2015; Conyon *et al.*, 2015; Faccio, 2010) support this finding and assert the notion that politically connected enterprises can produce better operational performance than non-connected firms.

Board political capital is also found to bring preferential treatment from government bodies. For instance, Kroszner and Stratmann (1998) conclude that when an enterprise has political relationships it can be protected from restricting regulations. Faccio *et al.* (2006) add that such connected firms are often more eligible for government bailouts than their non-connected counterparts. This empirical evidence demonstrates that political ties can be a blessing for an organisation. They also explain the recent and remarkable trend of firms building political relationships, particularly in emerging economies, where property rights' protection is underdeveloped (Khwaja and Mian, 2005; Faccio *et al.*, 2006; Ding *et al.*, 2014) and where business contracts depending strongly on connections with other parties, especially governments (Goldman *et al.*, 2009).

Despite the fact that much literature posits that the advantages of building political relationships outweigh their costs and disadvantages (Faccio, 2010), political connections also have a negative impact that can lead to harmful consequences for an enterprise (Sun *et al.*, 2016). From the perspective of agency theory, well connected shareholders may exploit political ties for their own interests, which can lead to higher agency costs (García-Meca, 2015). In this context, the political connections of controlling shareholders can provide the required power to expropriate firm resources at the expense of smaller shareholders, thereby exacerbating the principal-principal problem. For instance, Chen *et al.* (2010a) document that political connections increase information asymmetry problems since connected enterprises are found to disclose less accurate analyst forecasts than non-connected ones.

Principal-principal conflict evidently exists in contexts that have a high concentration of ownership (Young *et al.*, 2008). Private controlling shareholders usually seek personal rent appropriations; however, to do so, they need protection from regulatory oversight and sanctions. One effective means by which to obtain such protection is through recruiting politically connected members to the board of directors (Sun *et al.*, 2016). Wang (2015) observes in China that when a firm has a strong board and political capital the related-party transactions with dominant shareholders are increased significantly, implying that political ties benefit one party, at the expense of the other. In support of the adverse role that board political capital can play, Menozzi *et al.*

(2014) find that politically connected directors had a significant negative impact on the accounting performance of Italian public utilities firms from 1994 to 2004.

However, the impact of political connections on corporate governance in general, and on executive compensation in particular, is still inconclusive and shows mixed results. For example, on the one hand, political connections are found to harm the interests of minority shareholders since they enable rent appropriation. As such, Sun Sun *et al.* (2016) and Wang (2015) observe a positive and significant relationship between the presence of politically connected members and related-party transactions. Meanwhile, Sun *et al.* (2016) do not observe any relationship between political ties and firm performance. Political connections are also found to have a negative impact on the composition of boards of directors in China, since they were associated with fewer independent directors than their non-connected peers (Ding *et al.*, 2014).

On the other hand, Ding *et al.* (2015) observe that, when there is a controlling politically connected owner, politically connected managers cannot increase their own compensation. This indicates that political connections can create a balance of power between agents and principals. In other words, political ties are a supportive instrument for controlling shareholders, which allows them to thwart managerial opportunistic behaviours, even if those managers have political relationships as well. To the best of my knowledge, Chizema *et al.* (2015) is the only research that has clearly examined the role of political connections in constraining executive compensation. The findings demonstrate that politically connected directors can be a substitute for weak governance. That is to say, the authors find that directors with political experience play a significant role in curbing the opportunism of top executives by reducing their compensation packages.

However, as mentioned earlier, since the employment process in Saudi Arabia is significantly influenced by *wasta*, there is a strong likelihood that this influence also extends to executive positions. Thus, politically connected members may exercise their stewardship duties in favour of their relatives and close friends and appoint them to key managerial posts. As a result of this favouritism, the managers expect to receive higher perks and packages than their non-supported counterparts. Due to the fact that the bonus component of executive compensation is treated as another means by which to increase fixed pay (no link to firm performance) as demonstrated in the previous chapter, the

research develops the same hypothesis for all constituents of executive compensation as follows:

H1: The presence of a politically connected member on the board of directors has a positively significant impact on executive compensation.

However, each type of politically connected member can have different motives and goals. Therefore, their behaviours and stewardship role will not necessarily be the same. In order to ascertain the effects and attitudes of each type of politically connected member separately, board members who have political relationships are classified into three categories. The first includes members of the royal family, the second consists of members of the *Shura* Council, and the third consists of state representatives.

a) Members of the royal family

The behaviours of members of the royal family are influenced by two dimensions: political and economic. On the one hand, institutional theory argues that such types of members are cautious regarding the political costs that may result from involvement in any corruption issues since scandals may cause serious harm to their political situation (Goldman *et al.*, 2009). Even if the member has no official position in the government, he is still concerned about the reputation of the ruling family to which he/she belongs. Accordingly, the member of the royal family who serves on a board of directors should perform his stewardship role towards shareholders effectively. In doing so, he will enhance the monitoring function over managerial activities, which means that top executives are less likely to extract higher pay.

However, on the other hand, in Saudi Arabia the majority of royal family members who serve on boards of directors are either blockholders or representatives of other royal family blockholders. In other words, these directors have a high stake in the company. Therefore, arguably the main reason for their presence on a board of directors is to manage and protect their own business, not because they have been recruited by a company's owners to obtain advantages for the firm, as claimed by RDT. In this situation, such owner-directors will act as rational investors who primarily seek profitability.

Even though the presence of blockholders helps to control opportunistic managerial activities and thereby reduce principal-agency conflict, Young *et al.* (2008) argue that, in such a situation, relationships among shareholders are framed by principal-

principal theory. That is to say, the conflicts of interest will be between large and minority shareholders. In this case, controlling investors may take decisions that benefit them at the expense of small shareholders. This argument is supported by the findings of Sun *et al.* (2016) and Wang (2015) who demonstrate that having politically connected members on the board of directors significantly increases the transactions related to controlling shareholders.

Consequently, as the majority of royal family members who serve on firms' boards are blockholders or representatives of other related blockholders, they are assumed to be influenced more by economic factors than by the political dimension. However, they will also be concerned about the political dimension and hence will avoid issues that may lead to a corruption scandal. Against this, granting generous compensation for top related managers is not considered to be a serious scandal in the business field in Saudi Arabia, unless it leads to serious consequences such as a collapse or bankruptcy of the company. Therefore, the presence of members of the royal family on a board of directors is expected to increase the executive compensation of their related-managers significantly. Accordingly, the research develops the following hypothesis:

H2: The presence of a member of the royal family on the board of directors has a positively significant impact on executive compensation.

Typically, the presence of politically connected members on boards of directors shows the direct impact of political capital on the level of executive pay. However, this proxy does not capture the dimension of each member's stake in the firm. In order to do so, the research uses size of ownership of the connected member as an additional proxy to measure their stake.

The agency model argues that when a board director holds higher shares of the company, his/her interests are more likely to align with the firm's owners (Randøy and Nielsen, 2002). In other words, if a board member has a large stake in the firm, he will be concerned about his own investment; thus, his supervisory performance will be more effective. However, since most of royal family members who serve on boards of directors are also blockholders, the principal-principal model argues that there will be a conflict of interest between large and small shareholders (Young *et al.*, 2008). Therefore, dominant shareholders may take decisions that are not necessarily in the best interests of the

company as a whole; for example, granting top related managers high non-merit perks. Accordingly, the research develops the following hypothesis:

H3: If the member of the royal family has a higher level of ownership, top executives will receive generous compensation.

b) *Shura* Council members

A board member, who has a current or a former membership in the *Shura* Council, is expected to have stronger motives than members of the royal family to exercise his stewardship role towards all shareholders without discrimination. This is because, in practice, it is rare that *Shura* Council-related board members hold blocks of shares in firms in which they serve, implying that these politically connected members have been recruited by companies primarily to obtain political privileges. If this is the case, such directors will be primarily concerned about their political legitimacy since the political costs in this case outweigh the economic benefits that they may gain from the firm.

That is to say, unlike royal family blockholders, *Shura* Council members have a low stake in firm equity. Therefore, they have less power and discretion to place their relatives into senior executive positions. In this scenario, it can be assumed that *Shura* Council-related directors will not be loyal to top executives; hence, they are more likely to restrict any non-merit pay settings.

However, since the majority of listed firms are controlled by certain families, principal-principal theory argues that there is another potential scenario, whereby *Shura*-related members have been granted board memberships by controlling shareholders in order to extract private benefits (Wang, 2015). One of these benefits is protection from regulatory sanctions that will be imposed if large shareholders seek rents at the expense of minority shareholders (Faccio, 2010; Goldman *et al.*, 2009). In this scenario, political capital would allow, even indirectly, dominant shareholders to take decisions that increase their own wealth, but harm other stakeholders. This potential attitude is reinforced by the fact that Saudi Arabia is ranked 12th in terms of 'public trust in politicians' by the Global Competitiveness Report 2016–2017(World Economic Forum, 2016). Hence, family shareholders prefer the presence of a politician on a board of directors as it gives legitimacy to the decisions being made and reassures minority shareholders that their interests are being taken into account (Yu *et al.*, 2015).

A number of studies (Faccio, 2010; Kroszner and Stratmann, 1998) find evidence that politically connected firms face less regulatory oversight than their non-connected counterparts. Furthermore, Sun *et al.* (2016) and Wang (2015) observe a positive and significant relationship between board political capital and party-related transactions in China. These findings support the potential scenario in which *Shura* Council members are recruited by dominant shareholders to extract private economic rents.

Intuitively, *Shura*-related members will avoid clashing with controlling shareholders who appoint the former to the board and who also control the decisions about continuing their directorships. Guerra Pérez *et al.* (2015) point out that politicians usually prefer to build relations and exchange benefits with blockholders because they have a higher stability than small shareholders and control decision-making. Consequently, political appointees are expected to approve any decisions raised by blockholders, providing that these decisions do not incur unacceptable political costs. One decision that *Shura* Council-related members may perceive as not seriously harmful is top related-managers being granted generous pecuniary incentives, especially as there are practically no repercussions for connected directors if they approve such payments (Chalevas, 2011). Accordingly, the research formulates the following hypothesis:

H4: The presence of a Shura Council member on the board of directors has a positively significant impact on executive compensation.

However, unlike royal family members, *Shura* Council-related directors are less influenced by the economic dimension since they are not blockholders. On the contrary, they are driven by political legitimacy and if they have a stake in the company will be motivated to perform their monitoring function effectively. In support of this argument, agency theory suggests that when a board member has a higher stake in the firm's equity through holding shares, he/she will act as a shareholder and will be concerned about his own investment (Randøy and Nielsen, 2002). This will be reflected in the decisions related to executive compensation in a way that prevents non-merit pay setting. Accordingly, the study develops the following hypothesis:

H5: If the Shura Council member has a higher level of ownership, top executives will receive less compensation.

c) State representatives

Government institutions are dominant investors in the SSE since they own approximately 20% of the market value (Aleqtisadiah, 2014). Therefore, they have numerous representatives on corporate boards. The high voting rights in addition to the direct relationship to the government, give state representative directors massive power, allowing them to influence corporate decisions. RDT argues that directors related to government could provide vital privileges to the enterprise including less regulatory oversight (Guerra Pérez *et al.*, 2015; Faccio, 2010). However, because ownership in Saudi Arabia is highly concentrated, agency theory concerns that controlling shareholders may exploit this protection and seek private rents at the expense of minority shareholders (Young *et al.*, 2008). However, this argument is refuted since government institutions usually hold block of shares; thus, their representatives are less likely to be influenced by individual or institutional large shareholders.

However, this type of directors is perceived as indifferent to achieving the firm's objectives. For example, Li *et al.* (2007) argue that top executives can waste time in pleasing government officials rather than concentrating on achieving the firm's goals. This may negatively affect minority interests and hence lead to the emergence of the principal-principal conflict or agency problem Type II (Conyon and He, 2012). Furthermore, the authors add that state representatives on firms' boards have difficulty in distinguishing between their functional duties as investors' representatives and their administrative tasks. Relatedly, Menozzi and Vannoni (2014) point out that government officials are influenced by bureaucratic behaviour and political ideology. Hence, they may seek to achieve goals other than profitability, which may lead to unfavourable consequences for the enterprise.

The OECD (2015b) warns that boards connected to governments may find it difficult to balance between its duties as a representative of the shareholders and its commitment to achieving government goals, which may lead to interference in the management of the company. The OECD (2015b, p. 35) also suggests that:

> "in order to minimise possible conflicts of interest, the ownership entity should avoid electing an excessive number of board members from the state administration. This is particularly relevant for SOEs engaged in economic activities, where limiting board membership by representatives of the ownership entity or by other state officials can increase professionalism, help

prevent excessive government intervention in SOE management and it may help limit the state's responsibility for decisions taken by SOE boards".

However, the situation in Saudi Arabia is different from the above arguments. Unlike other countries, the controlling role of financial institutions is totally absent in Saudi market due to regulatory restrictions, as the Saudi Banking Control Law prevents financial institutions from owning in excess of 10% of a company's shares (SAMA, 1966). Therefore, government bodies and their representatives are presumed to fill this significant gap and play a substitutive monitoring role that is supposed to be carried out by financial institutions. In addition, the Saudi government attempts to be a role model for other large investors in protecting minority interests from malicious decisions made by large shareholders or their related management.

Furthermore, Colpan and Yoshikawa (2012) argue that government institutions may have other objectives such as long-term growth rather than seeking to earn immediate profits. In other words, state investments can be classified as growth-seeking rather than profit-seeking. Hence, they prefer to link executive compensation to long-term rather than short-term performance (David *et al.*, 1998). Moreover, Chizema *et al.* (2015) suggest that state representatives may adhere to the primary government objective, such as achieving a harmonious society. Thus, the authors argue that state representatives will ensure that government expectations are met with regards to executive remuneration.

Most studies (Conyon and He, 2012; Li *et al.*, 2007; Ramaswamy *et al.*, 2000; Chen *et al.*, 2011; Firth *et al.*, 2007; Hearn, 2013) that examine the role of state ownership are conducted in emerging countries, because the structure of ownership in developed contexts is usually based on institutional and foreign investments (Khan, 2006; Li, 1994). Various academic research on China, where the state has a dominant share of the stock market, find that state ownership is negatively and significantly associated with managerial rewards (Firth *et al.*, 2007; Chen *et al.*, 2011). Consequently, this study formulates two hypotheses as follows:

H6: The presence of a state representative on the board of directors has a negatively significant impact on executive compensation.

H7: If government institutions have a higher level of ownership, top executives will receive less compensation.

4.4.2 Sample Selection and Data Collection

This section provides details about the sources of data used in the thesis and the sample's time frame. Because there is no electronic database for the information on Saudi firms as there is in the developed countries such as the US and the UK, the procedures of collecting Saudi data need more effort and time. All data are collected manually from company annual reports through Tadawul database (*www.tadawul.com.sa*).

The study is based on a sample from the SSE. The context of Saudi Arabia is chosen for several reasons. First, the political regime in Saudi Arabia is stable; hence, there is no concern about the effect of political instability on the results. Second, since the study analyses the role of political connections on the practices of executive compensation, the political system and ownership structure in Saudi Arabia enable this goal to achieved Third, the context contains unique types of politically connected members namely royal family members and *Shura* Council members which enables a significant contribution to the related literature to be made. Last, data are accessible; the transparency of information in Saudi Arabia is much higher than in other emerging monarchical countries.

The initial sample contains all 160 listed firms in the SSE in 15 different industries from 2008 to December 2015 (Tadawul database). This period was chosen for two key reasons. First, data are available and accessible since the enforcement of corporate governance regulations and their disclosing requirements began in 2008. Moreover, this period provides the most recent investigation in the literature with respect to the determinants of executive compensation, which helps to fill the gap and improve the understanding of pay setting practices.

However, due to the characteristics of heterogeneity between financial and non-financial firms and being subject to different regulatory requirements (Wang and Shailer, 2015), the study uses only non-financial firms. This method is supported by prior studies such as (Sakawa *et al.*, 2012; Rashid, 2013; Méndez *et al.*, 2011; Ntim *et al.*, 2015; Shah *et al.*, 2009). After the exclusion of the financial firms, the total examinable sample is 114 firms over the eight-year period 2008-2015. Additionally, some firm-year observations were excluded as follows: 13 were missing disclosure, 56 firms not listed yet, and 24 firms facing bankruptcy issues. Consequently, the final unbalanced sample is 819 firm-year observations.

4.4.3 Models' Specifications

The research develops a model to investigate the hypotheses of the relationship between political connections and executive compensation settings. The model contains three dependent variables which allow the examination of the effect on various constituents of executive compensation packages namely **SALARY**, **BONUS** and finally **TOTAL PAY** (see Table 4.2). Since the data do not meet the assumptions of OLS, especially normality assumption (see the descriptive statistics section 4.5.1 p.186), the study does not use OLS regression; otherwise, the results would be biased and misleading (Baltagi, 2008; Greene, 2008). Consequently, and in order to overcome such bias and problems, this study employs non-parametric tests following prior studies (Elston and Goldberg, 2003; Chen *et al.*, 2010b; Conyon and He, 2011; Ntim *et al.*, 2015).

Based on the results of the Hausman tests (see regression tables pp. 197, 200, 201), the fixed-effect model is the most appropriate technique to investigate the study hypotheses for the dependent variables **SALARY** and **TOTAL PAY**. However, as the dependent variable **BONUS** has censored data because the number of zeros (no bonus) exceed 20% of the total observations, the study employs the Tobit model which is designed to deal with such censored data (Anderson and Bizjak, 2003). The use of Tobit regression is consistent with prior studies that faced similar limited dependent variables such as option packages (Anderson and Bizjak, 2003; Sakawa *et al.*, 2012; Ozkan, 2007). Consequently, the research formulates the firm-year fixed-effect model for the dependent variables **SALARY** and **TOTAL PAY** as follows:

$$\boldsymbol{ln\_PAY_{it} = \beta_0 + \beta_{it} X_{it} + u_i}$$

where;

$\boldsymbol{\beta_0}$ = Intercept
$\boldsymbol{\beta_{it}}$ = Coefficient of slope parameters
$\boldsymbol{X_{it}}$ = Independent variable i at time t
$\boldsymbol{u_i}$ = Error term

While, the **Tobit** model for the **BONUS** component can be formed as follows:

$$\boldsymbol{ln\_BONUS_{it}} = \begin{cases} \boldsymbol{ln\_BONUS^{*}_{it} = \beta_0 + \beta_{it} X_{it} + u_i} & \boldsymbol{if \quad ln\_BONUS^{*}_{it} > 0} \\ \boldsymbol{0} & \boldsymbol{if \quad ln\_BONUS^{*}_{it} \leq 0} \end{cases}$$

where ln_BONUS_{it} is the observed dependent variable; and $ln\_BONUS^{*}_{it}$ is a latent dependent variable that is observed for values greater than 0 and censored otherwise.

Table 4.2: Variable Definitions

Variable name	Description
Dependent variables	
ln_PAY it	The natural logarithm of average compensation per executive for firm *i* in year *t*, including two different components (variables): - **TOTAL PAY** (salary, bonus & non-cash compensation) - **SALARY**
ln_BONUS it	The natural logarithm of average **bonus** compensation per executive for firm *i* in year *t* (for more details see p. 117).
Independent variables	
PM	A dummy variable that equals 1 if the firm has either a royal family member, a *Shura* Council member, or a state representative in the board of directors and 0 otherwise
RFM	A dummy variable that equals 1 if the firm has a royal family member in the board of directors and 0 otherwise
SCM	A dummy variable that equals 1 if the firm has a *Shura* Council member in the board of directors and 0 otherwise
RSI	A dummy variable that equals 1 if the firm has a state representative in the board of directors and 0 otherwise
RFMOWN	The proportion of ordinary shares owned by the royal family members
SCMOWN	The proportion of ordinary shares owned by the *Shura* Council members
STATEOWN	The proportion of ordinary shares owned by the government and general pension funds.
Control variables	
FSIZE	The natural logarithm of the total assets
LEV	Total debt divided by total assets
FAGE	The natural logarithm of total number of years since the firm has been listed on the stock exchange.
ROA	Net profit in year t-1 divided by total assets in year t-1.

4.5 DATA ANALYSIS AND DISCUSSION

4.5.1 Descriptive Statistics

Table 4.3 and Table 4.6 provide evidence that the data in general do not meet the normality assumption required by the parametric tests. For example, Table 4.3 shows that all skewness and kurtosis values of executive compensation variables exceed the value of 1.96 and 3, respectively, even after the transformation of remuneration variables into their natural logarithm. Additionally, Table 4.6 demonstrates that some independent variables such as **RFM**, **SCM**, **RFMOWN**, **SCMOWN**, **STATEOWN**, **FSIZE**, **LEV** and **ROA** have higher kurtosis and skewness values than suggested.

These findings support and justify the usage of non-parametric techniques, which are discussed in the Chapter Three, Section 3.4.2.2, as an alternative approach to overcome the condition of meeting the normality assumption required by parametric tests. The following sub-sections discuss the state and trend of each variable in detail.

4.5.1.1 Descriptive Statistics for Executive Compensation

Table 4.3 displays the descriptive statistics of all the executive remuneration variables (i.e. **TOTAL PAY, SALARY** and **BONUS**). All compensation components are presented in SA Riyals which in practice has a fixed exchange rate equal to approximately 0.267 US dollars. As can be seen in Table 4.3, the average of total compensation (**TOTAL PAY**) is SAR1,511,352 (approximately USD403,530) with a median of SAR1,029,433 and a range from SAR12,000 to SAR28,100,000. This demonstrates that managers in the KSA are rewarded significantly higher compensation than their counterparts in China, who earn nearly US$66,336, as reported by (Conyon and He, 2012, p. 580). This can be attributed to the socialist system applied in China which significantly reduces the variance in labour wages. It can also be attributed to the oil revenues in KSA which have encourage higher levels of wages.

However, the level of executive remuneration in KSA is significantly lower than in Western countries such as the US, UK and Spain where managers on average earn nearly USD3.0 million (Conyon, 2014, p. 76), USD2.4 million (Alagla, 2012), and USD1.1 million (Méndez *et al.*, 2011, p. 62) respectively. This significant difference between managerial pay in KSA and Western region can be attributed to factors such as the existence of a highly competitive labour market, the usage of benchmark standards, different living

costs, and linking incentives to firm performance. Table 4.3 also shows details of other compensation components. As can be seen, the average (median) **SALARY,** and **BONUS** compensation are SAR983,414 (SAR800,275) and SAR515,067 (SAR170,000) respectively.

Table 4.3: Descriptive Statistics of Executive Compensation Variables

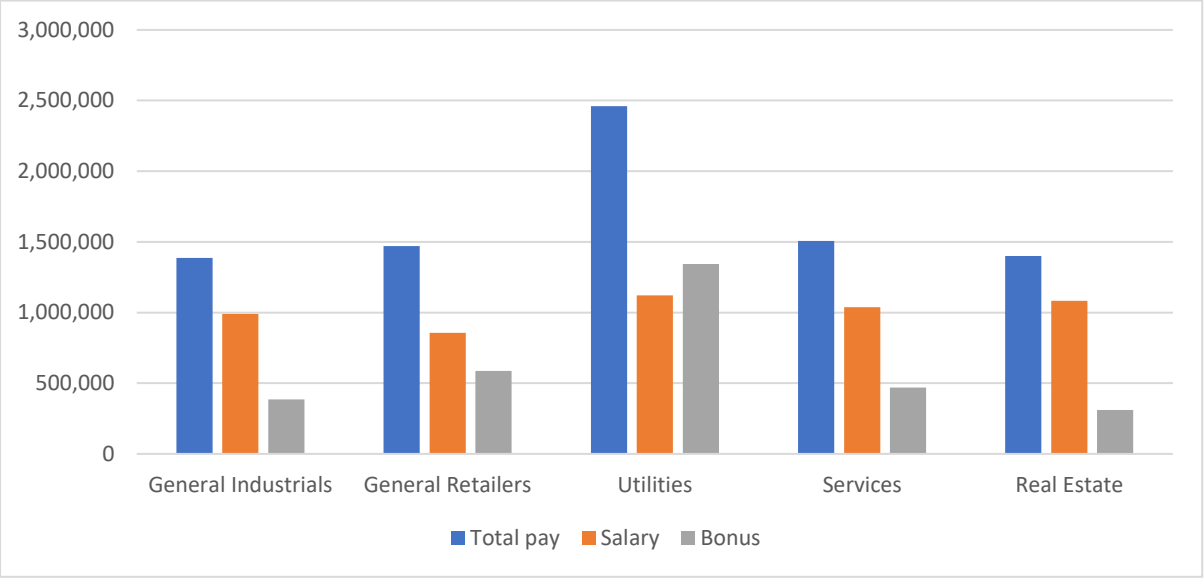
Variable	Mean	Median	Min	Max	Skewness	Kurtosis	Mann-Whitney test
TOTAL PAY	1,511,352	1,029,433	12,000	28,100,00	6.53	77.85	6.05***
SALARY	983,414	800,275	9,000	28,100,00	16.15	370.08	-7.34***
BONUS	515,067	170,000	0	12,900,00	6.30	59.32	-3.44***

Table 4.4 and Figure 4.1 display the mean of executive compensation variables based on the industry type. The study follows the industrial classification reported in Thomson One Banker database which classifies Saudi firms into five main sectors, namely General Industrials, General Retailers, Utilities, Services and Real Estate. As can be seen, managers in the utilities sector receive the highest remuneration (**TOTAL PAY**) compared with their counterparts in the other sectors. This sector also appears to use pay-for-performance criteria, because only in this sector do **BONUS** packages exceed the fixed compensation (**SALARY**). The ownership structure in Figure 4.4 reveals that the state investment (**STATEOWN**) is the dominant investor in the utilities sector; hence, this could be an indication that the greater the state investments, the stronger the link between managerial pay and firm performance.

Table 4.4: Average of Executive Compensation Variables (in SAR) by Sector

Variable	General Industrials	General Retailers	Utilities	Services	Real Estate
TOTAL PAY	1,386,594	1,469,802	2,460,424	1,505,968	1,399,638
SALARY	989,688	857,489	1,122,364	1,038,310	1,083,685
BONUS	385,290	587,546	1,343,997	468,785	310,993

Figure 4.1: Executive Compensation Variables by Sector



In contrast, the real estate sector pays the lowest **BONUS** perks but the second highest **SALARY** compared to the other sectors. According to Table 4.7, 82% of firms that operate in the real estate sector have at least one politically connected director. Therefore, this may indicate the existence of an agency problem resulting from the political capital in the board of directors which leads to a significant reduction in the link between firm performance and executive compensation in this sector. Finally, and in general, the other sectors show a slightly similar trend and magnitude of executive remuneration variables for the pooled sample over the period 2008-2015.

Table 4.5 highlights the change in the average of executive remuneration variables during the period 2008-2015. As shown in Table 4.5 and Figure 4.2, there was a significant upward trend in all managerial perks packages. For instance, **SALARY** is nearly doubled from SAR754,268 in 2008 to SAR1,398,213 in 2015. Furthermore, **BONUS** payments have increased by nearly 76% from SAR377,547 in 2008 to SAR664,487 in 2015.

Table 4.5: Average of Executive Compensation Variables by Year

Year	TOTAL PAY	SALARY	BONUS
2008	1,084,231	754,268	325,693
2009	1,188,071	783,944	397,568
2010	1,276,917	820,435	437,031
2011	1,403,069	879,909	512,877

2012	1,586,649	973,803	612,806
2013	1,664,908	1,003,428	654,856
2014	1,677,972	1,130,717	538,629
2015	2,007,184	1,398,213	573,286

Figure 4.2 demonstrates that **BONUS** showed an almost similar trend to that of **SALARY**; therefore, **BONUS** might be used as another means of increasing executive compensation without any consideration of firm performance. This argument is supported by Figure 4.3, which shows the performance of firms during the study period; i.e. there was a fluctuation in firm performance, whereas executive **BONUS** showed an upward trend during the same period.

Figure 4.2: Trend of Executive Compensation Variables (in SAR), 2008-2015

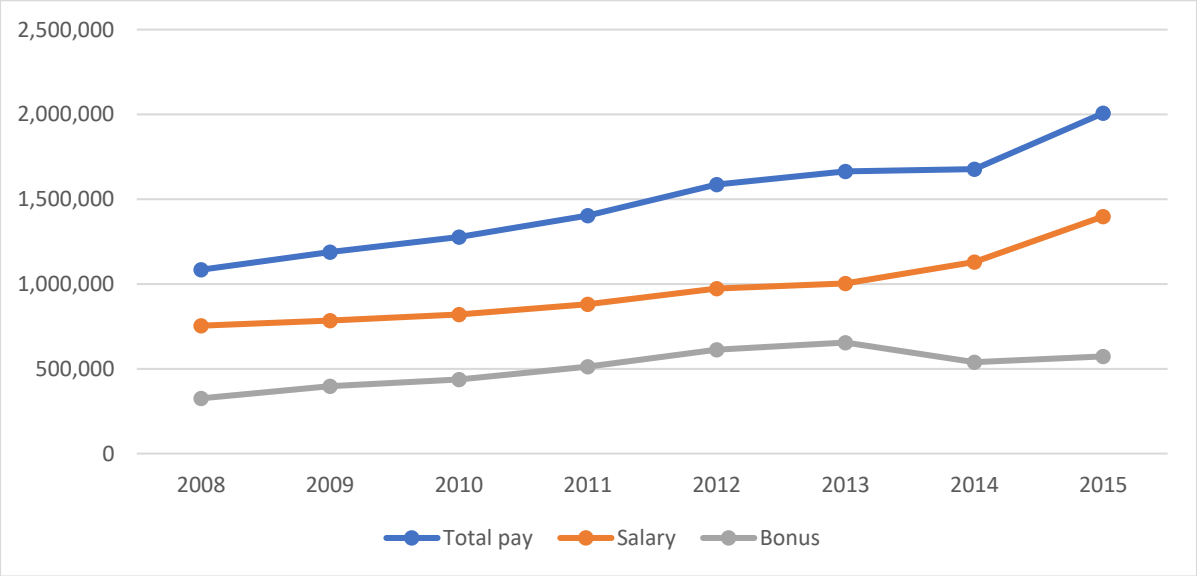
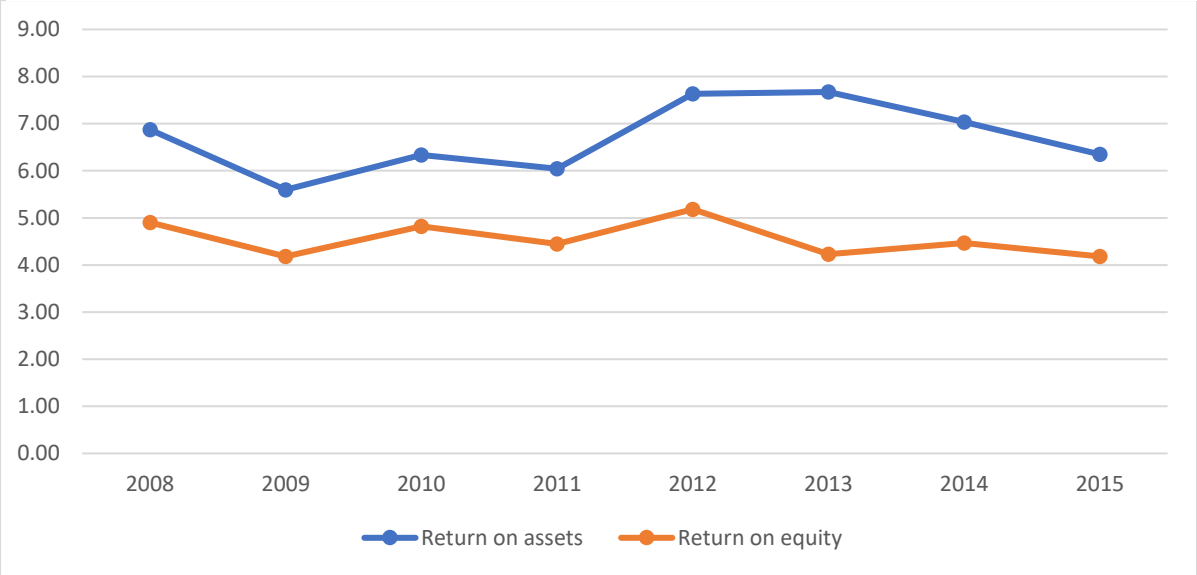


Figure 4.3: Firm Performance (%), 2008-2015



4.5.1.2 Descriptive Statistics for Political Connections and Ownership Variables

Table 4.6 presents the descriptive statistics for all the independent variables of this study. As can be seen, political connections are significant in Saudi Arabia since 60% of corporates' boards have at least one politically connected member (**PM**). This high proportion means that the majority of listed firms in Saudi Arabia have built political channels to ease their operations and to gain other benefits. This finding supports the conclusion of Faccio (2010), who states that the phenomenon of political relationships plays a significant role in the business field in emerging economies. Furthermore, the interaction between business elites and politicians in Saudi Arabia is consistent with the situation in Taiwan where majority of firms are observed to have political relationships (Civilize *et al.*, 2015). This interaction, however, is found to be significantly higher than other immature economies such as China and Pakistan where only 29% and 23%, respectively, of firms are politically connected (Khwaja and Mian, 2005; Zhang *et al.*, 2015). This divergence between the existence of political connectedness in the business field in Saudi Arabia on the one hand, and China and Pakistan on the other, could be attributed to various reasons.

First, the demographic structure in Saudi Arabia is unique outside the GCC and mainly based on a tribal system which is significantly influenced by an orientation to collectivism; thus, personal connections play a significant role in accomplishing everyday transactions, including those related to business (Budhwar and Debrah, 2013; Tlaiss and

Kauser, 2011). This argument is supported by the fact that Saudi Arabia has been assessed at 75% collectivist and having a power distance of 95% (The Hofstede Centre, 2014). Another potential cause for the difference is the adoption of dissimilar definitions of political connections. For instance, this study is using a definition of connectedness that includes the existence of the royal family and *Shura* Council which are not available either in China or in Pakistan.

After classifying the sources of political connections, it is clear that state representation (**RSI**) on the board of directors is the most common way to build political connections since 39% of corporate boards have at least one state representative, while royal family members (**RFM**) are found to serve on one-fifth of the boards of Saudi listed companies. Last, almost 16% firms build political relationships through members of the *Shura* Council (**SCM**), which is a very high proportion in comparison to the number of members of the *Shura* Council. The *Shura* Council only has 150 members, each serving for three years; however, they are recruited by 18 of the listed firms.

Table 4.6: Descriptive Statistics of Independent Variables

Variable	Mean	Median	Min	Max	Skewness	Kurtosis	Mann-Whitney test
PM	0.60	1	0	1	-0.41	1.17	n/a
RFM	0.20	0	0	1	1.49	3.22	
SCM	0.16	0	0	1	1.86	4.44	
RSI	0.39	0	0	1	0.45	1.21	
RFMOWN %	3.39	0	0	95.00	5.32	36.29	
SCMOWN %	0.05	0	0	3.18	7.17	55.19	
STATEOWN %	10.68	0	0	83.60	2.14	6.76	
FSIZE ('000,000)	12,600	2,110	54	358,00	6.18	44.21	-13.90***
LEV %	37.41	34.95	0.41	463.09	5.64	91.66	-1.45
FAGE	2.52	2.83	0	4.11	-0.52	2.31	-6.81***
ROA %	6.73	5.66	-67.81	49.27	-0.30	12.20	-1.40

Importantly, the magnitude level of political ties is significantly different across the different sectors. As shown in Table 4.7, political connections (**PM**) are highest in the real estate and utilities sectors with 82% and 79%, respectively, of companies politically connected. These relationships seem to be built mainly through representatives of the

state (**RSI**) since these representatives are on 74% and 68% of the corporate boards in the real estate and utilities sectors, respectively.

Meanwhile, members of the royal family (**RFM**) and the *Shura* Council (**SCM**) are mostly concentrated in the services and general industrials sectors. Royal family members (**RFM**) dominate the services sector being present in about half of its corporate boards, due to the high equity (22%) that they have in this sector. *Shura* members (**SCM**) are found in the services and general industrials sectors equally. It is worth noting that members of the royal family (**RFM**) and *Shura* Council (**SCM**) are also present in non-state dominated sectors. This demonstrates that companies resort to alternative means of opening political channels if there is no direct contact with government through state representatives.

Across industrial sectors, Table 4.7 highlights that each source of political connections has different levels of stake (see Figure 4.4). For example, the Saudi state (**STATEOWN**) concentrates its investments in the utility sector; probably as a means of control rather than seeking profitability, as the utility sector provides the most vital services for the public, including electricity, energy and telecommunications. In contrast, royal family members (**RFM**) invest in the services sector which is generally dominated by family investments. Interestingly, ownership of *Shura* members is found to be trivial i.e. their average ownership does not exceed 5% of any industry.

Table 4.7: Average of Political Connections and Ownership Variables by Sector

Variable	General Industrial	General Retailers	Utilities	Services	Real Estate
PM	0.63	0.39	0.79	0.56	0.82
RFM	0.21	0.17	0.10	0.44	0.12
SCM	0.23	0.05	0.07	0.20	0.13
RSI	0.40	0.19	0.68	0.13	0.74
RFMOWN %	1.82	2.62	0.56	21.69	1.95
SCMOWN %	0.06	0.00	0.00	0.26	0.00
STATEOWN %	11.64	4.36	27.37	1.42	13.50

This finding supports the notion that *Shura* members are recruited by firms to benefit from their political connections, rather than serving on the board of directors to manage their own investment as royal family members and state representatives do. The importance of building political relationships through the three sources appears to be highly significant over the whole period 2008 to 2015 (see Table 4.8). This confirms the argument that political connections play a significant role in the business environment in less-developed economies (Faccio, 2010)

Figure 4.4: Ownership of Politically Connected Investors by Sectors

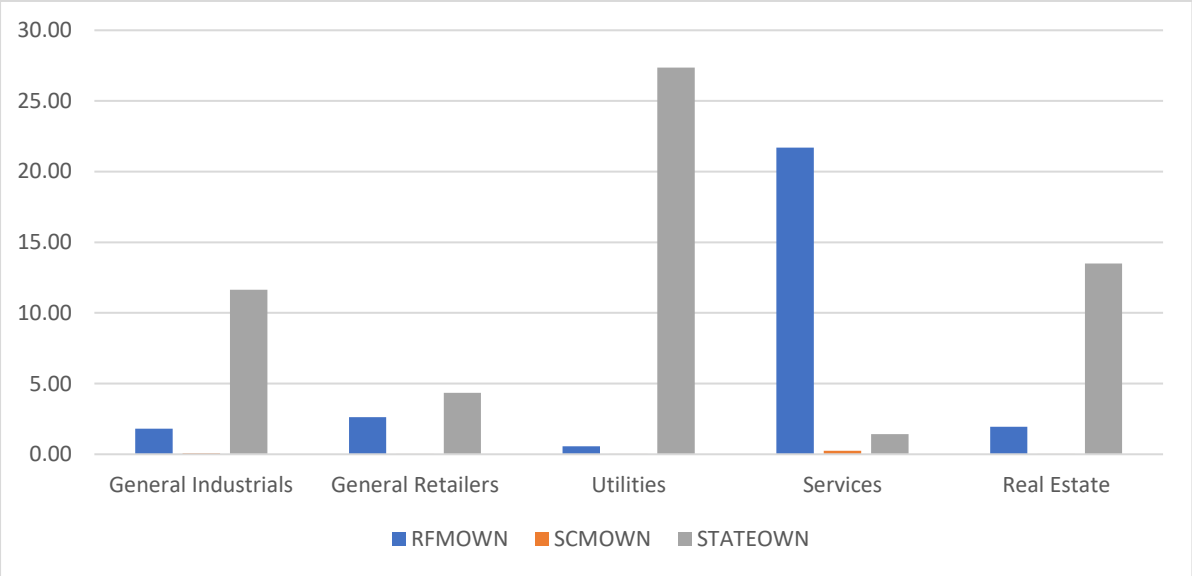


Table 4.8: Average of Political Connections and Ownership Variables by Year

Variable	2008	2009	2010	2011	2012	2013	2014	2015
PM	0.56	0.57	0.60	0.61	0.61	0.60	0.61	0.62
RFM	0.21	0.19	0.19	0.20	0.21	0.20	0.21	0.20
SCM	0.17	0.17	0.18	0.17	0.16	0.15	0.15	0.13
RSI	0.36	0.37	0.38	0.41	0.40	0.40	0.40	0.40
RFMOWN	3.81	3.50	3.37	3.54	3.31	3.24	3.25	3.23
SCMOWN	0.07	0.08	0.07	0.06	0.06	0.03	0.03	0.02
STATEOWN	9.63	11.12	10.79	10.92	10.58	10.57	10.57	11.01

4.5.2 Correlation Coefficients

According to Table 4.9, the results of the correlation matrix show that no serious collinearity problem exists between regressors i.e. all pairwise correlations between

explanatory variables are lower than 80% (Gujarati, 2003; Hair *et al.*, 2006). According to Spearman's correlation, the data in the Table reveals that there is a high correlation (0.87) between state representatives (**RSI**) and state ownership (**STATEOWN**), although the results of Pearson's test show a lower correlation (0.66). The same situation is found between members of royal family (**RFM**) and their ownership (**RFMOWN**), where the correlations according to Spearman's and Pearson's are 0.78 and 0.48, respectively. Consequently, in order to avoid serious multicollinearity problem, the research investigates the effect of political members and their related ownership variables in two separate regression models. Furthermore, there are moderately positive correlations between firm size (**FSIZE**) and **STATEOWN** (0.57) and **RSI** (0.56). Consequently, it can be concluded after splitting up the highly-correlated variables into different separate regressions estimates, the study's models do not suffer from the multicollinearity problem.

For further checks, the study emplys the VIF test for each model. Statistically, it is argued that if any predictor has a VIF exceeding 10, the regression model suffers from multicollinearity (Hair *et al.*, 2006; O'brien, 2007). Accordingly, the outcomes of VIF tests, reported in Table 4.10, Table 4.11, and Table 4.12, confirm the findings of the Spearman's test that multicollinearity does not seriously influence the coefficient estimates of the predictors of the second empirical model.

Table 4.9: Correlation Matrix

	[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[12]	[13]	[14]	[15]
[1] TOTAL PAY		0.89*	0.46*	0.19*	0.09*	0.10*	0.21*	0.15*	0.02	0.20*	0.59*	0.25*	-0.19*	0.18*
[2] SALARY	0.90*		0.23*	0.22*	0.08*	0.13*	0.25*	0.10*	0.05*	0.25*	0.56*	0.22*	-0.17*	0.09*
[3] BONUS	0.75*	0.47*		0.07*	0.05*	0.04*	0.08*	-0.01	0.04*	0.11*	0.30*	0.12*	-0.09*	0.27*
[4] PM	0.21*	0.26*	0.12*		0.40*	0.36*	0.65*	0.21*	0.13*	0.43*	0.45*	0.05*	0.21*	0.07*
[5] RFM	0.11*	0.10*	0.10*	0.40*		-0.09*	-0.06*	0.48*	-0.08*	0.01	0.04*	-0.04*	0.01	0.13*
[6] SCM	0.10*	0.14*	0.04*	0.36*	-0.09*		0.06*	-0.06*	0.36*	0.01	0.15*	0.14*	-0.08*	-0.08*
[7] RSI	0.21*	0.26*	0.11*	0.65*	-0.06*	0.06*		-0.07*	0.03	0.66*	0.54*	-0.03*	0.28*	0.11*
[8] RFMOWN	0.10*	0.06*	0.08*	0.34*	0.78*	-0.09*	0.00		-0.04*	-0.06*	0.11*	0.05*	-0.13*	-0.16*
[9] SCMOWN	0.03*	0.05*	0.04*	0.20*	-0.12*	0.56*	0.09*	-0.11*		-0.07*	0.01	0.04*	-0.02	-0.07*
[10] STATEOWN	0.25*	0.28*	0.17*	0.59*	0.00	0.02	0.87*	0.03*	-0.04*		0.56*	0.04*	0.16*	0.12*
[11] FSIZE	0.59*	0.62*	0.40*	0.49*	0.04*	0.17*	0.56*	0.04*	0.03*	0.57*		0.29*	-0.10*	-0.02
[12] LEV	0.40*	0.36*	0.30*	0.05*	-0.08*	0.19*	-0.03*	-0.02	-0.01	0.03*	0.40*		-0.20*	-0.17*
[13] FAGE	-0.17*	-0.16*	-0.09*	0.24*	0.04*	-0.13*	0.32*	0.02	-0.07*	0.31*	-0.04*	-0.30*		-0.01
[14] ROA	0.19*	0.06*	0.33*	0.05*	0.17*	-0.11*	0.04*	0.03*	-0.05*	0.05*	-0.07*	-0.24*	0.01*	

Spearman rank correlations are reported below the diagonal, and Pearson correlation coefficients are reported above the diagonal.

* denotes significance at 0.05 level

4.5.3 Discussion of Research Findings

Table 4.10 presents the results of the regression analysis for the variables of political connections and their effects on each component of executive remuneration. The R-squared of models 1 and 2 demonstrate that 22% and 18% of the variation in the dependent variables **(TOTAL PAY)** and (**SALARY**), respectively, are explained by the variations of the included independent variables. These moderate proportions of explanatory power (R^2) are consistent with previous studies. For instance, the R-squared statistics of García-Meca (2015) and Chizema *et al.* (2015) are 31% and 27%, respectively. However, these moderate explanatory powers indicate that there are other, omitted variables that influence the practices of setting executive perks packages. In the context of KSA, where personal connections and tribal ties play a significant role in the process of hiring top managers and determining their wages (Budhwar and Debrah, 2013), such moderate R-squared statistics are not surprising. However, these behavioural characteristics, which are beyond the scope of this study, are not statistically measurable.

Consistent with Hypothesis 1, which predicts a positive and significant relationship between the presence of political members on boards of directors (**PM**) and executive pay, the results in Table 4.10 show that the presence of political members on the board (**PM**) is significantly associated with higher **TOTAL PAY** and **SALARY**. However, their presence is found to have a negative relationship with **BONUS** perks which is the only variable compensation that could be linked to firm performance in the Saudi context.

The positive association between political connections (**PM**) and **TOTAL PAY** and **SALARY** supports the conclusion of Faccio (2010) that political ties in general play a significant role in shaping business decisions in less-developed economies. However, with regards to executive compensation, the outcome does not match the finding of Chizema *et al.* (2015) who observe a contrasting outcome, i.e. top executives are less likely to receive higher compensation when the board of directors has at least one politically connected director. To the best of the author's knowledge, the study of Chizema *et al.* (2015) is the only one that directly investigates the relationship between political connections and executive compensation. However, García-Meca (2015), who examines the impact of political ties on the decisions related to board remuneration in Spain,

observes a negative and significant reduction in remuneration level if the firm is politically connected.

Although politically connected members are susceptible to serious political loss if their names are involved with financial scandals (Goldman *et al.*, 2009), as mentioned earlier they may perceive that granting managers generous pay is unlikely to lead to a serious scandal as long as the financial position of the company is stable. Therefore, they would not mind benefiting their related managers with high compensation packages. Since controlling decisions related to executive compensation is considered a reflection of good corporate governance and vice-versa, this result implies that political connections might not be beneficial for governance purposes.

Table 4.10: Regression Analysis: Political connections and Executive compensation

	(1) **TOTAL PAY**	**(2)** **SALARY**	**(3)** **BONUS**	**VIF**
	Fixed effect	**Fixed effect**	**Tobit**	
PM	0.195*** (2.96)	0.234*** (3.41)	-1.234* (1.83)	1.38
FSIZE	0.342*** (5.27)	0.270*** (3.02)	1.302*** (4.70)	1.42
LEV	0.002*** (3.08)	0.002*** (3.27)	0.016 (2.03)	1.17
FAGE	0.270*** (6.33)	0.292*** (6.62)	0.355 (1.09)	1.13
ROA	0.009*** (4.16)	0.002 (1.03)	0.113*** (4.36)	1.04
Constant	5.567*** (4.13)	6.754*** (4.83)	-20.266*** (3.44)	
Observations	819			
Adj. R2	.22	.18		
F-statistics	38.62***	31.72***		
Wald Chi2			45.25***	
Mean VIF				1.23
Hausman's Chi2	67.13***	67.71***		

All variables are defined in Table 4.2
***** p<0.01, ** p<0.05, * p<0.10**

This argument is supported by several studies (Ding *et al.*, 2014; Sun *et al.*, 2016; Wang, 2015), which find that political relationships weaken the quality of corporate

governance in emerging economies. For example, Ding *et al.* (2014) conducted empirical research in China in order to examine the role of political connections in structuring boards of directors. Their study documents that the existence of political ties is significantly associated with lower levels of board independence. However, this contradicts the suggestions of good practice of corporate governance, which encourage the independence of corporate boards (Fama and Jensen, 1983b; Ozdemir and Upneja, 2012). Furthermore, Sun *et al.* (2016) and Wang (2015) also observe a negative relationship between political relationships and blockholder appropriation in China. The authors find that when a firm is politically connected, related-party transactions, which primarily benefit controlling shareholders, are significantly increased.

In terms of political connections, Table 4.11 shows the impact of each type of politically connected member on executive compensation. Inconsistent with Hypotheses 2 and 4, the findings reveal that when political connections are classified into different categories according to the source of connections, neither royal family members (**RFM**) nor *Shura* Council members (**SCM**) have any significant relationship with executive compensation packages. Additionally, the research does not accept Hypothesis 6 which predicts a negative and significant relationship with the presence of state representatives on board of directors and managerial pay. On the contrary, the results show a positive and significant relationship between the presence of state representatives (**RSI**) and **TOTAL PAY** and **SALARY**.

With regards to **BONUS** perks, all types of political connections are found to have a negative but not statistically significant, except **RSI**, association with **BONUS** perks. This evidence supports the previous conclusion that politically connected members do not consider components of pay that are supposed to link remuneration with improved firm performance. The finding indicates that the presence of a politically connected director does not enhance the effectiveness of governance standards, in particular the ones related to the decisions on executive compensation. The outcome is consistent with the finding of Cheung *et al.* (2010) who finds that directors affiliated with the Chinese central government increase the amount of related-party transactions. In other words, their presence weakens governance quality and allows for blockholders appropriation. This finding somewhat confirms the argument that top managers are treated preferentially when the firm is protected from regulatory oversight (Kroszner and Stratmann, 1998).

Overall, it can be concluded that all types of political connections—namely, royal family members (**RFM**), *Shura* Council members (**SCM**) and state representatives (**RSI**)—are not effective in controlling managerial opportunism, in particular executive compensation. In contrast, their presence appears to provide protection for controlling shareholders and their related managers from any regulatory surveillance. This does not necessarily mean that these connected directors are directly colluding with decisions related to executive compensation. However, their political connections might be exploited by related-parties to achieve personal benefits, such as extracting high non-merit perks, with no concern for any legal liability.

Table 4.11: Regression Analysis: Type of Political Connections and Executive compensation

	Royal family members				*Shura* council members				State representatives			
	(1)	(2)	(3)		(4)	(5)	(6)		(7)	(8)	(9)	
	TOTAL PAY	SALARY	BONUS	VIF	TOTAL PAY	SALARY	BONUS	VIF	TOTAL PAY	SALARY	BONUS	VIF
	Fixed effect	Fixed effect	Tobit		Fixed effect	Fixed effect	Tobit		Fixed effect	Fixed effect	Tobit	
RFM	-0.024 (0.22)	0.073 (0.64)	-0.214 (0.24)	1.02								
SCM					0.035 (0.48)	0.072 (0.96)	-0.827 (1.10)	1.04				
RSI									0.187** (1.92)	0.167* (1.65)	-1.454* (1.85)	1.74
FSIZE	0.346*** (5.28)	0.280*** (4.12)	1.154*** (4.31)	1.10	0.347*** (5.31)	0.276*** (4.07)	1.176*** (4.38)	1.11	0.342*** (5.25)	0.271*** (4.01)	1.358*** (4.59)	1.74
LEV	0.002*** (2.85)	0.002*** (3.04)	0.016** (2.12)	1.17	0.002 (2.87)	0.002*** (3.03)	0.017** (2.15)	1.17	0.002*** (2.89)	0.002*** (3.03)	0.016** (2.08)	1.20
FAGE	0.273*** (6.37)	0.297*** (6.68)	0.304 (0.92)	1.05	0.274*** (6.39)	0.299*** (6.71)	0.282 (0.86)	1.05	0.265*** (6.16)	0.289*** (6.47)	0.409 (0.82)	1.21
ROA	0.010*** (4.57)	0.003 (1.38)	0.107*** (4.12)	1.05	0.010*** (4.58)	0.003 (1.49)	0.106*** (4.15)	1.04	0.010*** (4.66)	0.004 (1.57)	0.109*** (4.36)	1.05
Constant	5.560*** (4.10)	6.657*** (4.70)	-17.636** (3.05)		5.563** (4.10)	6.747*** (4.79)	-17.978*** (3.10)		5.625*** (4.15)	6.805*** (4.84)	-21.787*** (3.63)	
Observations	819											
Adj. R2	.21	.17			.21	.17			.21	.17		
F-statistics	36.43***	29.01***			36.47***	29.14***			37.34***	29.57***		
Wald Chi2			41.54***				42.65***				44.95***	
Mean VIF				1.08				1.08				1.39
Hausman's Chi2	54.50***	108.18***			54.59***	513.56***			64.34***	53.42***		

All variables are defined in Table 4.2.
***** p<0.01, ** p<0.05, * p<0.10**

Meanwhile, Table 4.12 reveals the outcomes of the further analysis which investigates the relationship between stake magnitudes in the corporate equity related to each type of political connections and the levels of executive compensation. As can be seen, contrary to Hypothesis 7, ownership by the state (**STATEOWN**) is found to have a positive and significant association with **TOTAL PAY** and **SALARY**. The positive relationship between state investment and executive pay-settings confirms the data in Table 4.11 that the state ownership exacerbates agency costs by raising the levels of executive compensation. A potential interpretation is that government representative directors, who usually work in government, have difficulty in distinguishing between their functional duties as investors' representatives and their administrative tasks (Conyon and He, 2012).

Table 4.12: Regression Analysis: Ownership by Type of Politically Connected Member and Executive compensation

	(1)	**(2)**	**(3)**	
	TOTAL PAY	**SALARY**	**BONUS**	**VIF**
	Fixed effect	***Fixed effect***	***Tobit***	
RFMOWN	0.004 (0.20)	0.006 (0.27)	-0.013 (0.33)	1.08
SCMOWN	-0.046 (0.64)	-0.035 (0.46)	0.153 (0.20)	1.02
STATEOWN	0.010** (2.38)	0.008* (1.78)	-0.038 (1.52)	1.66
FSIZE	0.335*** (5.14)	0.276*** (3.94)	1.388*** (4.54)	1.74
LEV	0.002*** (2.94)	0.002*** (3.06)	0.016** (2.08)	1.18
FAGE	0.271*** (6.30)	0.295*** (6.59)	0.337 (1.03)	1.13
ROA	0.010*** (4.76)	0.004* (1.64)	0.108*** (4.19)	1.08
Constant	5.698*** (4.20)	6.848*** (4.85)	-22.386*** (3.45)	
Observations	819			
Adj. R2	.21	.17		
F-statistics	27.10***	21.23***		
Wald Chi2			44.29***	
Mean VIF				1.27
Hausman's Chi2	70.18***	41.23***		

All variables are defined in Table 4.2
***** p<0.01, ** p<0.05, * p<0.10**

In contrast, neither the ownership of royal family members (**RFMOWN**) nor the ownership of *Shura* Council members (**SCMOWN**) are found to have any significant association with executive remuneration decisions. Therefore, Hypotheses 3 and 5 are not accepted. These findings, in addition to those shown in Table 4.11, indicate that, unlike the situation of state ownership, ownership by the royal family and *Shura* Council are observed to have no direct influence on the decisions related to executive pay.

In terms of the impact of firm characteristics on managers' remuneration, all regression estimates demonstrate that firm size (**FSIZE**) is a key determinant of executive compensation in KSA and has a positive and significant relationship with all components of managerial pay. This means that top managers who serve in larger companies are compensated more generously than their counterparts in smaller companies. The positive relationship is because larger companies have more complicated operational activities (Cheng and Firth, 2006; Core *et al.*, 1999). Hence, there is a need to hire better qualified and skilled managers, who will demand higher compensation packages in exchange for their services (Chalevas, 2011; Baker *et al.*, 1988). This conclusion is one of the few for which there is conclusive evidence in the literature (Méndez *et al.*, 2011) since numerous studies document similar findings, both in developed and less-developed economies (Conyon, 2014; Hearn, 2013; Armstrong *et al.*, 2012; Colpan and Yoshikawa, 2012; Conyon and He, 2012; Banghøj *et al.*, 2010).

The relationship between the leverage ratio (**LEV**), which reflects the financial structure of the company, and executive pay settings has been extensively researched (Chalevas, 2011; Banghøj *et al.*, 2010; Firth *et al.*, 2007). The results in almost all the relevant tables show that the debt ratio (**LEV**) is significantly and positively associated with higher executive compensation**.** In other words, top managers are found to be rewarded with higher remuneration when the firm has high financial leverage. This evidence does not support the notion of the theory of free cash flow (Jensen, 1986) which states that corporates with high financial leverage have a greater interest in curtailing their payments; thus, they have less ability to pay high remuneration to top managers. Empirically, the outcome is also opposite to the findings of previous studies (Basu *et al.*, 2007; Bryan *et al.*, 2000; Cyert *et al.*, 2002; Firth *et al.*, 2007), which document negative correlations between debt ratio and managerial pay levels. This interesting finding in the Saudi context can be attributed to several potential reasons. First, as business

transactions including access to bank loans depend significantly on personal connections, managers may be highly compensated in exchange for their connections and efforts. Another potential interpretation is that as these firms have higher risks, managers may demand for higher compensation in order to offset future dismissal risks

All tables reveal that firm age (**FAGE**) has a positive and significant impact on compensation variables, namely **TOTAL PAY** and **SALARY**. This conclusion confirms the notion that older companies are more efficient and more profitable than their younger counterparts; thus, they have a greater ability and more likelihood to pay their managers generously (Rashid, 2013). The result is consistent with Rashid (2013) who uses a sample of Bangladeshi firms and finds that the longer the firm has been listed on the stock exchange, the greater the compensation the executives received.

The regression analysis in all models shows that firm performance (**ROA**) is positively and significantly correlated to **TOTAL PAY** and **BONUS**. This evidence matches the findings reported by international research which documents that firm performance has a positive and significant effect on managerial pay (Ntim *et al.*, 2015; Conyon and He, 2012; Colpan and Yoshikawa, 2012; Sakawa *et al.*, 2012).

4.5.4 Robustness Checks

In order to check how robust the findings are, further analyses is carried out. First, another proxy is used to measure the variable of political connections (**PM**). Instead of using a dummy variable to capture the influence of politically connected members on a board of directors as shown in Table 4.10, their presence has been measured as proportion to the total number of board members. Interestingly, Table 4.13 shows that in general the variation of politically connected members as a proportion of total board membership does not affect the decisions related to executive compensation. However, it does so on variable compensation since it shows a negative impact on **BONUS** component. That is to say, the results demonstrate that the higher the proportion of politically connected members, the lower the link between executive compensation and firm performance. Although there are differences in statistical levels of the relationships between political connections and executive compensation between Table 4.10 and Table 4.13, the direction of the relationships are similar, confirming that political connections in general are not effective in constraining managerial incentives.

Table 4.13: Robustness Tests: Ratio of Political Connections to Total Board Membership and Executive Compensation

	(1) TOTAL PAY	(2) SALARY	(3) BONUS	VIF
	Fixed effect	*Fixed effect*	*Tobit*	
PM2	0.003 (0.97)	0.004 (1.43)	-0.042* (1.85)	1.60
FSIZE	0.343*** (5.25)	0.270*** (3.98)	1.388*** (4.70)	1.66
LEV	0.002*** (2.90)	0.002*** (3.07)	0.016** (2.05)	1.17
FAGE	0.276*** (6.43)	0.300*** (6.74)	0.339 (1.04)	1.12
ROA	0.010*** (4.46)	0.003 (1.35)	0.112*** (4.34)	1.05
Constant	5.605*** (4.13)	6.812*** (4.84)	-22.174*** (3.55)	
Observations	819			
Adj. R2	.21	.17		
F-statistics	36.65***	29.41***		
Wald Chi2			45.11***	
Mean VIF				1.32
Hausman's Chi2	56.86***	921.76***		

PM2 is defined as the total number of politically connected members divided by board size. All other variables are defined in Table 4.2.
***** p<0.01, ** p<0.05, * p<0.10**

Additionally, the study adopts various definitions of political connections to ensure that the findings are robust in terms of different definitions. The original definition consists of three types of political connections, namely royal family members, *Shura* Council members and state representatives. However, in this stage, the sources of political connections are classified into different variables as follows: **PM3** is defined as a dummy variable that equals 1 if the firm has either a royal family member or a *Shura* Council member on the board of directors and 0 otherwise; **PM4** equals 1 if the firm has either a royal family member or a state representative on the board of directors and 0 otherwise; **PM5** equals 1 if the firm has either a *Shura* Council member or state representative on the board of directors and 0 otherwise. Each new variable is investigated in a separate regression analysis, as can be seen in Table 4.14. The Table shows that definitions of political connections include state representatives (**PM4** and

PM5) lead to the same finding of the original definition of political connections (Table 4.10). On the other hand, **PM3,** which represents individual political members (i.e. excludes state representatives), shows no significant relationship with the settings of executive compensation. However, the direction of relationships between political connections and executive compensation in the two tables (Table 4.10 and Table 4.14) is almost identical. This evidence demonstrates that the findings of the main model are significantly robust to other definitions of political connections, which implies the validity of the definition of political connections in Saudi Arabia

Table 4.14: Robustness Tests: Various Definitions of Political Connections and Executive Compensation

	(1)	(2)	(3)		(4)	(5)	(6)		(7)	(8)	(9)	
	TOTAL PAY	**SALARY**	**BONUS**	**VIF**	**TOTAL PAY**	**SALARY**	**BONUS**	**VIF**	**TOTAL PAY**	**SALARY**	**BONUS**	**VIF**
	Fixed effect	***Fixed effect***	***Tobit***		***Fixed effect***	***Fixed effect***	***Tobit***		***Fixed effect***	***Fixed effect***	***Tobit***	
PM3	0.044 (0.87)	0.096 (1.43)	-0.695 (1.08)	1.02								
PM4					0.142* (1.64)	175 (2.25)	-0.931 (1.30)	1.45				
PM5									0.198** (2.41)	0.210*** (2.47)	-1.596** (2.11)	1.55
FSIZE	0.348*** (5.21)	0.278*** (4.12)	1.172*** (4.36)	1.11	0.348*** (5.22)	0.278*** (4.11)	1.273*** (4.52)	1.51	0.342*** (5.26)	0.271*** (4.01)	1.361*** (4.83)	1.54
LEV	0.002*** (2.96)	0.002*** (3.06)	0.016** (2.12)	1.17	0.002*** (3.03)	0.002*** (3.15)	0.016** (2.06)	1.17	0.002*** (2.98)	0.002*** (3.13)	0.016** (2.04)	1.17
FAGE	0.273*** (5.77)	0.300*** (6.73)	0.281 (0.85)	1.05	0.269*** (5.69)	0.291*** (6.55)	0.342 (1.04)	1.13	0.266*** (6.21)	0.289*** (6.50)	0.416 (1.27)	1.20
ROA	0.010*** (4.50)	0.003 (1.30)	0.109*** (4.23)	1.04	0.010*** (4.50)	0.003 (1.31)	0.110*** (4.26)	1.05	0.010*** (4.58)	0.003 (1.49)	0.109*** (4.27)	1.04
Constant	5.519*** (4.18)	6.652*** (4.72)	-17.787*** (3.07)		5.474*** (4.17)	6.640*** (4.72)	-19.853*** (3.32)		5.594*** (4.14)	6.782*** (4.83)	-21.666*** (3.61)	
Obs	819											
Adj. R2	.21	.17			.21	.18			.21	.18		
F-statistics	36.53***	29.41***			37.32***	30.14***			37.88***	30.39***		
Wald Chi2			42.57***				43.41***				46.51***	
Mean VIF				1.08				2.6				1.30
Hausman's Chi2	54.50***	213.74***			61.90***	57.43***			65.45***	60.28***		

PM3 is defined as a dummy variable that equals 1 if the firm has either a royal family member or a *Shura* Council member in the board of directors and 0 otherwise; **PM4** is a dummy variable that equals 1 if the firm has either a royal family member or a state representative in the board of directors and 0 otherwise; **PM5** is a dummy variable that equals 1 if the firm has either a *Shura* Council member or state representative in the board of directors and 0 otherwise. All other variables are defined in Table 4.2.

***** p<0.01, ** p<0.05, * p<0.10**

4.6 CONCLUSION

This research contributes to the extant body of literature related to political connections and their implications on managerial incentives in several ways. First, although Chizema *et al.* (2015) and Hearn *et al.* (2017) investigate the relationship between political ties and executive pay-setting in China and various African economies respectively, this research investigates this phenomenon in the context of Saudi Arabia which has unique characteristics, i.e. rule by an absolute monarchical regime, the existence of the *Shura* Council, and a high domination of family and state investment in listed companies. To the best of the researcher's knowledge, this context with its distinct institutional settings has not been previously studied, implying that the research findings fill a significant gap in the related literature and enhance the understanding of the interaction between political connections and the practices of executive compensation. Second, since the ownership concentration in Saudi Arabia is high in general, this highlights the interaction between political connectedness and executive pay-settings through the lens of the principal-principal model. In particular, it shows how political capital interacts in a context with a dominance of certain controlling shareholders. Third, unlike prior related studies that have been conducted in Africa and East Asia (Chizema *et al.*, 2015; Hearn *et al.*, 2017), this research enjoys a high generalizability in the Arab Gulf countries which have many cultural, institutional, and economic characteristics in common with Saudi Arabia. Last, this research develops a novel definition of political connections that captures different political channels namely royal family, *Shura* Council and the state.

The previous chapter demonstrates that the adoption of the Anglo-American model of corporate governance is not sufficient to control executive remuneration in the emerging economy Saudi Arabia, due to the heterogeneity of institutional settings between the two contexts. Therefore, this chapter goes beyond the formal institutions and investigates informal institutions to provide a complete picture of executive pay-settings. In essence, this research considers the consequences of having political connections, which is a vital source of *wasta*, on the practices of managerial compensation. Based on a sample from Saudi listed companies for the period 2008-2015, the study finds that the phenomenon of political connections exists significantly in Saudi Arabia since the majority of firms are politically connected. This evidence supports the

conclusion of Faccio (2010) that political ties are prevalent in emerging economies. The results also show that if firms do not have a direct relationship with the state, they tend to build connections through inviting members of the royal family or *Shura* Council to serve on their boards of directors. Therefore, it is clear that board political capital is a pillar of doing business in Saudi Arabia. The latter finding is consistent with institutional theory, which argues that political relationships act as a substitute for the absence of effective formal institutions to protect the interests of related parties and make business smooth-running (Faccio, 2010; Young *et al.*, 2008).

Although political relationships are found to enable access to vital resources for the enterprise (Civilize *et al.*, 2015; Goldman *et al.*, 2009; Pfeffer and Salancik, 1978), this research demonstrates that they could also be costly in less developed economies. That is to say, politically connected firms are observed to be more generous with their senior managers. Since the Saudi market is dominated by family firms, the process of choosing and remunerating top managers is influenced by nepotism and cronyism (Budhwar and Debrah, 2013). This leads to higher incurred agency costs which might result from the appointment of unqualified-managers in leading positions. Thus, political connections may be utilised to provide regulatory protection for blockholders' abuse of power. This outcome, however, is subject to the type of political connections. Only state representatives are found to boost executive pay. However, royal family and *Shura* Council affiliated directors show no significant association with decisions related to managerial incentives. This evidence demonstrates that none of political connections types is effective in enhancing governance quality, in particular the ones related to executive pay-setting.

However, these results should not be interpreted as a conspiracy between dominant shareholders or top managers and politically connected directors against small investors (Sun *et al.*, 2016). The results do not necessarily mean that these connected members implicitly approve the expropriation of minority shareholders' wealth through paying top related-managers with high non-merit compensation. However, their political power might be exploited by dominant shareholders or senior executives to achieve private benefits, such as extracting high non-merit perks for executives, who are often family-affiliated, with less concern for accountability.

The study findings have practical benefits for related stakeholders such as firms and regulators in several ways. First, although the Saudi Law of the Council of Ministers forbids ministers from accepting memberships in private corporate boards (BECM, 1993), the results show that firms are still able to establish political connections through other means. Thus, the political connectedness is significant in the Saudi context. The high dependence of business on political relationships increases uncertainty and creates a challenging environment for foreign investment. Consequently, as Saudi government is seeking foreign investment to achieve the objectives of the 'Saudi Vision 2030', further efforts are necessary to minimise dependence on political connections in order to make the Saudi context more attractive for external investors. Second, the results provide an overview of how political connections interact with governance mechanisms. The understanding of this interaction helps bodies in charge to reform governance regulations, taking into consideration board political power. Thus, it helps to re-balance the power among stakeholders fairly and ensure that no single party is disadvantaged due to lack of control. Finally, the research develops a novel contextualised definition for political connections which can be employed by researchers to establish the implications of political relationships on other economic and governance characteristics in Saudi Arabia or in the other GCC economies.

However, it is worth noting that the scope of the research and the interpretation of its findings are limited to the relationship between political connectedness and the practices of executive compensation which is only one of the mechanisms of corporate governance. Furthermore, the sample does not capture the impact of such connections on the settings of managerial pay in financial firms, which are subject to further and different regulatory supervision (Wang and Shailer, 2015; Méndez *et al.*, 2011). Last, although the research findings enjoy high generalizability in the Gulf region, the research population is based on a sample from Saudi Arabia only and does not use multi-country samples.

CHAPTER FIVE:

EXECUTIVE COMPENSATION PRACTICES: FAMILY VS NON-FAMILY FIRMS

5.1 INTRODUCTION

Family business is ubiquitous and is a dominant business form in global economies (De Cesari *et al.*, 2016). Such dominance also exists in emerging markets where ownerships are concentrated in the hands of certain families (Young *et al.*, 2008). This high dependence of the economy on family business concerns governments. This disquiet is derived from the warnings of many researchers that privately-owned family enterprises, which are mainly dependent on the founders, may encounter survival challenges after the founders' retirement (Cucculelli and Micucci, 2008; Ibrahim *et al.*, 2001; Tagiuri and Davis, 1996). Consequently, in order to make these firms more sustainable, governments encourage privately-owned family firms to go public (Ehrhardt and Nowak, 2003). This transition ensures that other parties, such as representatives of minority shareholders, become involved in an internal monitoring process, while externally, the enterprise will become subject to different regulatory institutions. Enhancing the governance structure assists family firms to survive and thereby avoid negative, and potentially serious, consequences for the national economy (Ehrhardt and Nowak, 2003).

However, being publicly traded does not ensure business sustainability. For example, any conflict of interest among family successors may become one between dominant shareholders and minority investors (Young *et al.*, 2008). The conflict between the two parties is worse in immature economies, where investor legal protection is fairly weak. In such contexts, other informal institutions (such as family ties, nepotism, cronyism and political connections) play important substitutive roles in shaping business policy (Faccio, 2010). Relatedly, Sitthipongpanich and Polsiri (2015) argue that in emerging economies families may prefer to retain blocks of shares and to be involved directly in management for two reasons: to control cash flow rights and to prevent any potential managerial opportunism. The authors attribute these behaviours to the absence of effective formal institutions.

During the past two decades, the government of Saudi Arabia has made considerable efforts to convince privately-owned firms to become publically traded. The result of this effort has resulted in the number of listed firms which has been doubled from 73 in 2000 to nearly 160 in 2015 (Tadawul, 2015). However, these developments require parallel legal reforms. Therefore, the CMA set out the first set of Corporate

Governance Regulations in late 2006 (CMA, 2010). However, similar to other emerging economies, the Saudi corporate governance code appears to be significantly influenced by the Anglo-American model which has been developed for Western contexts (Fallatah and Dickins, 2012). Its direct adoption disregards the institutional and political differences between Saudi Arabia and developed countries. For example, while Western economies are market-oriented and their business ownership structure is diffuse; the market in Saudi Arabia is network-oriented and mostly closed to foreign investment, with a high concentration of family-owned firms (Al-Ghamdi and Rhodes, 2015). Furthermore, the political systems are dissimilar, which has different consequences for business policy. Accordingly, ignoring these contextual differences is likely to lead to the enforcement of an inappropriate template of governance regulations (Young *et al.*, 2008).

In an attempt to reduce family control over the board of directors and to support minority shareholders, the Saudi code states that all companies should use a cumulative voting system (CMA, 2010). Although a cumulative voting system is not commonly applied in Anglo-Saxon countries, the recommendation to use it in Saudi Arabia demonstrates the need for special regulations. However, the enforcement of this rule is fairly poor, for example the majority of companies did not meet this requirement in 2010 (four years after release of legislation). Most companies attribute their use of a statutory voting system, rather than the cumulative voting system, to the fact that the Companies Law allows the use of a statutory system. Thus, firms have found a legal loophole in the use of voting system, which allows controlling shareholders to maintain their control. These limited efforts by the authorities will not reduce the domination of family members over a board of directors and strategic decisions, as long as regulations do not explicitly recognise principal-principal conflict. For example, the Taiwanese Security and Exchange Act 2006 explicitly forbids board members who have second-degree kinship ties from occupying more than half of the seats on a board of directors (Wu, 2013).

Chapter Three demonstrates that the Anglo-Saxon model of corporate governance is incompatible with a family firm-dominated economy and inadequate to control executive compensation. Furthermore, Chapter Four shows how other informal institutions, in particular political connections, can influence policy towards executive compensation. Although the principal-agent model is predominant in the growing literature on executive compensation, this chapter sheds light on principal-principal

conflict by using a novel data set of Saudi family and non-family controlled firms. The main hypothesis of this chapter is that the concentrated ownership is not the only difference between family and non-family firms (Martin *et al.*, 2016; De Cesari *et al.*, 2016). Differences are also evident in the structure of internal governance and the need to build political connections, both of which implications for policies over executive compensation. Unlike firms with diffuse ownership patterns, the decisions in family-controlled firms primarily consider family interest and concern less the interests of other stakeholders including minority shareholders (Ding and Pukthuanthong, 2013).

Accordingly, the research answers two key questions: *a) Do the structures of corporate governance and the need for political connections differ between family and non-family firms?* and *b) What are the implications of this variation for executive compensation practices in family and non-family firms?* The remainder of this chapter is structured as follows: section 2 reviews the existing literature; section 3 develops the related hypotheses and illustrates the research design; and section 4 presents and discusses the empirical results; section 5 provides the research conclusion and limitations.

5.2 REVIEW OF LITERATURE

Family business topics are one of the most prominent areas in management and finance literature (De Cesari *et al.*, 2016). Their importance is derived from the fact that family firms represent a significant share of the global economy, with a particularly high presence in emerging economies (Young *et al.*, 2008). During the past two decades, scholars have given considerable attention to behaviours and attitudes of family firms and the implications for different issues; for example, firm performance (Anderson and Reeb, 2003; Miller *et al.*, 2007; Al-Ghamdi and Rhodes, 2015), capital structure (Morresi and Naccarato, 2016; Schmid, 2013), shareholder conflict (Martin *et al.*, 2016; Morck and Yeung, 2003), governance systems (Martin *et al.*, 2016; Bartholomeusz and Tanewski, 2006), and executive compensation (Subekti and Sumargo, 2015; Cheng *et al.*, 2015; Michiels *et al.*, 2013). These studies indicate that family influence is widespread and affects corporate policy decisions.

The body of literature that investigates differences in executive compensation practices between family and non-family firms is small but growing (Wu, 2013; Chen *et al.*, 2014; Tsao *et al.*, 2015). The lack of research could be attributed to the difficulties of

data accessibility and the lack of information about executive compensation, especially in emerging countries, where transparency and disclosure is very weak (Michiels *et al.*, 2013). Accordingly, this section reviews the findings of prior studies related to the behaviours of family firms and non-family firms with a focus on emerging economies. It also sheds light on the literature gap.

5.2.1 Identification of Family Firms

Due to cross-country differences, the literature on family business has various definitions for the term 'family firm'. For example, Miller *et al.* (2007) document 28 definitions for 'family firm' that are used in prior studies. In other words, there is no consensus on a widely-accepted definition of family firm in the literature. Indeed, the use of different definitions is a key problem in family firm research. Kraiczy (2013) states that although many studies analyse the phenomenon of family business, the different definitions make comparability between the research challenging and less effective. He attributes the use of diverse definitions to the heterogeneity of family firms, not only on a country level, but also on an organisation level. That is to say, even though family firms are recognised as a distinct group from other organisations, they are also dissimilar in the ownership structure and the involvement level of family members in management.

Typically, a family business refers to an organisation that is owned and controlled by an individual or multiple family members (Shanker and Astrachan, 1996; Miller *et al.*, 2007; Young and Tsai, 2008), often by multiple family generations (Anderson and Reeb, 2003). A review of family business definitions in the literature shows that a firm is characterised as family-controlled according to two key factors: ownership and management (Amoako-Adu *et al.*, 2011; Al-Ghamdi and Rhodes, 2015; Young and Tsai, 2008; Muñoz-Bullón and Sánchez-Bueno, 2014). On the one hand, Sitthipongpanich and Polsiri (2015) and Croci *et al.* (2012) consider a family business as any firm in which the largest shareholder is a family member who with other related family members own more than 10% of company shares. Similarly, Amoako-Adu *et al.* (2011) and Young and Tsai (2008) recognise a firm as a family business according to the level of ownership. In this setting, the definitions mainly depend on ownership criteria, which this research refer to as the equity approach.

In contrast, others, such as (Muñoz-Bullón and Sánchez-Bueno, 2014) and (Al-Ghamdi and Rhodes, 2015) consider a firm to be family-controlled if two conditions are

met: a) family members hold at least 10% of firm equity and b) family members are involved directly in the management or on the board of directors, which this research refers to as an internal-influence approach. The latter approach means that family members are an influential party in two dimensions: having voting rights and taking part in the decision-making process. In Saudi Arabia, the majority of family members are involved or have relatives in management or on the board of directors. Therefore, this research adopts an internal-influence approach to identify family-controlled firms.

5.2.2 Role of Family and Executive Compensation

During the past three decades, executive compensation issues have received a great deal of attention from scholars in management and finance literature (Jensen *et al.*, 2004; Petra and Dorata, 2008; Young and Tsai, 2008). The majority of corporate governance studies are conducted and developed in the west, where principal-agency conflict is important (Core *et al.*, 1999; Conyon, 2014). However, in emerging economies such studies, although growing, are still underdeveloped (Young and Tsai, 2008). The scarcity of research makes understanding corporate governance practices in emerging countries unclear. It also leads regulators to adopt inappropriate governance regulations, arguing that these regulations have worked effectively in developed economies (Rashid, 2013). The scarcity of research might be attributed to problems with data accessibility in emerging countries, which prevents scholars from studying the phenomenon of corporate governance. Furthermore, markets in such contexts are still emerging and have only recently received the attention of interested researchers.

One can argue that corporate governance regulations are generalizable; thereby, the Western model of corporate governance can be used globally. However, several studies (Young *et al.*, 2008; Jiang and Peng, 2011) demonstrate that emerging economies have unique characteristics that differ significantly from the ones present in developed counterparts. One key difference is the ownership structure of companies in emerging economies, which see a high concentration of ownership in the hands of certain families (Rashid, 2013). Furthermore, legal enforcement and investor protection are still poor in emerging countries, in contrast to the legal systems in developed economies (Faccio, 2010). Consequently, the norms of corporate governance should consider and capture these differences in order to develop an appropriate model of corporate governance that fits the domestic situation appropriately (Young *et al.*, 2008). This section reviews the

literature related to the impact of family members on executive compensation and shows how corporate governance practices vary between family and non-family firms.

Most studies that examine executive compensation practices in family firms operating in emerging economies are carried out in East Asia (Wu, 2013; Chen *et al.*, 2014; Tsao *et al.*, 2015), partly due to better data availability; the results are mixed. For example, Wu (2013) investigates the relationship between boards that have family ties and excessive board compensation in Taiwan. Based on a sample over the period 2007-2010, the researcher observes that when a board of directors has a strong relationship with family dominant shareholders, board members are more likely to be paid excessive compensation. This excessive non-merit compensation is granted at the expense of minority shareholders, which indicates the existence of principal-principal conflict. Although board compensation is not within the scope of this study, it reveals how family involvement influences board members, who are supposed to consider all shareholders' interests, not only certain shareholders.

In the same context and based on a sample from the period 2005-2010, Chen *et al.* (2014) analyse the influence of family characteristics on the ratio of variable managerial pay. The study finds evidence that the number of family members on the board of directors and the level of ownership held by family members are significantly associated with lower variable executive compensation. In other words, the existence of family elites reduces the link between firm performance and executive compensation, which may lead to higher agency costs. However, the research findings are limited to the ratio of variable managerial pay. The results do not explain the role of family on the amounts granted to executives.

Furthermore, Tsao *et al.* (2015) use a sample from Taiwan, in particular from R&D-intensive industries, between 1996 and 2009. Their research focuses on how CEO compensation is influenced by the involvement of family members and their ownership. The findings reveal that families are significant shareholders since they hold approximately 26% of their firms' shares. The study document that CEOs are less likely to earn higher compensation if family members are present and their ownership is fairly high. However, this study suffers from a number of limitations. For example, the sample reflects firms that operate in R&D-intensive industries only; thus, it lacks generalizability

to other industries. However, my research is more generalizable since the sample covers all non-financial industries in Saudi Arabia.

The findings discussed demonstrate that the excessive involvement of family members in corporate decisions is not always beneficial, especially in contexts that lack effective formal institutions. As can be seen from Wu (2013) and Chen *et al.* (2014) family presence, in fact, increases directors' compensation and reduces the link between firm performance and executive compensation. This evidence highlights how the presence of large family shareholders may lead to another conflict of interest, principal-principal, and thereby higher agency costs.

Using a sample of Chinese firms that operated between 2002 and 2008, Cheng *et al.* (2015) investigate the impact of family characteristics on executive cash compensation. They find that family members hold 46% of their companies' shares. This concentration of ownership is high compared with developed countries such as the US and the UK (Rashid, 2013). Moreover, the study observes that when ownership of the largest family shareholder increases, executives receive less cash remuneration. However, ownership of other family members show a positive and significant impact on executive compensation. These findings indicate that behaviours vary even among family members. In this sense, the decisions are different if there is only one controlling family shareholder and when there are multi-family shareholders. In contrast, neither family founders nor family CEOs are found to influence executive compensation practices.

Relatedly, Theeravanich (2013) analyses the characteristics of boards of directors and their relationship with board cash compensation in Thailand. The sample consists of two groups: family and non-family firms, which provides the possibility of comparison. The author observes that director compensation is higher in family firms. Although the proportion of outside directors on the board of family firms is significantly higher than their counterparts in non-family firms, outside directors are not significantly associated with board compensation either in family firms or in non-family firms. Furthermore, the author finds that splitting the positions of CEO and board chairperson, which is strongly suggested by agency theory (Core *et al.*, 1999; Bebchuk and Fried, 2004), does not affect directors' pay packages.

Outside Asia, Gallego and Larrain (2012) use a longitudinal sample of three Latin American markets to investigate the role of three types of ownership, namely family,

foreign and state, in reducing managerial compensation. The researchers state that professional CEOs in family-controlled firms earn 30% higher compensation than their counterparts in non-family controlled firms. Additionally, the study finds evidence that family-controlled firms have a positive and significant relationship with executive total compensation. In terms of pay-for-performance, the findings show that family-controlled firms are less likely to pay bonus packages for executives. In other words, there is low link between managerial pay and firm performance. Foreign and state ownership are not associated with decisions related to executive compensation, except when foreign investors control a firm, executives are found to be paid higher bonus packages. It is worth mentioning that Latin American economies have many market features in common to the Saudi context including development level, family domination and weakness of legal regulations.

It can be deduced from the studies that the adoption of the traditional agency model of corporate governance in emerging economies is not as effective as its adoption in developed countries. That is because agency theory argues that the presence of large shareholders reduces the gap of interests between principal-agent. However, in emerging economies the presence of large shareholders leads to a different conflict of interest among principals themselves (large and small shareholders). The agency costs that result from principal-principal conflict, in certain cases, may exceed the ones caused by principal-agent conflict (Gomez-Mejia *et al.*, 2003; Young *et al.*, 2008).

The literature also shows that the influence of family in firms is significant, even in the West. For instance, Croci *et al.* (2012) investigate the relationship between family control and CEO compensation in 14 European countries. Their findings reveal that when there is family control or when a CEO is a family member, CEOs are less likely to earn high compensation. Surprisingly, the results also show that independent directors and institutional ownership are significantly associated with higher CEO compensation. This latter finding is inconsistent with the agency model of corporate governance, which argues that board independence and institutional investments are effective mechanisms in constraining CEO compensation (Fama and Jensen, 1983b; Lin *et al.*, 2011).

In Canada, Amoako-Adu *et al.* (2011) analyse the role of family on various components of executive compensation. Family directors are found to occupy nearly 15% of board seats. This significant presence of family members on boards of directors

enables them to curb managerial pay since the results show a negative and significant association between the two variables. Furthermore, board independence and institutional ownership is shown to have a negative and significant impact on executive compensation. These findings are consistent with the shareholder model of corporate governance which argue that shareholder presence, independent directors and institutional ownership are effective tools in constraining managerial opportunism (Fama and Jensen, 1983b; Lin *et al.*, 2011). However, the results are out of date, because the study examined the phenomenon between 1998 and 2006; hence, the impact of the latest reforms of corporate governance are not assessed.

The US context has the lion's share of studies that examine the association between family role and executive compensation in the West. One empirical studies is Combs *et al.* (2010), who examine two scenarios of family influence on CEO compensation. Based on a sample from the S&P 500 for the period 2002 to 2005, the study finds that when a CEO is family member and he/she is the only representative of the family, he/she is more likely to be paid generously. However, if there are multiple family members serving in the executive team, a family CEO earns less perks in their package. This indicates that other executive family members observe CEO activities and constrain his/her opportunism. However, when there are no family executives, a family CEO feels free and acts in his/her own interests.

In the same context, Gomez-Mejia *et al.* (2003) use a sample of family-controlled firms and find evidence to support agency theory. That is to say, the research outcomes demonstrate that when family ownership is high and when a CEO is a family member, CEOs receive less compensation. Furthermore, the direct involvement of family members on boards of directors and compensation committees is found to have no influence CEO pay. However, the study sample is out of date since it covers firms operating between 1995 and 1998. Thus, the sample does not capture the developments and reforms of corporate governance regulations such as the Sarbanes-Oxley Act (2002) and the Dodd–Frank Act (2010), which introduce new legislation related to executive compensation. However, my research provides evidence using recent data sets from 2008 to 2015. This enables the investigation of the latest corporate governance regulations that control executive compensation practices.

Nevertheless, Muñoz-Bullón and Sánchez-Bueno (2014), who use a more updated sample (2005-2009) from 2,679 US publically listed family firms, reach a similar conclusion. Their research analyses the role of family on board compensation. They examine three family related variables, namely the presence of family director, level of family equity, and proportion of family directors on board of directors, and their effect on the level of total and variable board members' compensation. The findings demonstrate that family presence have a negative and significant impact on board compensation. This evidence is consistent with the agency assumption that the presence of shareholders diminishes agency costs (Fama and Jensen, 1983b); however, as mentioned earlier this assumption is not generalizable to emerging economies.

Relatedly, Michiels *et al.* (2013) do not find any significant relationship between blockholders and CEO cash compensation. Analysing 529 privately held US family firms, the study documents that CEO compensation is unrelated to how many shareholders the firm has. Furthermore, even if the CEO is a family member, CEO compensation is still unaffected. However, the research results lack robustness since it employs cross-sectional analysis that only investigates the variation in 2003. In addition, 2003 is prior to the changes introduced by the Dodd–Frank Act (2010) which can affect executive compensation.

It is clear from the literature that the role of family varies according to the context and its institutional development. While the presence of families in developed economies is associated with higher governance quality since it significantly reduces managerial remuneration (Gomez-Mejia *et al.*, 2001; Croci *et al.*, 2012; Muñoz-Bullón and Sánchez-Bueno, 2014), their role in emerging counterparts has the opposite effect (Gallego and Larrain, 2012; Wu, 2013). That is to say, when a family takes part in the process of decision-making in developing countries, they seem to extract personal benefits through compensating their related managers generously. Unfortunately, there is a lack of evidence of the relationship between family role and executive compensation in Arab countries in general, and in Saudi Arabia in particular, despite their unique characteristics. For example, Saudi Arabia is characterised as a network-oriented economy since there are strong family ties, high ownership concentration, and a closed business environment. Therefore, this research is expected to add a significant

contribution to the extant literature and provides evidence from the Saudi context, which has a high generalizability to other Arab economies.

In terms of political connections in family and non-family firms and their implications regarding executive compensation practices, there is a dearth of literature on the subject. Although political connections have received a considerable attention in recent years (Goldman *et al.*, 2009; Faccio, 2010; Wang, 2015; Sun *et al.*, 2016), to the best of my knowledge, no single study has yet investigated the behaviours of political connectedness in both family and non-family firms simultaneously, in particular with respect to compensation arrangements. Intuitively, as norms and behaviours of family business differ from non-family enterprises, the need to build political ties and the implications of this relationship may also differ in the two types of organisations. The gap in family business and political connections literature motivates this research to analyse how the role and presence of political connections vary between family and non-family firms with a focus on executive compensation practices.

In general, the literature on political connections shows that political relationships can benefit the firm and increase its value through various channels (Goldman *et al.*, 2009). For instance, politically connected enterprises can obtain favours through the allocation of lucrative government contracts (Goldman *et al.*, 2009). Moreover, governments may tolerate and exempt connected firms from certain regulations (Imai, 2006). Another example is related to market share; i.e. firms which receive government favour might enjoy a monopolistic environment and be protected from competition (Civilize *et al.*, 2015), while tariffs are imposed on foreign competitors (Goldman *et al.*, 2009). All these benefits can ultimately result in higher firm value and better performance.

However, the evidence for the impact of political connections on corporate governance in general, and on executive compensation in particular, is still inconclusive. For example, political connections are found to harm the interests of minority shareholders since they enable rent appropriation. As such, Sun Sun *et al.* (2016) and Wang (2015) observe a positive and significant relationship between the presence of politically connected members and related-party transactions. Political connections are also found to have a negative impact on the composition of boards of directors in China since they were associated with fewer independent directors than their non-connected

peers (Ding *et al.*, 2014). On the other hand, Hearn *et al.* (2017) and Chizema *et al.* (2015) find that politicalled connected directors play a significant role in curbing the opportunism of top executives through reducing their compensation packages. Table 5.1 presents summary of main research to date.

Table 5.1: Summary of Key Research

Study	Dependent Variable(s)	Independent Variable(s)	Sample characteristics	Analysis Technique	Main Findings
Cheng *et al.* (2015)	- Executive cash compensation	1. Ownership of Largest family shareholder 2. Ownership of other family members 3. Family founder 4. Family CEO	A sample of Chinese family firms for the period 2002 to 2008	- Fixed effect - 2sls	1) Family members own 46% of their firms. 2) Highest family shareholder has negative (positive) and significant impact on executive compensation (pay-for-performance). 3) Neither family founder nor family CEO have any relationship with executive compensation practices.
Croci *et al.* (2012)	- CEO cash - CEO total - CEO equity-based-compensation	1. Family control 2. Family CEO 3. Board size 4. Board IND	A sample of 754 listed firms from 14 European countries for the period 2001 to	- Fixed effect - Tobit	1) Family control is negatively and significantly associated with CEO compensation. 2) The presence if family CEO leads to less CEO compensation. 3) Board size, independent directors, institutional ownership are significantly associated with higher CEO compensation.
Combs *et al.* (2010)	- CEO cash compensation - CEO stock options	1. Lone-family CEO member 2. Multi-family executive members	A sample from S&P 500 for the period 2002 to 2005	- Random effect	1) When there are multiple family representatives, family CEOs receive lower compensation. 2) However, if family CEO is the only representative of family members, he/she earns higher compensation.
Gomez-Mejia *et al.* (2003)	- CEO total compensation	1. Family on board 2. Family ownership 3. Family on compensation committee 4. Family CEO 5. CEO ownership 6. CEO on comp committee 7. CEO founder 8. Institutional ownership	A sample of 253 US family – controlled firms for the period 1995 to 1998	- N/A	1) Neither the presence of family member on board of directors nor on compensation committee affects CEO compensation. 2) When family ownership increases and when the CEO is a family member, CEO receives lower remuneration packages.
Amoako-Adu *et al.* (2011)	- Various components of executive compensation	1. Board size 2. Board Independence 3. Institutional Ownership 4. Family directors 5. CEO Duality	A sample of 140 single and dual class Canadian firms for the period 1998 to 2006	- Fixed effect - 2SLS	1) Family directors occupy nearly 15% of board seats and they are significantly associated with less executive compensation. 2) Board independence and institutional ownership also have a negative and significant impact on managerial pay. 3) When board size is large and CEO serves as chairman simultaneously, executives are more likely to be paid generously.
Tsao *et al.* (2015)	- CEO cash compensation - CEO equity-based compensation	1. Existence of a family member 2. Family ownership	A sample of 375 Taiwanese firms in R&D-intensive industries from for the period 1996 to 2009	- N/A	1) Families own approximately 26% of their firms' equity. 2) The presence of a family member and the greater family ownership have a negative and significant effect on CEO remuneration packages.

Gallego and Larrain (2012)	- Total compensation - Bonus	1. Family controlled firms 2. Foreign controlled firms 3. State controlled firms	A sample from three Latin American markets for the period 1997 to 2007	- Fixed effect	1) Professional CEOs in family controlled firms earn 30% compensation than their counterparts in non-family controlled firms. 2) Family controlled firms have a positive and significant relationship with executive total compensation. 3) Family-controlled firms are less likely to pay bonus packages for executives. In other words, there is a weak link between managerial pay and firm performance.
Wang and Xiao (2011)	- Performance-based compensation	1. Controlling shareholders' tunnelling	A sample of 1286 Chinese firms for the period 1999 to 2005	- Fixed effect - 2SLS	1) There is a negative and significant association between controlling shareholders' tunnelling and performance-based compensation. In other words, the more the tunnelling activities that dominant shareholders do, the weaker the link to executive compensation.
Wu (2013)	- Adjusted board compensation - Excessive board compensation	1. Board with family ties	All Taiwanese listed firms between 2007 and 2010	- Fixed effect - 2SLS - Logit	1) Board compensation is more likely to be excessive if board has ties with family.
Muñoz-Bullón and Sánchez-Bueno (2014)	- Board total compensation - Ratio of board variable compensation	1. Family director 2. Family equity 3. Ratio of family directors	A sample of 2679 US publically listed family firms between 2005 and 2009	- Tobit - Random effect	1) Average directors' compensation in family firms is 18% higher than in non-family firms. 2) If there is a family director, board members earn less total compensation and have a lower ratio of variable compensation. 3) Family equity and ratios of family director also have a negative and significant impact on board total pay and variable compensation.
Chen *et al.* (2014)	- Ratio of variable executive compensation	1. Family members on board 2. Family member's ownership	A sample of non-financial Taiwanese listed firms between 2005 and 2010	- Fixed effect	1) When the number of family members on board and family ownership increases, executives receives a lower ratio of variable compensation
Michiels *et al.* (2013)	- CEO cash compensation	1. Number of shareholders 2. Family CEO 3. Firm performance	A sample of 529 privately held US family firms	- Fuller's LIML	1) Neither number of shareholders nor family CEO have any relationship with CEO cash compensation. 2) Firm performance has a positive and significant impact on CEO cash compensation.
Theeravanich (2013)	- Total director cash compensation	1. Firm performance 2. Independent directors 3. Directors' ownership 4. Split CEO/Chairperson positions	A sample of 363 Thai firms 2002-2008	- Fixed effect	1) Director compensation is greater in family firms. 2) The proportion of outside directors on the board of family firms is significantly higher than their counterparts in non-family firms. However, outside directors are not significantly associated with board compensation neither in family firms nor in non-family firms. 3) Directors' ownership has a negative and significant impact on board remuneration. 4) Firm performance has a positive and significant impact on total director cash compensation.

5.3 THEORETICAL FRAMEWORK

As mentioned earlier, the economy of Saudi Arabia has unique cultural and religious characteristics that differ from other countries, which increases the importance of developing an appropriate theoretical landscape that suits the Saudi context. The process of setting executive compensation in Saudi Arabia is affected by several factors including culture, personal connections, regulations and religion. As this study considers the relationship between corporate governance and executive compensation, the same models of Chapter Three are adopted due to the same aforementioned reasons; however, with significant emphasis on the principal-principal conflict. Since the data sets have both family and non-family firms, the theoretical development requires appropriate perceptions for each firm type: family and non-family firms in terms of governance norms and practices. Moreover, the conflicts between family controlling shareholders and minority investors need to be carefully addressed and understood, since the conflicts are among one party (investors) and go beyond the opportunism of individual managers. The following sub-sections discuss the theoretical thoughts that frame the conflict of interests between family large shareholders and minority investors in family-controlled firms: moreover, the conflicts between shareholders and non-family managers in non-family firms.

5.3.1 Agency Theory

Jensen *et al.* (2004, p. 50) argue that "while remuneration can be a solution to agency problems, it can also be a source of agency problems". The traditional agency model (principal-agent conflict) assumes that ownership concentration is diffuse and managers have considerable discretion and control over decision-making (Fama and Jensen, 1983b). However, these assumptions are not relevant in the majority of cases in Saudi Arabia where many firms are family controlled. In these firms, which represent nearly 60% of Saudi listed firms, there is no real effective separation of ownership and control. Therefore, non-family managers are less likely to have the discretionary ability to expropriate the firm's resources, especially in family-controlled firms. Thus, the principal-agent model is only adequate to explain the opportunism phenomena in non-family firms (Young *et al.*, 2008).

The model considers concentrated ownership as an effective mechanism through which to mitigate agency costs (Jensen and Meckling, 1976). However, scholars came to recognise that concentrated ownership transforms the conflict from principal-agent to a conflict among shareholders themselves (principal-principal) (Young *et al.*, 2008). Since ownership in family-controlled firms is highly concentrated, the principal-principal conflict is likely to represent the reality in such firms (Young *et al.*, 2008). In this setting, blockholders may expropriate minority shareholders' wealth by extracting tangible and intangible private benefits (Basu *et al.*, 2007; Shleifer and Vishny, 1986). For instance, controlling families may appoint unqualified family members or close relatives to key positions and overlook better qualified non-family managers (Faccio *et al.*, 2001; Gilson, 2006; Ramaswamy *et al.*, 2000; Young *et al.*, 2008). Thus, small shareholders are unable either to access these intangible benefits or obtain higher financial returns due to the poor performance of family-related managers (Young *et al.*, 2008).

Sun *et al.* (2016) state that the severity of conflict between large and small shareholders is sensitive to the effectiveness of the legal system in which the firm is operating and the efficiency of the market. First, the enforcement of effective sanctions acts as a deterrent to blockholders from abusing their power and vice-versa (La Porta *et al.*, 2000). Second, blockholders can be constrained by efficient markets, because committing opportunistic activities sends a negative signal to the market, which, in turn, affects the stock price (Gomes, 2000) and limits opportunities for future equity financing (Durnev and Kim, 2005). Applying these two factors in the Saudi context, which has neither an effective legal regime (Al-Twaijry *et al.*, 2003) nor an efficient stock market (Asiri and Alzeera, 2013), means that family-controlled firms in Saudi Arabia are susceptible to principal-principal conflict. Although, regulatory bodies have imposed mechanisms to curb rent appropriation by controlling shareholders (e.g. requiring one-third of board members to be independent and enforcing the adoption of a cumulative voting system in board elections (CMA, 2010)), controlling shareholders and their representatives still comprise the majority on company boards

Therefore, it can be argued that although concentrated ownership plays a substitutive role for the poor external governance mechanisms and mitigates the Type I agency problem (Fama and Jensen, 1983b; Li *et al.*, 2007; Lin, 2005; Banghøj *et al.*, 2010; Conyon and He, 2012), principal-principal conflict can arise. In certain cases, the agency

costs of the principal-principal conflict are higher than those resulting from principal-agent conflict (Gomez-Mejia *et al.*, 2003; Young *et al.*, 2008). From this perspective, there is a concern that family-related managers in Saudi firms may extract higher non-merit compensation at the expense of minority shareholders. This expropriation becomes worse if the firm is politically connected. That is to say, in such situations, blockholders may take actions that maximise their private wealth at the expense of minority shareholders, i.e. extract higher compensation for their related managers with less concern to any possible legal sanctions. Thus, even if the two aforementioned instruments become effective, a politically connected blockholder is less likely to be affected by external sanctions. His/her political ties will protect him/her from any legal consequences and will also open alternative channels for equity financing when needed.

5.3.2 Institutional Theory

Institutional theory argues that adopting the Western corporate governance model, which is based on principal-agent conflict, in emerging economies with less consideration to the institutional cross-country differences would make the situation more costly and problematic (North, 1990; Wright *et al.*, 2005). For example, ownership concentration, which is considered to be an effective mechanism by which to enhance governance quality in developed economies (Fama and Jensen, 1983b; Jensen and Meckling, 1976), is a root cause of principal-principal conflicts in emerging countries. Therefore, instead of resolving the issue in the Saudi context, the Western corporate governance model may exacerbate the principal-principal problem (Faccio *et al.*, 2001; Young *et al.*, 2008).

The agency model implicitly assumes that the formal underpinning institutions in relation to corporate governance found in developed countries also exist in emerging economies (Young *et al.*, 2008). However, this is not the case in Saudi Arabia, where the "formal institutions such as laws and regulations regarding accounting requirements, information disclosure, securities trading, and their enforcement are either absent, inefficient, or do not operate as intended" (Young *et al.*, 2008, p. 198). The main objective of an enterprise is to survive; however, economic success is not sufficient to achieve this. Furthermore, firms need to establish legitimacy with the surrounding institutions (Suchman, 1995; Zucker, 1987). Therefore, there is a potential scenario that firms may

ostensibly comply with corporate governance requirements as a response to the institutional change, i.e. only for legitimating purposes (Dacin *et al.*, 2002).

Furthermore, since external governance in emerging economies is still weak (Peng, 2004; Peng *et al.*, 2003), families prefer to retain controlling shares in order to play a substitutive internal role (Gedajlovic *et al.*, 2004). This, in turn, may explain the high ownership concentration found in Saudi Arabia (The World Bank, 2009). In this context, the board of directors (the most prominent internal control mechanism) is often considered to be a 'rubber stamp' for dominant shareholders; thus minority shareholders' rights are constrained and may be abrogated (Young *et al.*, 2008).

Therefore, in the Saudi context, the informal institutional environment tends to play a greater role in addressing corporate governance norms than the formal institutional environment (Peng and Heath, 1996; Young *et al.*, 2008). These informal institutions include "relational ties, business groups, family connections, and government contacts" (Young *et al.*, 2008, p. 198). Given the fact that human resource management in KSA is influenced by tribal ties and family connections (Budhwar and Debrah, 2013), there is reason to believe that the controlling shareholders may appoint relatives or close friends to key positions; these, in turn, are able to extract high non-merit-compensation (Young *et al.*, 2002).

With regards to political connectedness, RDC argues that the success of an organisation is primarily subject to dependences on others (Pfeffer and Salancik, 1978). The culture and the trade in general in Saudi Arabia are influenced by *wasta*; in this sense, both family and non-family firms need to build political connections, albeit on different levels. That is to say, family-controlled firms, which are owned by politically-connected family members, already have personal connections with high profile and senior government officials (Al-Hadi *et al.*, 2016; Alzharani and Che-Ahmad, 2015). Thus, their need to have politically connected members on their board of directors is less than their non-family counterparts. However, both types firms are expected to employ such connections for their own private benefits. For example, firms may use political connections to reduce regulatory oversight and therefore take decisions that may not be in the best interests of the company, e.g. hiring non-qualified family managers.

In contrast, Young *et al.* (2008) argue that non-family political members, who are less influenced by large shareholders as opposed to regular independent directors who

are accused of being a 'rubber stamp' for dominant shareholders, are driven by the general orientation of the government. Thus, Chizema *et al.* (2015) explains that such politically connected directors may act to reinforce government expectations with regards to top executive compensation and control non-merit extraction. Moreover, since these directors are usually cautious, they are seriously concerned about the political costs that would arise if they collude either with top managers or controlling shareholders for private interests (Goldman *et al.*, 2009). Put differently, the legitimacy of these members and of the political organisations to which they belong will be significantly affected if they caught engaging in any corruption scandals. However, the situation might be different if that politician holds a block of shares concurrently. In such scenario, the blockholder politician may act as a normal investor who seeks rent; thereby, his relationship with other small shareholders will be framed by principal-principal theory (Young *et al.*, 2008).

5.4 RESEARCH METHOD

Family business topics are one of the most prominent areas of research in management and finance literature (De Cesari *et al.*, 2016). Their importance is derived from the fact that family firms represent a significant share of the global economy, with a particularly high share in emerging economies (Young *et al.*, 2008). During the past two decades, scholars have paid considerable attention to behaviours and attitudes of family firms and the implications for different issues; for example, firm performance (Anderson and Reeb, 2003; Miller *et al.*, 2007; Al-Ghamdi and Rhodes, 2015), capital structure (Morresi and Naccarato, 2016; Schmid, 2013), shareholder conflicts (Martin *et al.*, 2016; Morck and Yeung, 2003), governance systems (Martin *et al.*, 2016; Bartholomeusz and Tanewski, 2006), and executive compensation (Subekti and Sumargo, 2015; Cheng *et al.*, 2015; Michiels *et al.*, 2013). These studies indicate that family influence is widespread and affects corporate policy decisions.

The literature which investigates the differences in executive compensation practices between family and non-family firms is small but growing. This could be attributed to the difficulties of data accessibility and the lack of information about executive compensation, especially in emerging countries where transparency and disclosure is very weak (Michiels *et al.*, 2013). In order to employ the findings of the previous chapters optimally, this chapter determines the behavioural differences in

corporate governance and the political connections between family and non-family firms and their ultimate impact on compensation policy. The following sub-sections develop appropriate hypotheses and illustrate the research method.

5.4.1 Hypotheses Development

5.4.1.1 Corporate Governance and Executive Compensation

A stream of family business literature documents that family investors may have non-financial objectives that could lead to a collision with non-family shareholders in terms of corporate governance (Martin *et al.*, 2016). Gomez-Mejia *et al.* (2001) provide an example of such non-financial goals when they find that a family executive is less likely to be dismissed even in situations of poor performance. In addition, other studies observe that the average tenure of family managers is triple those of non-family counterparts (Chrisman *et al.*, 2005; Schulze *et al.*, 2003). These facts confirm the prevalence of favouritism in family firms.

The perspective of the agency model is predominant in corporate governance literature (Hillman *et al.*, 2009), which is probably because most governance studies are conducted in the West. Agency theorists suggest three key mechanisms to mitigate the conflict of principal-agent "(1) optimizing risk bearing properties of principals and agents, (2) increasing incentive alignment between principals and agents, and (3) effective principal monitoring of agents" (Dharwadkar *et al.*, 2000, p. 651). However, as discussed earlier, such solutions have been developed to deal with traditional agency problems in efficient governance contexts such as developed economies. Immature economies, which are characterised by weak governance and underdeveloped institutions (Young *et al.*, 2008), have a different set of agency problems related to expropriation of small investors' wealth (Cho, 1999). In recent years, institutional theory has shown greater ability than other theories in explaining economic phenomena in emerging and transition economies (Zhang *et al.*, 2015). With respect to corporate governance, institutional theory raises a key argument that the agency governance model does not fit every context because of differing cultural and institutional characteristics (Young *et al.*, 2008). Disregarding these differences may lead to the adoption of an inappropriate model of corporate governance.

The agency concerns in Saudi Arabia are unlike those in developed countries but similar to other emerging countries. Saudi Arabia suffers from a conflict between controlling investors and minority shareholders, commonly known as principal-principal conflict (Young *et al.*, 2008). Principal-principal conflict is clear and severe in family-controlled firms where families control the process of decision-making and there is a likelihood of the expropriation of minority shareholder wealth (Martin *et al.*, 2016). In essence, such control is derived from the high concentration of ownership in the hands of families, by which they influence the appointment of both board members and top executives. Saudi Arabia is a network-oriented society where *wasta* play a significant role in normal life as well as in the process of employment (Tlaiss and Kauser, 2011). Family altruism is a key feature of Saudi culture which is assessed as 75% collectivist by The Hofstede Centre (2014). Therefore, in family-controlled firms it is expected to find family members at all top levels of the organisation—owners, board of directors and top management (Corbetta and Salvato, 2004). As family business represents 95% of the private sector in Saudi Arabia (Alriyadh, 2013) and the majority of listed firms, it can be argued that in general there is no real separation between ownership and control in Saudi Arabia, except in diffusely-owned enterprises.

In terms of executive compensation, the principal-agent model suggests that managerial incentives could bridge the gap between shareholders' and managers' interests (Jensen and Meckling, 1976). The suggestion implicitly assumes that compensation is designed according to performance criteria (Fama and Jensen, 1983a; Jensen *et al.*, 2004). However, the principal-principal perspective argues that executive pay might be exploited to extract private benefits with no improved performance (Cheng *et al.*, 2015). In Saudi Arabia, controlling shareholders monitor top managers closely; hence managers are less likely to influence their compensation packages (Young *et al.*, 2008). However, there is another potential scenario in which a manager is a family member. In this situation, executive compensation may be used as a tunnelling for expropriation of small investors' wealth (Chen *et al.*, 2014).

a) Board composition

- **Family directors**

Shareholders rely on the board of directors to set long-term strategic plans and delegate to them the functions of appointing, supervising, compensating and dismissing

top managers (Muth and Donaldson, 1998; Lin, 2005; Basu *et al.*, 2007). These vital functions demonstrate the importance of boards of directors in global governance regulations and literature. A board of directors derives its authority and legitimacy from shareholders, who are the firm's highest authority, and from Companies Law of the relevant country (Fama and Jensen, 1983b; Lin, 2005). Hence, all related parties strive to dominate this board in order to control the main source of decision-making including executive pay (Ramaswamy *et al.*, 2000).

Traditional agency theory assumes that the greater the separation between ownership and control, the higher the agency costs and vice-versa (Jensen and Meckling, 1976; Fama and Jensen, 1983b). In this context, the presence of family directors on a board of directors is expected to reduce executive compensation (Combs *et al.*, 2010). In support of this assumption, studies, such as (Sapp, 2008; Muñoz-Bullón and Sánchez-Bueno, 2014; Tsao *et al.*, 2015), find that the involvement of family members on a board of directors curbs managerial incentives. However, the situation in emerging countries is different because the main conflict exists between major investors and minority shareholders (Young *et al.*, 2008). The principal-principal model argues that in contexts where ownership is concentrated in the hands of certain investors, small shareholders will be unable to protect their interests (Li *et al.*, 2007). For example, Amoako-Adu *et al.* (2011) and Wu (2013) observe that top executives are more likely to receive higher compensation if the board has family-related directors. The latter evidence does not support the argument of the principal-agent model but demonstrates the existence of principal-principal conflict in developing economies. Relatedly, stewardship theory argues that family members may perceive the generous compensation for their family-managers as a family obligation (Vallejo, 2009). In this sense, family-related managers are expected to gain higher remuneration packages than their non-family counterparts in emerging economies (Vallejo, 2009).

Saudi Arabia is a network-oriented economy and *wasta* is influential in business contracts in general and human resource practices in particular (Tlaiss and Kauser, 2011; Budhwar and Debrah, 2013). Given that the majority of firms are family-controlled, there is a high likelihood that top management is also family-affiliated. Kinship loyalty may outweigh the need to meet the requirements of the position. In other words, a top executive post may be granted to a family member who does not have necessary

qualifications and experience. Thus, the appointment of an unqualified family-manager could lead to higher direct agency costs such as high non-merit compensation and higher indirect agency costs that result from poor performance (Young *et al.*, 2008). Therefore, it can be argued that if family members are involved in executive pay decisions, family-related managers would be compensated generously. Accordingly, the study formulates the following hypothesis:

H1: There is a positively significant relationship between the presence of family members on a board of directors and executive compensation.

- **Board independence**

Board independence is a key mechanism of internal governance and one of the most discussed issues in governance literature (Jensen and Murphy, 1990; Core *et al.*, 1999; Sapp, 2008). The reliance on outsider directors is based on the notion that such directors are less influenced and controlled by management (Fama and Jensen, 1983b). Hence, they should assess managers' performance objectively, including the deserved level of compensation. The optimal contracting model argues that independent directors ensure that executives are compensated according to an arm's-length principal (Janakiraman *et al.*, 2010). This theory assumes that outsider directors are totally independent and have no joint interests with management.

However, as argued by the managerial power model, the situation is different if the firm is family-controlled where the board of directors and management are occupied by the same persons or persons belonging to the same family (Bebchuk and Fried, 2004; Corbetta and Salvato, 2004). In this context, independent directors are not free from family influence, which could threaten the re-nomination their directorship (Ozerturk, 2005). Therefore, if family shareholders arrange high non-merit compensation for their family-related managers, outsider directors may avoid collisions with family shareholders and thus approve the compensation (Chalevas, 2011). This approach is relevant to Saudi family-controlled firms in which family members control the board of directors, including the nomination process.

Furthermore, the institutions-based perspective suggests that independent directors in emerging economies are not as effective as in institutionally developed countries (Young *et al.*, 2008). In network-oriented economies, even outsider directors

need to build connections with dominant parties inside the firm; thus, such directors appear independent in form but not in substance (Young *et al.*, 2008). In other words, outside directors may not enjoy full independence even in non-family firms. Empirically, the findings are mixed, with some finding that board independence is ineffective in curbing executive compensation, i.e. board independence is associated with higher executive pay (Ozkan, 2007; Fahlenbrach, 2009; Ozdemir and Upneja, 2012; Croci *et al.*, 2012). Based on these arguments, the study develops the following hypothesis:

H2: Board independence has a positively significant impact on executive compensation in family and non-family firms.

- **Role duality**

Role duality (CEO/chairman) is another crucial dimension in governance literature and involves two related but contrasting arguments. On the one hand, stewardship theory argues that the combination of both positions in the hands of a single individual is advantageous for the company since it gives the CEO sufficient discretion to take decisions easily and in appropriate time (Davis *et al.*, 1997). Proponents of this theory perceive a CEO as a company steward; thus, he/she will not exploit his/her power to extract private benefits (Muth and Donaldson, 1998; Ramaswamy *et al.*, 2000). In this view, family controlled-firms may prefer to pay an owner-manager less compensation since he/she will receive dividends through his/her ownership in the company (Banghøj *et al.*, 2010). In addition, signalling theory suggests that a family CEO/chairman would accept a lower level of managerial pay in order to send a message that minority shareholders are not exploited by family managers (Ding and Pukthuanthong, 2013). For instance, (Gomez-Mejia *et al.*, 2003) and (Croci *et al.*, 2012) find that when the CEO is a family member, he/she is paid less than non-family counterparts. Furthermore, other studies (Chalmers *et al.*, 2006; Rashid, 2013) document that if a CEO serves as board chairperson at the same time, top executives are less likely to receive high compensation.

On the other hand, the managerial power model, which is derived from agency theory, argues that role duality increases CEO power and enables him/her able to boost his/her own compensation (Bebchuk and Fried, 2004; Core *et al.*, 1999). This assumption may exist in non-family firms where CEOs usually do not hold shares in the company; hence, their wealth is based on and obtained mostly from managerial compensation. Despite the fact that previous studies do not reach a consensus, the dominant view is that

role duality is significantly associated with higher agency costs (Combs *et al.*, 2010; Amoako-Adu *et al.*, 2011; Cheng *et al.*, 2015). Accordingly, the research posits the following hypothesis:

H3: Role duality has a negatively significant impact on executive compensation in family-controlled firms and a positive and significant impact in non-family firms.

- **Blockholder chairman**

The board of directors is at the top of the pyramid of power in a firm; therefore, the position of board chairperson is considered as the highest office (Brickley *et al.*, 1997). The board chairperson sets board meeting agendas (Jensen, 1993) and has the right to cast an additional vote if the board voting results in a tie (Douma, 1997). Furthermore, the position provides other incorporeal advantages such as prestige, honour and pride (Nada and Andrew, 2007), which are important in Saudi Arabia which is ranked as 95% in power distance (The Hofstede Centre, 2014). Hence, it stands to reason that dominant shareholders will use their voting rights to chair a board of directors.

The principal-agent model suggests that the presence of large shareholders on a board of directors will reduce the gap between shareholders' and managers' interests and, therefore, lead to lower executive compensation (Méndez *et al.*, 2011). However, as the Saudi context is significantly affected by principal-principal conflict, there is a possibility that if a board of directors is chaired by a family member, family-related managers will be able to extract higher non-merit executive compensation (Young *et al.*, 2008). Since the literature lacks empirical evidence, this research depends on the theoretical arguments and develops the following hypothesis:

H4: A blockholder chairman has a positively significant impact on executive compensation in family-controlled firms and a negative and significant impact in non-family firms.

- **Chairman multi-directorships**

Fama and Jensen (1983b) argue that when a director holds multi-memberships of other corporate boards, he/she will gain more knowledge and experience. In so doing, his/her monitoring performance will be greatly improved; therefore, this will lead to a reduction in the level of executive compensation. Moreover, sitting on other companies' boards gives the director more opportunities to use benchmarking criteria which may justify decisions on managerial rewards. In contrast, Ozdemir and Upneja (2012) and

Petra and Dorata (2008) argue that serving on other corporate boards leads to reduced supervisory efficiency as multi-directorships reduce the time and effort allocated to each company. Empirically, Core *et al.* (1999) find that when outside directors have seats on four or more boards, the CEO receives higher remuneration packages. This outcome is also supported by the findings of other studies (Armstrong *et al.*, 2012; Ozdemir and Upneja, 2012; Sapp, 2008).

In Saudi Arabia where the majority of corporate boards are chaired by large shareholders, approximately 70% of board chairmen are members of other companies' boards. This enhances chairmen' knowledge and enables to use benchmarking criteria. Therefore, their decisions related to executive compensation are expected to prevent excessive compensation. Consequently, this study formulates the following hypothesis:

H5: A negatively significant relationship exists between chairmen with multi-directorships and executive compensation in family and non-family firms.

- **Existence of a remuneration committee**

Good corporate governance regulations recommend corporate boards transfer the responsibility for pay-setting to a remuneration committee comprised wholly or mainly of independent members (Girma *et al.*, 2007; Méndez *et al.*, 2011). According to the optimal contracting model, the negotiation process between board of directors and top executives is assumed to be rational and unbiased (Chen *et al.*, 2010b). Therefore, the remuneration committee is expected to enhance the design and effectiveness of managerial incentives and, therefore, diminish the gap between managers' and shareholders' interests (Chen *et al.*, 2010b).

However, in Saudi Arabia, there is no independency requirement for the composition of remuneration committee. Furthermore, CEOs and other senior executive are allowed to part in the remuneration committee. From the view of managerial power model, the presence of affiliated directors or executive members will lead to higher levels of executive pay and, in general, poorly structured incentives packages (Bebchuk and Fried, 2009). However, institutional theory argues that emerging economies often are dominated by certain families and have weak institutional settings. Hence, there is a likelihood that a remuneration committee is established only to meet regulatory requirements, while, in practice, the board of directors is solely responsible for decisions

related to executive pay (Young *et al.*, 2008). This arguement is supported by the findings of previous studies which find that remuneration committees facilitate higher executive compensation (Conyon and He, 2012; 2011; Chen *et al.*, 2010b). Therefore, according to the discussion, the study develops the following hypothesis:

H6: A positively significant relationship exists between the existence of a remuneration committee and executive compensation in family and non-family firms.

b) Ownership structure

- **Director ownership**

Internally, the board of directors is considered to be the most effective governance mechanism for reducing agency costs (Ramaswamy *et al.*, 2000). However, the principal-agent model argues that if a board's interest is different from that of shareholders, this may lead to increased agency costs (Muth and Donaldson, 1998). To ensure an optimal alignment of interests between shareholders and members of a board of directors, board members should also become shareholders. Minow and Bingham (1995, p. 497), cited by Muth and Donaldson (1998), state that "nothing makes directors think like shareholders more than being shareholders". In this sense, directors view their equity in a similar way to other shareholders; hence, this will increase their supervisory effectiveness over management.

However, (Young *et al.*, 2008) warn that high ownership levels held by board members in weak institutional settings can exacerbate principal-principal conflict and lead to increased exploitation of minority shareholders. The majority of studies find that director ownership increases governance effectiveness and curbs managerial pay (Méndez *et al.*, 2011; Ozkan, 2011; Sapp, 2008). However, a number fail to find any significant impact from director ownership on executive compensation arrangements (Rashid, 2013; Hearn, 2013). As directors' interests vary between family and non-family firms, the hypothesis is developed as follows:

H7: Director ownership has a positively significant impact on executive compensation in family-controlled firms; and a negatively significant impact in non-family firms.

- **Pension fund ownership**

Pension funds are one of the largest investors in the Saudi stock market, which allows them to influence governance policies. The agency-based view suggests that pension funds can enhance the monitoring function of board of directors and hence they can contribute in controlling managerial incentives (Lin *et al.*, 2011). Colpan and Yoshikawa (2012) state that institutional investors, such as pension funds, are frequently growth-seekers. In this context, such investors may prefer to link executive compensation to long-term rather than short-term performance (David *et al.*, 1998). Public pension funds are considered "pressure-resistant" investors because they have no direct business relationships with corporate management (Colpan and Yoshikawa, 2012). In addition, unlike ordinary individual investors, representatives of institutional investors are appointed according to their skills and usually have experience in the business industry (Qi *et al.*, 2000). Accordingly, the presence of pension funds is supposed to increase shareholders' protection from managerial opportunism in relation to compensation arrangements.

The literature lacks studies investigating the effect of pension funds' investments on compensation policies. However, a number of scholars examine the role of institutional ownership, of which pension funds are a part, and find that institutional investments are significantly associated with lower executive pay (Ozkan, 2007; Chalevas, 2011; Lin *et al.*, 2011; Ntim *et al.*, 2015). However, (Rashid, 2013) and (Shah *et al.*, 2009) observe no significant relationship between institutional equity and managerial compensation in Bangladesh and Pakistan, respectively. Taking the latter evidence into consideration and as pension funds do not have high investment stakes in family-controlled enterprises, their governing role over managerial compensation in such firms is expected to be weak. Thus, the hypothesis is developed as follows:

H8: Investments of pension funds have a negatively significant impact on executive compensation in non-family firms, while, they have no significant relationship with executive compensation in family-controlled firms.

- **State ownership**

Agency theory argues that the domination of the state in firm equity may negatively affect minority interests and hence lead to the emergence of the principal-principal

conflict (Conyon and He, 2012). Li *et al.* (2007) add that top executives may waste time attempting to please government officers rather than concentrating their efforts on achieving the firm's goals. Furthermore, Conyon and He (2012) support this argument and suggest that state representatives on firms' boards have difficulty in distinguishing between their functional duties as investors' representatives and their administrative tasks. Firth *et al.* (2007) and Chen *et al.* (2011) find that state ownership is significantly associated with lower executive remuneration packages in China

State investment in Saudi Arabia is more focused on non-family firms than family-controlled firms. This means that the state has less influence on the boards of family-controlled firms. Therefore, its control and impact over family-controlled firms is expected to be insignificant in general. Saudi state investment is concentrated in certain giant corporations that are provide essential facilities for the nation, such as in the energy and telecommunications sectors. This indicates that the state does not always seek profitability; sometimes it has other objectives such as maintaining national security. Consequently, the supervisory function over decisions related to executive compensation even in non-family firms may have a lower priority from the state's perspective. Hence, this research formulates the following hypothesis:

H9: State investment has a negatively significant impact on executive compensation in non-family firm, while it has no significant relationship with executive compensation in family-controlled firms.

5.4.1.2 Political Connections and Executive Compensation

Political connections have a significant influence on economic outcomes (Chen *et al.*, 2010a; Ding *et al.*, 2015; Faccio, 2010; Khwaja and Mian, 2005; Sun *et al.*, 2016; Wang, 2015). Nevertheless, their influence and presence on family and non-family firms is still not clear because, as to the best of my knowledge, no single study examines this phenomenon in family and non-family firms. However, Faccio (2010) analyse a cross-country sample and find that political connections are active in emerging economies, especially in the most corrupt ones. The author states that political ties emerge as a result of the weak enforcement of laws and thus create a balance of power among business elites. In this context, the business environment in Saudi Arabia, which is network-oriented, is more likely to be affected by political connections.

Although Saudi Arabia is not recognised as one of the most corrupt countries (Transparency International, 2015), there is a high likelihood that political connections are important for business transactions. This is because the demography in Saudi Arabia is based around a tribal structure, in which personal relationships play a significant role in normal daily life. The report of The Hofstede Centre (2014) supports this argument, assessing Saudi Arabia at 75% collectivist and power distance at 95%. Thus, political connectedness is considered as a substantial element in balancing power among business elites and will affect decisions related to the appointment of key executives and their compensation.

Although much of the literature shows the advantages of building political relationships outweighs their costs (Faccio, 2010), political connections also have a negative aspect that can harm an enterprise (Sun *et al.*, 2016). From the perspective of agency theory, well connected shareholders may exploit political ties for their own interests, which can lead to higher agency costs (García-Meca, 2015). Thus, political affiliations of controlling shareholders can provide them with the required power to exploit firm resources at the expense of small shareholders, thereby exacerbating the principal-principal problem. For instance, Chen *et al.* (2010a) document that political connections increase information asymmetry problems since connected enterprises are found to disclose less accurate analyst forecasts than non-connected ones. Principal-principal conflict evidently exists in contexts that have a high concentration of ownership (Young *et al.*, 2008). Private controlling shareholders usually seek personal rent appropriation; however, to do so, they need protection from regulatory oversight. One effective means to obtain such protection is through recruiting politically connected members to the board of directors (Sun *et al.*, 2016).

However, the impact of political connections on corporate governance in general, and on executive compensation in particular, is still unclear from the research. For example, on the one hand, political connections are found to harm the interests of minority shareholders since they enable rent appropriation. As such, Sun Sun *et al.* (2016) and Wang (2015) observe a positive and significant relationship between the presence of politically connected members and related-party transactions. In terms of executive compensation, to the best of my knowledge, Chizema *et al.* (2015) is the only

research that examine the role of political connections in constraining executive compensation.

As discussed earlier, since the employment process in Saudi Arabia is significantly influenced by *wasta* in general, there is a likelihood that this influence also extends to executive positions. Thus, controlling shareholders may exercise their stewardship duties in favour of their relatives and close friends and appoint them to key managerial posts. As a result of this favouritism, these related managers are expected to receive generous, higher remuneration and packages than their non-supported counterparts. Furthermore, there is no concern about regulatory sanctions as the controlling shareholders expect protection from politically connected members. On the view of this, the research expects similar relationships between political connections and executive compensation in family and non-family firms as follows:

H10: Political connections have a positively significant impact on executive compensation in family and non-family firms.

5.4.2 Sample Selection and Data Collection

The study is based on a sample from the SSE. The context of Saudi Arabia is chosen for several reasons. First, the political regime in Saudi Arabia is stable; hence, there is no concern about the effect of political instability on the results. Second, since the study analyses the practices of executive compensation in family and non-family firms, the ownership structure in Saudi Arabia enable this goal to be achieved. Lastly, data are accessible, because the transparency of information in Saudi Arabia is much higher than other monarchical emerging countries.

The initial sample contains all 160 listed firms in the SSE in 15 different industries between 2008 and 2015 (Tadawul database). This period has been chosen for two key reasons. First, data are available and accessible since the enforcement of corporate governance regulations and their disclosure requirements began in 2008. Moreover, this period is the most recent investigation with respect to the determinants of executive compensation, which helps to fill the gap and improve the understanding of pay setting practices

However, due to the characteristics of heterogeneity between financial and non-financial firms and being subject to different regulatory requirements (Wang and Shailer, 2015), the study uses only non-financial firms. This method is supported by other studies, such as (Sakawa *et al.*, 2012; Rashid, 2013; Méndez *et al.*, 2011; Ntim *et al.*, 2015; Shah *et al.*, 2009). Therefore, after excluding the financial firms, the total sample is 114 firms. Furthermore, some firm-year observations are excluded as follows: 13 missing disclosure, 56 firms not listed yet, and 24 firms facing bankruptcy issues. Therefore, the final unbalanced sample is 819 firm-year observations.

5.4.3 Models' Specifications

The research develops two empirical models. The first model investigates the hypotheses concerning the relationship between corporate governance and executive compensation setting in family-controlled and non-family firms. The second model examines the association between political connections and executive compensation arrangements in family-controlled and non-family firms. Both models contain three dependent variables which allow an examination of the effect on various constituents of executive compensation packages, namely **SALARY**, **BONUS**, and finally **TOTAL PAY** (see

Table 5.2). Since the data do not meet the assumptions of OLS, especially normality assumption (see the descriptive statistics section 5.5.1 p.245), the study will not use OLS regression; otherwise, the results will be biased and misleading (Baltagi, 2008; Greene, 2008). Consequently, in order to overcome such bias, this study employs non-parametric tests following other key studies (Elston and Goldberg, 2003; Chen *et al.*, 2010b; Conyon and He, 2011; Ntim *et al.*, 2015).

Based on the results of Hausman tests (see the regression tables in pp.256, 263), the fixed-effect model is the most appropriate technique by which to investigate the study hypotheses for the dependent variables **SALARY** and **TOTAL PAY.** However, as the dependent variable **BONUS** has censored data because the number of zeros (i.e. no bonus) exceed 20% of the total observations, the study employs the Tobit model which is designed to deal with such censored data (Anderson and Bizjak, 2003). The use of Tobit regression is consistent with studies that face similar limited dependent variables such as option packages (Anderson and Bizjak, 2003; Sakawa *et al.*, 2012; Ozkan, 2007). Consequently, the research formulates the firm-year fixed-effect model for the dependent variables **SALARY** and **TOTAL PAY** as follows:

$$\boldsymbol{ln\_PAY_{it} = \beta_0 + \beta_{it} X_{it} + u_i}$$

where;

$\boldsymbol{\beta_0}$ = Intercept
$\boldsymbol{\beta_{it}}$ = Coefficient of slope parameters
$\boldsymbol{X_{it}}$ = Independent variable i at time t
$\boldsymbol{u_i}$ = Error term

The **Tobit** model for the **BONUS** component can be formed as follows:

$$\boldsymbol{ln\_BONUS_{it}} = \begin{cases} \boldsymbol{ln\_BONUS^{*}_{it} = \beta_0 + \beta_{it} X_{it} + u_i} & \boldsymbol{if \quad ln\_BONUS^{*}_{it} > 0} \\ \boldsymbol{0} & \boldsymbol{if \quad ln\_BONUS^{*}_{it} \leq 0} \end{cases}$$

where $\boldsymbol{ln\_BONUS_{it}}$ is the observed dependent variable, and $\boldsymbol{ln\_BONUS^{*}_{it}}$ is a latent dependent variable that is observed for values greater than 0 and censored otherwise

Table 5.2: Variable Definitions

Variable name	Description
Dependent variables	
ln_PAY it	The natural logarithm of average compensation per executive for firm *i* in year *t*, including two different components (variables): - **TOTAL PAY** (salary, bonus & non-cash compensation) - **SALARY**
ln_BONUS it	The natural logarithm of average **bonus** compensation per executive for firm *i* in year *t* (for more details see p. 117).
Independent variables	
FAMDIRs	The proportion of family member directors to total board members.
BRDIND	The proportion of independent directors to total board members
DUAL	A dummy variable that equals 1 if the chairman simultaneously holds an executive position and 0 otherwise.
BLKCHR	A dummy variable that equals 1 if the board chairman is a blockholder and 0 otherwise.
CHRMDs	A dummy variable that equals 1 if the board chairman has membership on board of directors of other firms.
REXIST	A dummy variable that equals 1 if the firm has a remuneration committee and 0 otherwise
DIROWN	The proportion of ordinary shares owned by the members of board of directors.
PFOWN	The proportion of ordinary shares owned by general pension funds.
STATEOWN	The proportion of ordinary shares owned by the government and general pension funds.
PM	A dummy variable that equals 1 if the firm has either a royal family member, a *Shura* Council member, or a state representative in the board of directors and 0 otherwise
PMOWN	The proportion of ordinary shares owned or represented by the politically connected members
Control variables	
FSIZE	The natural logarithm of the total assets
LEV	Total debt divided by total assets
FAGE	The natural logarithm of total number of years since the firm has been listed on the stock exchange.
ROA	Net profit in year t-1 divided by total assets in year t-1.

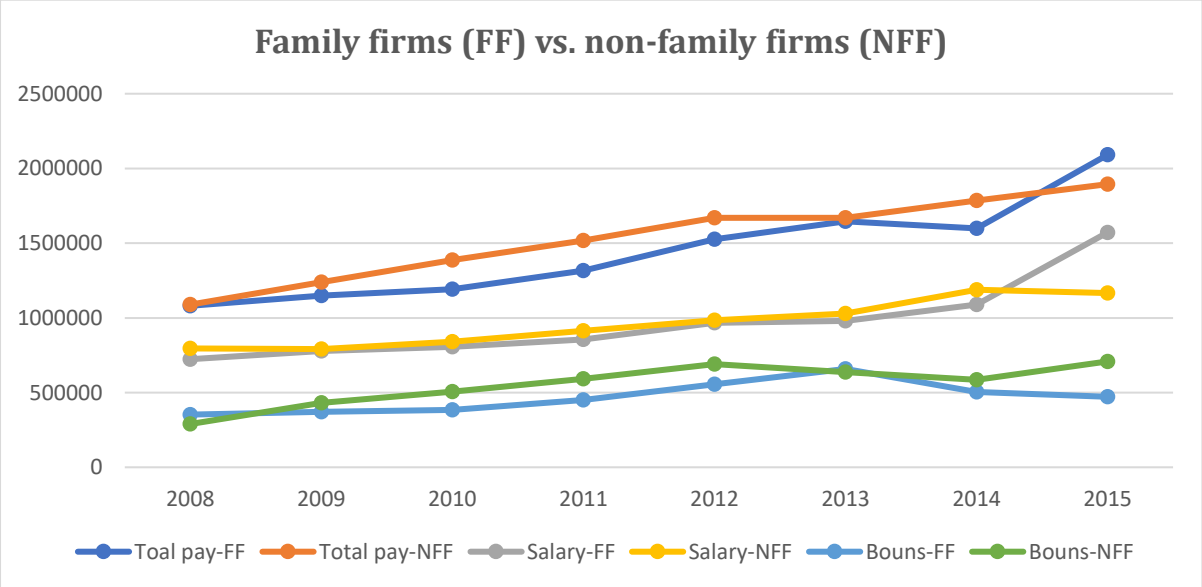
5.5 DATA ANALYSIS AND DISCUSSION

5.5.1 Descriptive Statistics

5.5.1.1 Descriptive Statistics for Executive Compensation Variables

Table 5.3 displays the descriptive statistics of the executive remuneration variables (i.e. **TOTAL PAY, SALARY** and **BONUS**) in family and non-family firms. All compensation components are presented in SA Riyals which in practice has a fixed exchange rate equal to approximately 0.267 US dollars. As can be seen in Table 5.3, top managers in family firms receive slightly lower **TOTAL PAY** (SAR1,477,190) than their counterparts in non-family firms (SAR1,556,675). This finding is consistent with Croci *et al.* (2012) who find that family firms provide less total compensation for their senior executives than do non-family firms in Europe. However, the table reveals that executive compensation in family firms tends to be based on **SALARY**. For example, the maximum compensation in family firms (SAR28,100,000) is granted on a fixed basis, while in non-family firms the maximum pay was SAR12,900,000 on a variable basis (**BONUS**).

Figure 5.1: Executive Compensation in Family and Non-Family Firms, 2008-2015



Although the compensation amounts are different in form, they are similar in substance since the variance in **TOTAL PAY** between the family and non-family firms is insignificant. This finding is supported by the results of the Mann-Whitney test (see Table 5.3) which show that there is no significant difference between the means of

compensation variables in family and non-family firms. Moreover, Figure 5.1 and Figure 5.2 demonstrate that in general executive compensation variables took a similar upward trend in family and non-family firms from 2008 to 2015, although there were fluctuations in the performance of family and non-family firms during the period. This might be an indication that non-family firms prefer to use a variable form of compensation to reassure shareholders that managers are paid according to performance-based criteria. However, family firms have less need to provide this assurance because controlling shareholders are involved at the board and management levels. Accordingly, it can be inferred that executive compensation practices in Saudi Arabia differ in form but not in substance between family and non-family firms, with only a weak link to firm performance.

5.5.1.2 Descriptive Statistics for Corporate Governance and Political Connections Variables

Table 5.3 presents also the descriptive statistics for the independent variables used in this chapter. The data show that practices and norms of corporate governance are different in family and non-family firms. For instance, 85% of family firms have at least one blockholder on the board of directors, while only one-half of non-family firms have a large shareholder on their boards. Furthermore, family directors occupy nearly one-fifth of total boards seats in general, but almost one-third of family first in particular. Members of boards of directors are also found to own approximately 15% of family companies' shares. This evidence highlights how individual and family shareholders dominate and influence the Saudi economy. Therefore, it is essential that governance mechanisms should acknowledge the role of controlling shareholders in influencing policy and norms within and across organisations.

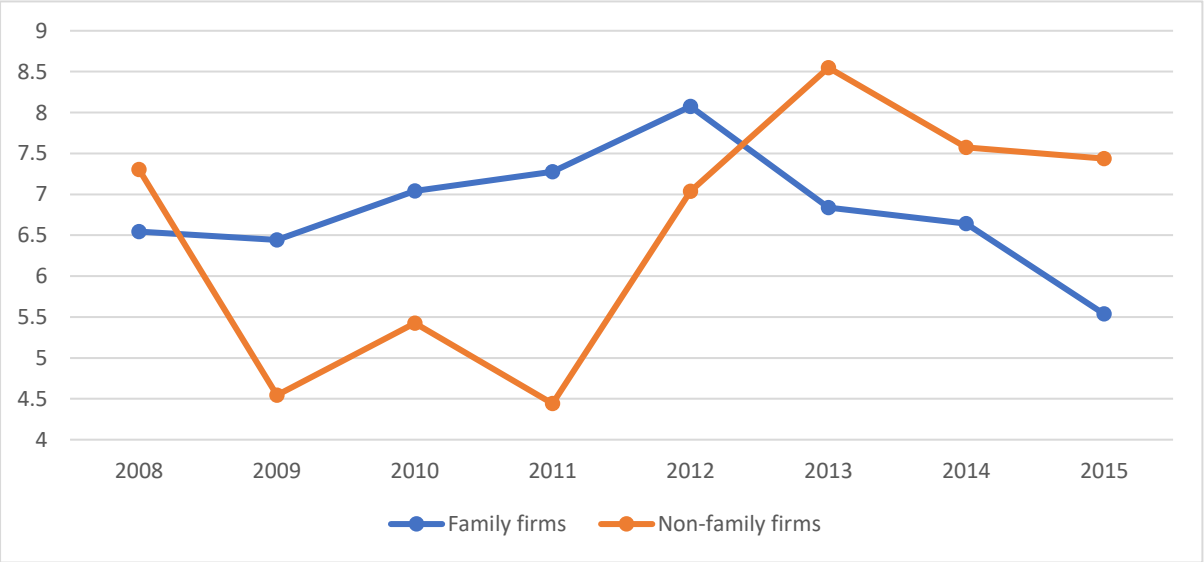
Table 5.3: Descriptive Statistics of Dependent and Independent Variables

Variable	Full sample			Family firms			Non-family firms			Mann-Whitney test
	Mean	Skewnes	Kurtosis	Mean	Min	Max	Mean	Min	Max	
TOTAL PAY (*'000*)	1,511,352	6.53	77.85	1,477,190	12,000	28,100,000	1,556,675	149,859	14,400,000	-0.79
SALARY (*'000*)	983,414	16.15	370.08	989,364	9,000	28,100,000	975,521	118,324	5,026,080	-0.47
BONUS (*'000*)	515,067	6.30	59.32	477,119	0	4,844,800	565,413	0	12,900,000	0.13
FAMDIRs %	17.50	0.87	2.94	29.38	0	100	-	-	-	n/a
BRDIND %	45.96	0.83	3.28	44.31	0	91.67	48.16	0	100	1.91*
DUAL	0.15	1.99	4.94	0.17	0	1	0.12	0	1	-1.79*
BLKCHR	0.69	-0.85	1.72	0.85	0	1	0.49	0	1	-10.96***
CHRMDs	0.70	-0.87	1.76	0.77	0	1	0.61	0	1	-5.12***
RCEXIST	0.92	-3.11	10.69	0.95	0	1	0.89	0	1	-3.15***
DIROWN %	9.18	2.75	12.30	14.98	0	95.84	1.48	0	15.31	-15.35***
PFOWN %	3.24	2.38	9.30	2.04	0	35.10	4.84	0	32.50	5.30***
STATEOWN %	7.44	2.56	8.74	2.03	0	55.20	14.61	0	81.21	7.84***
PM	0.60	-0.41	1.17	0.49	0	1	0.74	0	1	7.28***
POWN	14.12	1.81	5.43	9.54	0	95.00	20.20	0	83.60	5.594***
FSIZE (*'000,000*)	12,600	0.56	3.43	4,170	58	50,700	23,900	54	358,000	3.60***
LEV %	37.41	5.64	91.66	38.62	0.41	463.09	35.80	1.85	118.91	-1.88*
FAGE (*in years*)	19	-0.52	2.31	16.89	1.00	61.00	20.64	1.00	61.00	4.81***
ROA %	6.73	-0.30	12.20	6.81	-58.98	34.36	6.61	-67.81	49.27	-2.65***

All variables are defined in Table 5.2
***** p<0.01, ** p<0.05, * p<0.10**

In terms of government and pension fund investments, they are found to be concentrated in non-family firms. The outcomes show that government and pension funds jointly own 20% of the shares of non-family firms. Political connections also have a significant presence in the Saudi business field. The outcomes reveal that 60% of listed firms are politically connected. More specifically, 49% of family firms and 74% of non-family counterparts have at least one politically connected member on their board of directors. This finding supports the conclusion of Faccio (2010) who states that the phenomenon of political relationships plays a significant role in the business field in emerging economies. The significant interaction between business elites and politicians in Saudi Arabia is consistent with the situation in Taiwan where 65% of firms are observed to have political relationships (Civilize *et al.*, 2015). However, this interaction is found to be significantly higher than in other immature economies such as China and Pakistan where only 29% and 23%, respectively, of firms are politically connected (Khwaja and Mian, 2005; Zhang *et al.*, 2015).

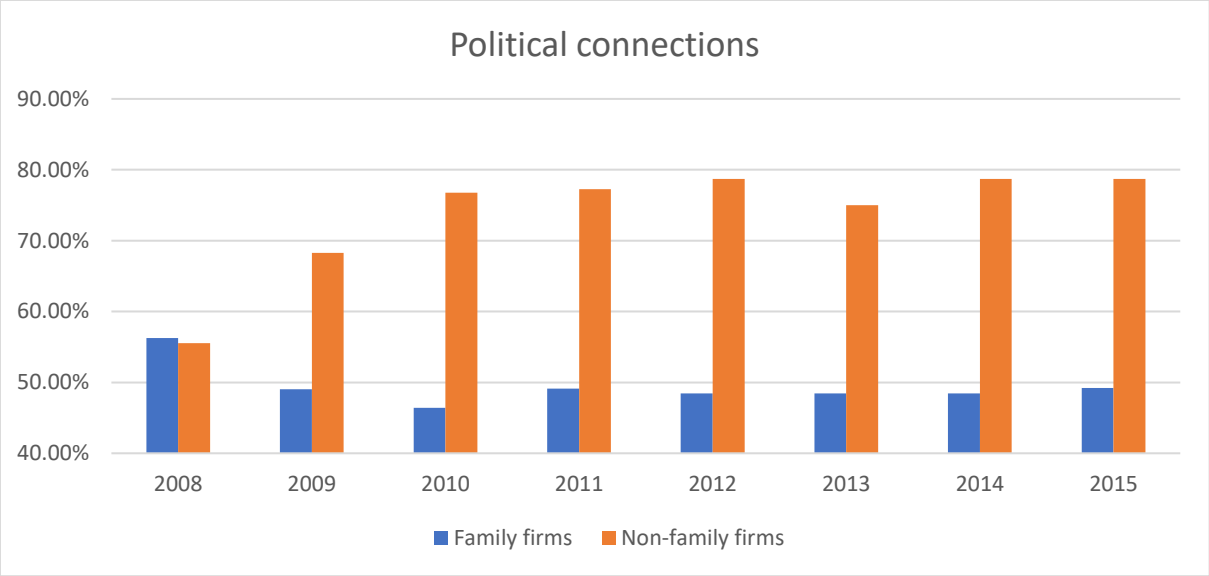
Figure 5.2: Firm Performance of Family and Non-Family Firms, 2008-2015



The high dependence of non-family firms on political connections as well as the earlier results related to the significant presence of family shareholders indicate that business policy in Saudi Arabia is driven by interlocking relationships. On the other hand, Table 5.3 indicates that family firms have less need for political connections, although half of them have members with a political background. Hence, it can be argued that the roles of political connections and family ties are substitutive. Both politically connected and

family affiliated members have strong connections with regulators and the business elite. Indeed, the wide existence and need for political connections or family ties demonstrate that the Saudi economy is subject to and significantly influenced by non-economic characteristics. These influential informal institutions provide evidence that emerging economies have different key drivers compared to developed economies.

Figure 5.3: Presence of Political Connections in Family and Non-Family Firms, 2008-2015



5.5.2 Correlation Coefficients

In order to verify that the data are not violated by collinearity problems, the study employs the test of Spearman rank correlations as a primary approach to analyse the pairwise correlation among the model's independent variables. The Spearman's test is the most appropriate for non-parametric data (Knack and Keefer, 1995). However, Pearson's correlation is also reported to produce greater robustness. According to the rule of thumb, the model can be harmed by multi-collinearity if the degree of correlation between two independent variables exceeds 0.80 (Gujarati, 2003; Hair *et al.*, 2006).

Table 5.4 displays the results of the correlation matrix and shows that no serious collinearity problem exists between regressors, i.e. all pairwise correlations between explanatory variables are lower than 80% (Gujarati, 2003; Hair *et al.*, 2006). According to Spearman's correlation, Table 5.4 reveals that there is a moderately positive correlation (0.74) between the presence of politically connected members (**PM**) and their ownership (**POWN**), although the results of the Pearson's test show lower correlation

(0.49). However, this outcome does not violate the data validity since the correlations do not exceed 0.8 and therefore the models do not suffer from a serious collinearity problem.

However, Belsley *et al.* (2005), Kutner *et al.* (2004) and Kleinbaum *et al.* (2013) criticise the correlation matrix since it only examines the pairwise correlation between independent variables, although collinearity is highly likely to involve more than two regressors simultaneously. In order to overcome this limitation, the authors suggest a more elaborate approach to detect multi-collinearity, namely the Variance Inflation Factor (VIF).

The VIF test allows researchers to regress each predictor against all other independent variables and to produce an R-square value for each. By doing so, the test examines the existence of the multi-collinearity problem in each predictor with other regressors jointly rather than only through pairwise correlation. Therefore, in addition to the correlation matrix test, this study employs the VIF test for each model to make further checks on the existence of collinearity. Statistically, it is suggested that if any predictor has a VIF exceeding 10, the regression model suffers from multi-collinearity (Hair *et al.*, 2006; O'brien, 2007). According to the outcomes of the VIF tests (reported in Table 5.5 and Table 5.6), the findings confirm the conclusions of Spearman's and Pearson's tests that multi-collinearity does not seriously influence the coefficient estimates of the predictors.

Table 5.4: Correlation Matrix

		[1]	[2]	[3]	[4]	[5]	[6]	[7]	[8]	[9]	[10]	[11]	[12]	[13]	[14]	[15]	[16]	[17]	[18]
[1]	**TOTAL PAY**		0.89*	0.46	-0.01*	-0.29*	-0.13*	0.13*	0.06*	0.14*	0.11*	0.17*	0.17*	0.19*	0.26*	0.59*	0.25*	-0.19*	0.18*
[2]	**SALARY**	0.90*		0.23*	-0.04*	-0.26*	-0.15*	0.17*	0.09*	0.13*	0	0.15*	0.23*	0.22*	0.27*	0.56*	0.22*	-0.17*	0.09*
[3]	**BONUS**	0.75*	0.47*		0.09*	-0.16*	-0.09*	0.10*	0.09*	0.13*	0.14*	0.23*	0.04*	0.07*	0.09*	0.30*	0.12*	-0.09*	0.27*
[4]	**FAMDIRs**	0.04*	0.00	0.05*		-0.23*	-0.03*	0.43*	-0.01*	0.09*	0.46*	-0.26*	-0.34*	-0.38*	-0.36*	-0.18*	0.09*	-0.34*	0.13*
[5]	**BRDIND**	-0.29*	-0.25*	-0.22*	-0.22*		-0.01	-0.30*	0.01	-0.05*	-0.11*	-0.17*	-0.07*	-0.01	-0.12*	-0.35*	-0.16*	0.26*	-0.09*
[6]	**DUAL**	-0.11*	-0.13*	-0.09*	-0.09*	0.02		-0.03	-0.03	-0.07*	-0.06*	-0.06*	-0.10*	-0.03	-0.08*	-0.05*	0	-0.01	-0.10*
[7]	**BLKCHR**	0.16*	0.22*	0.07*	0.07*	-0.24*	-0.03		0.08*	0.11*	0.27*	-0.19*	0.06*	-0.12*	0.07*	0.15*	0.12*	-0.32*	-0.02
[8]	**CHRMDs**	0.10*	0.14*	0.05*	0.05*	0	-0.03	0.08*		0.05*	-0.14*	0.11*	0.04*	0.12*	0.02	0.10*	0.09*	-0.07*	0.12*
[9]	**RCEXIST**	0.16*	0.15*	0.14*	0.14*	-0.02	-0.07*	0.11*	0.05*		0.08*	-0.01	-0.04*	-0.01	0.01	0.03	0.02	-0.04*	-0.01
[10]	**DIROWN**	0.04*	-0.04*	0.11*	0.11*	-0.02	-0.07*	0.22*	-0.01	0.10*		-0.22*	-0.23*	-0.19*	0.05*	-0.04*	0.02	-0.34*	0.08*
[11]	**PFOWN**	0.25*	0.24*	0.26*	0.26*	-0.12*	-0.04*	-0.16*	0.09*	0	-0.21*		0.22*	0.40*	0.40*	0.35*	-0.04*	0.16*	0.26*
[12]	**STATEOWN**	0.11*	0.16*	0.04*	0.04*	-0.04*	-0.06*	-0.06*	0.06*	-0.06*	-0.41*	0.38*		0.35*	**0.82***	0.51*	0.07*	0.13*	0.04*
[13]	**PM**	0.21*	0.26*	0.12*	0.12*	0.02	-0.03	-0.12*	0.12*	-0.01	-0.26*	0.48*	0.43*		0.49*	0.45*	0.05*	0.21*	0.07*
[14]	**POWN**	0.29*	0.30*	0.21*	0.21*	-0.08*	-0.04*	-0.01	0.07*	0.01	-0.31*	**0.60***	**0.70***	**0.74***		0.56*	0.06*	0.08*	0.02
[15]	**FSIZE**	0.59*	**0.62***	0.40*	0.40*	-0.27*	-0.04*	0.12*	0.15*	0.03	-0.15*	0.48*	0.38*	0.49*	0.53*		0.29*	-0.10*	-0.02
[16]	**LEV**	0.40*	0.36*	0.30*	0.30*	-0.21*	0.01	0.13*	0.10*	0.03	0	-0.05*	-0.02	0.05*	0.07*	0.40*		-0.20*	-0.17*
[17]	**FAGE**	-0.17*	-0.16*	-0.09*	-0.09*	0.23*	-0.03	-0.30*	-0.07*	-0.03	-0.27*	0.29*	0.27*	0.24*	0.22*	-0.04*	-0.30*		-0.01
[18]	**ROA**	0.19*	0.06*	0.33*	0.33*	-0.06*	-0.14*	-0.03	0.08*	0.03	0.28*	0.23*	0.01	0.05*	0.03	-0.07*	-0.24*	0.01	

Spearman rank correlations are reported below the diagonal, and Pearson correlation coefficients are reported above the diagonal.
* denotes significance at 0.05 level

5.5.3 Discussion of Research Findings

Table 5.5 presents the results of the regression analysis for the variables of corporate governance and their effects on each component of executive remuneration in family and non-family firms. The Table also shows the results for the entire sample, which allows for the analysis of the differences of governance practices between family firms and non-family counterparts. The R-squared of all models of **TOTAL PAY** and **SALARY** range between 22%-28%, which demonstrates that the independent variables used are able to explain roughly one-quarter of the variation in the executive compensation settings within firms and over time. In comparison, the R-squared statistics of Gomez-Mejia *et al.* (2003), Tsao *et al.* (2015) and Wu (2013) are 33%, 26% and 23% respectively. Others also find similar R-squared statistics around 30% (Combs *et al.*, 2010; Chen *et al.*, 2014). These outcomes confirm that the explanatory power of the study models relies on the acceptable range found by literature. Nevertheless, these moderate explanatory powers indicate that there are other omitted variables that influence the practices of setting executive remuneration packages.

Consistent with Hypothesis 1, the table reveals that when a greater number of family members serve on the board of directors (**FAMDIRs**), top managers are more likely to earn greater **TOTAL PAY** and **BONUS**. However, there was no significant association between family directors and **SALARY**. This can be seen as a sign that family firms prefer to compensate their executives according to their performance rather than by a fixed salary. However, Figure 5.2 and Figure 5.3 reject this argument. That is to say, **TOTAL PAY** in family firms has shown the same upward trend of firm performance from 2008 until 2014; however, **SALARY** in 2015, and **TOTAL PAY** accordingly, have shown a sharp increase although firm performance continues on a downward trend. This could be an indication that total compensation is the primary issue for family firms. Thus, they follow performance criteria only when the firm achieves a superior performance. Otherwise, they extract higher compensation on a fixed basis.

This interesting outcome neither matches the findings of Sapp (2008) and Croci *et al.* (2012), who report a negative and significant link between family control and managerial compensation in Canada and Continental Europe, respectively, nor with Gomez-Mejia *et al.* (2003), who find no evidence of such a relationship in the US. Although agency theory argues that the close participation of shareholders in the decision-making

process helps to reduce the agency costs in general and executive compensation in particular, this assumption may only be valid in developed countries which are characterised by diffuse share ownership (Rashid, 2013). Indeed, my findings demonstrate a contrary relationship in emerging countries such as KSA, where other factors may affect the design of managerial pay packages. The positive and significant association between family directors and executive rewards found in Saudi Arabia may be a consequence of the strong and close affiliation between the two parties.

As mentioned earlier, the recruitment process in the Saudi context is highly dependent on *wasta* (Budhwar and Debrah, 2013); thus, family members often appoint their relatives and close friends to executive posts. Accordingly, large shareholders may grant their related executives higher compensation. Moreover, these family members, who own and dominate listed firms, are usually extremely rich; hence, according to the Saudi culture, they are supposed to be generous to their surrounding community; for example, assisting relatives, employees, the neighbourhood where they live and needy people, for which they receive honour, prestige and legitimation.

The results in Table 5.5 also demonstrate that independent members on the board of directors (**BRDIND**) are significantly associated with managerial pay in both family and non-family firms, which is consistent with Hypothesis 2. The role of independent members in family firms are found to have similar impact to family directors on executive compensation**.** In non-family firms, independent directors are also ineffective in constraining executive compensation since the findings reveal that their presence is associated with higher **TOTAL PAY** and **SALARY**. Generally, these findings demonstrate that such members lack real independence in practice whether in family-controlled firms or in non-family firms. It also supports the study argument that firms in Saudi Arabia may follow governance recommendations in form but not in substance.

The positive relationship between outsider directors (**BRDIND**) and executive compensation support the findings of previous studies (Ozkan, 2007; Fahlenbrach, 2009; Ozdemir and Upneja, 2012; Croci *et al.*, 2012), which observe that independent directors do increase managerial pay. This evidence also rejects the assumption of agency theory that board independence is an effective mechanism for mitigating agency costs, particularly those related to managerial pay. However, institutional theory offers a more reliable interpretation for the attitudes of pay settings in a context such as KSA (Young *et*

al., 2008), in which personal characteristics and family names are strongly involved in such decisions.

The weak role of independent directors in controlling managerial pay in family and non-family firms can be attributed to the control and presence of large shareholders on most Saudi corporate boards. According to institutional theory, a firm might appoint outsider members to the board of directors in order to pretend that it is complying with regulations, thereby legitimising its existence among its competitors (Young *et al.*, 2008). In other words, a firm might allow external members to sit on the board of directors solely to satisfy minority shareholders and regulators, while, in fact, these members are not really involved in the process of decision-making. In such a scenario, independent directors may prefer not to challenge the decisions of the large shareholders in order to retain their jobs and ensure their re-nomination (Ozdemir and Upneja, 2012), since the approval of decisions related to managerial pay has almost no repercussions for independent directors (Walkner, 2004). Furthermore, the close supervisory role played by blockholders over managerial activities may make outsider members feel more relaxed and under less pressure to perform their stewardship duties.

In terms of role duality (**DUAL**), Table 5.5 shows no significant relationship between **DUAL** and all the components of executive pay in both family and non-family firms. Therefore, Hypothesis 3 is not accepted. In contrast, and more interestingly, the results reveal a negative but not statistically significant impact of the role duality (**DUAL**) variable on all constituents of managerial remuneration except for the **BONUS** in family firms, which shows a positive direction relationship**.** This evidence does not support the managerial power model which argues that the determination of executive compensation is subject to the influence that managers are able to exert over related decisions (Bebchuk and Fried, 2004). Thus, the findings provide strong support for the stewardship theory, which suggests that combining the positions of CEO and chairperson in the hands of a single individual is not harmful for the company (Donaldson and Davis, 1991).

Empirically, the results are in line with the findings of Li *et al.* (2007), Conyon and He (2011), Chalevas (2011), and Ntim *et al.* (2015). These studies observe similar relationships i.e. when a CEO serves as board chairperson at the same time, this does not affect his/her pay-related decisions. Actually, it is not surprising to find no significant association between role duality and managerial pay in a context such as KSA since

blockholders already have control over decisions-making and have less need to access the power gained through positions such as CEO/chairman. Furthermore, as the majority of Saudi firms are chaired by blockholders, such owner-directors receive higher dividends than managerial compensation.

The findings also show that when position of board chairperson is occupied by a blockholder (**BLKCHR**), top managers in family firms are more likely to earn greater pecuniary rewards. Hence, the first part of Hypothesis 4, which predicts a positive and significant association between blockholder chairman and managerial pay in family firms, is accepted. However, the role of blockholder chairman (**BLKCHR**) in non-family firms are found to have no impact on executive compensation. Therefore, the related hypothesis, which assumes that a blockholder chairman in a non-family firm will reduce executive compensation, is not accepted. Despite the lack of studies examining the role of blockholder chairperson in the enhancement of governance quality, Alagla (2012), who uses a different proxy (chairperson ownership) to measure the power of chairperson through his/her voting rights (ownership), obtains a contrary result. That is to say, the author observes that the higher the number of shares held by the chairperson, the lower the remuneration earned by the CEO. My finding is also inconsistent with the notion of the agency model, which states that the presence and close supervision of large shareholders help to mitigate the agency costs resulting from the separation between ownership and management.

Table 5.5: Regression Analysis: Corporate Governance and Executive Compensation

	Full Sample				Family firms				Non-family firms			
	(1)	(2)	(3)		(4)	(5)	(6)		(7)	(8)	(9)	
	TOTAL PAY	SALARY	BONUS	VIF	TOTAL PAY	SALARY	BONUS	VIF	TOTAL PAY	SALARY	BONUS	VIF
	Fixed effect	*Fixed effect*	*Tobit*		*Fixed effect*	*Fixed effect*	*Tobit*		*Fixed effect*	*Fixed effect*	*Tobit*	
FAMDIRs	0.004	0.000	0.037*	1.85	0.006*	-0.001	0.105***	1.79				
	(1.61)	(0.06)	(1.68)		(1.74)	(0.37)	(3.36)					
BRDIND	0.004***	0.004***	0.019	1.38	0.005**	0.003	0.090***	1.49	0.005**	0.007***	-0.029	1.48
	(2.91)	(2.85)	(1.20)		(2.21)	(1.00)	(3.47)		(2.40)	(3.97)	(1.41)	
DUAL	-0.071	-0.121*	-0.310	1.04	-0.012	-0.148	0.930	1.15	-0.134	-0.118	-1.149	1.17
	(1.12)	(1.86)	(0.44)		(0.13)	(1.48)	(0.94)		(1.49)	(1.47)	(1.18)	
BLKCHR	0.156**	0.268***	-0.790	1.51	0.170*	0.309***	-1.732	1.42	-0.069	-0.047	1.087	1.38
	(1.94)	(3.22)	(1.01)		(1.82)	(2.93)	(1.57)		(0.38)	(0.29)	(0.83)	
CHRMDs	-0.054	-0.069	0.464	1.1	-0.195**	-0.297***	1.041	1.38	0.088	0.157**	-0.741	1.23
	(1.00)	(1.23)	(0.79)		(2.43)	(3.28)	(1.16)		(1.14)	(2.26)	(0.9)	
RCEXIST	0.109**	0.072	1.489***	1.03	0.008	-0.007	1.037	1.05	0.138**	0.096	1.541	1.03
	(2.26)	(1.43)	(2.46)		(0.11)	(0.09)	(1.07)		(2.07)	(1.6)	(2.16)	
DIROWN	-0.005**	-0.007**	0.039	1.44	-0.008***	-0.009***	0.029	1.52	0.011	0.007	0.361**	1.23
	(1.95)	(2.42)	(1.58)		(2.87)	(2.88)	(1.1)		(0.67)	(0.44)	(2.35)	
PFOWN	0.038***	0.039***	0.108*	1.48	0.038**	0.032*	0.162	1.58	0.022	0.021	0.163**	1.55
	(3.52)	(3.53)	(1.67)		(2.34)	(1.73)	(1.58)		(1.47)	(1.57)	(1.76)	
STATEOWN	0.003	0.001	-0.049*	1.62	-0.005	-0.005	-0.177**	1.22	0.009	0.005	-0.001*	2.23
	(0.64)	(0.16)	(1.81)		(0.74)	(0.69)	(2.33)		(1.28)	(0.74)	(0.04)	
FSIZE	0.320***	0.256***	1.367***	1.93	0.318***	0.170*	1.612***	1.26	0.386***	0.471***	0.471	3.68
	(4.92)	(3.79)	(4.53)		(3.91)	(1.85)	(3.51)		(3.35)	(4.56)	(0.95)	
LEV	0.002***	0.002***	0.018**	1.21	0.003***	0.003***	0.017	1.06	-0.001	-0.001	0.046**	1.97
	(3.25)	(3.32)	(2.31)		(3.68)	(3.06)	(2.01)		(0.6)	(0.86)	(2.34)	
FAGE	0.210***	0.210***	0.338	1.35	0.212***	0.239***	0.407	1.5	0.279***	0.198**	1.648***	1.39
	(4.48)	(4.33)	(0.96)		(3.78)	(3.78)	(0.90)		(3.09)	(2.44)	(2.52)	
ROA	0.011***	0.004**	0.098***	1.22	0.014***	0.005	0.166***	1.3	0.007**	0.001	0.027	1.49
	(5.03)	(1.97)	(3.83)		(4.05)	(1.31)	(4.1)		(2.4)	(0.47)	(0.87)	
Constant	5.783***	6.947***	-25.344***		6.050***	9.248***	-35.638***		4.056*	2.111	-8.925	
	(4.26)	(4.93)	(3.86)		(3.61)	(4.89)	(3.49)		(1.67)	(0.97)	(0.85)	
Observations	819				467				352			
Adj. R2	.25	.22			.28	.24			.26	.28		
F-statistics	17.6***	14.71***			11.70***	9.43***			8.73***	9.45***		
Wald Chi2			68.93***				61.10***				42.80***	
Mean VIF				1.40				1.36				1.65
Hausman's Chi2	71.48***	50.25***			78.22***	42.48***			28.76***	53.76***		

All variables are defined in Table 5.2. ***** p<0.01, ** p<0.05, * p<0.10**

In the KSA, blockholders, particularly those who carry out the chairperson's functions, do not seem to be performing their supposed monitoring duties effectively. This positive association between blockholder chairman (**BLKCHR**) and executive compensation in family firms supports the study's argument that there is a principal-principal problem in emerging countries where certain individuals control the decision-making within the organisation without taking in consideration minority shareholders' interests. In other words, blockholder chairmen, who combine both dimensions of powers through voting rights and chairing the board of directors, might use their power to influence the decisions on remuneration of executives, who in many cases are their relatives or close friends, in a way that extracts greater pay.

In line with Hypothesis 5, which presumes a negative and significant association between chairman business (**CHRMDs**) and managerial pay, the study finds evidence that in family firms when a chairman serves on more than one board of directors, top employees receive lower **TOTAL PAY** and **SALARY**. Fama and Jensen (1983b) justify this result by stating that serving on more than one board extends the knowledge and expertise of the director with respect to the function of supervision. They also argue that sitting on other corporate boards gives the decision-maker greater opportunity to utilise benchmarking criteria, which helps to ensure that the compensation is within the reasonable wage range of the labour market.

However, chairman multi-directorships in non-family firms are found to have a positive and significant effect on executive fixed compensation (**SALARY**). Although no study has investigated the relationship between chairman multi-directorships and the practices of executive compensation, a number of researchers (Armstrong *et al.*, 2012; Core *et al.*, 1999; Ozdemir and Upneja, 2012; Sapp, 2008) use a more comprehensive variable that captures the directorship of the entire board of directors and obtain the opposite result. In other words, they find that when the members of a board of directors are simultaneously serving on other corporate boards, their monitoring role is significantly reduced; as a result, the executive team members receive greater remuneration. In the case of the KSA, chairman multi-directorships in non-family firms are not effective in constraining executive salary probably because one-half of the board chairpersons are government representatives. These representatives are busy with their administrative tasks in government in addition to representing government investment

in other companies' boards. Thus, the overload caused by the different tasks leads to weak supervision quality.

With respect to the reumeration committee (**RCEXIST**), the regression analysis presented in Table 5.5 supports Hypothesis 6 and shows evidence that the remuneration committee does not play its role effectively in controlling executive compensation. On the contrary, it does significantly increase managerial pay packages in non-family firms. In other words, it exacerbates the agency problem rather than mitigates it. Empirically, this conclusion is consistent with Conyon and He (2012) and Chen *et al.* (2010b) who also find in the Chinese context that the existence of a remuneration committee is significantly associated with higher managerial compensation packages.

This study finds earlier that the presence of large shareholders on board is related to higher executive remuneration. Therefore, the committee members, who know that their reappointment is in the hands of the dominant shareholders, might prefer to go along with any decision approved by those controlling shareholders rather than oppose them because opposition might lead to a loss of their jobs (Ozdemir and Upneja, 2012). Furthermore, the institutions-based view argues implicitly that there is a strong potential scenario in a context such as KSA, where family ownership is predominant and their control over decision-making process is strong, of a remuneration committee being established only to fulfil SGCR requirements and legitimate the firm's existence (Young *et al.*, 2008).

Inconsistent with Hypothesis 7, the results demonstrate that when the members of board of directors hold more equity (**DIROWN**), top executive are paid lower **TOTAL PAY** and **SALARY** in family firms. However, in non-family firms, director ownership (**DIROWN**) is found to be positively and significantly associated with only **BONUS** perks. This evidence indicates that directors' behaviours in family firms are influenced by their level of holdings of the company's equity; thus, they perform more effective control over executive compensation. However, this is not the case in non-family firms where the results show that their ownership does not influence managerial pay arrangements in general. The difference of roles can be attributed to the fact that board directors hold block of shares in family firms since they own nearly 15% of total equities of family companies (see Table 5.3). In contrast, board directors are less influential in non-family firms as they own less than 2% of the shares in such companies. This finding indicates

that the level of shareholding is the rationale behind the diverse impacts of directors' equity between family and non-family firms.

The findings confirm the perspective of agency theorists who argue that when the members of board of directors own more shares, they will be transformed from delegated directors to shareholders (Minow and Bingham, 1995). As a result, their main objective will be aligned with shareholders and thereby will have greater incentives and motivations to protect their own equity through constraining managerial remuneration (Lin, 2005; Zald, 1969; Shleifer and Vishny, 1986; Jensen and Meckling, 1976; Muth and Donaldson, 1998). Empirically, a number of studies document similar results (Méndez *et al.*, 2011; Ntim *et al.*, 2015; Ozkan, 2007; Sapp, 2008), when they observe a negative and significant relationship between shareholding level of directors and executive remuneration.

Surprisingly, the findings show that investment by pension funds (**PFOWN**) has a positive and significant impact on **TOTAL PAY** and **SALARY** in family firms, but generally no effect in non-family firms, except a significantly positive impact on **BONUS**. This outcome is an opposite of the Hypothesis 8 in relation to family firms which presumes that such ownership would help to significantly diminish managerial pay levels. Furthermore, the finding does not match the agency-based argument, which suggests that the presence of institutional investors can improve supervisory functions over managerial activities and therefore, reduce executive compensation (Chalevas, 2011; Fahlenbrach, 2009; Hartzell and Starks, 2003; Lin *et al.*, 2011; Ozkan, 2007; Ramaswamy *et al.*, 2000). However, the findings support the part of the Hypothesis related to non-family firms, which expected that pension funds' investments would perform a less effective monitoring role over managerial incentives. To the author's best knowledge, no previous empirical research observes a positively significant relationship between pension fund investment and executive compensation arrangements. To the contrary, most studies state that institutional investment significantly curbs top managers' compensation (Chalevas, 2011; Fahlenbrach, 2009; Lin *et al.*, 2011; Ntim *et al.*, 2015; Ozkan, 2007; Ramaswamy *et al.*, 2000). In addition, Rashid (2013) and Shah *et al.* (2009) do not find any relationship between the two variables in Bangladesh and Pakistan, respectively, which share many in common cultural features with the KSA.

The rationale behind the positive impact of pension fund investment on executive compensation is because institutional investors are growth-seekers rather than profit-seekers (Colpan and Yoshikawa, 2012; Colpan *et al.*, 2011; David *et al.*, 2010). Based on this view, those investors may compensate their top employees generously in order to incentivise them to expand the firm activities; in Saudi Arabia, stock options cannot be used to incentivise for long-term performance. Alternatively, because in the KSA pension funds are controlled and administrated by the Saudi state (GOSI, 2000; PPA, 2004), the reason for the findings might follow the logic of Conyon and He (2012). They argue that state representatives can experience tensions between their duties as investors' stewards and as state administrators. Accordingly, they might be less concerned about executive team compensation, especially as there are practically no repercussions if they approve such payments (Chalevas, 2011).

Although the Saudi state owns virtually 20% of the market value of the Saudi Stock Exchange (Aleqtisadiah, 2014), the results show that state investment (**STATEOWN**) does not enhance the protection of shareholders' interest by limiting executive remuneration. State investment is only associated with lower **BONUS**. However, no significant relationships are found between state equity and other components of executive compensation. This evidence is in line with Conyon and He (2012), Li *et al.* (2007), and Ramaswamy *et al.* (2000), who conclude that state investment does not influence the practices of managerial pay in Asia. However, Chen *et al.* (2011) and Firth *et al.* (2007) find that state ownership negatively and significantly impacts the level of top managers' remuneration.

Conyon and He (2012) attribute the ineffective monitoring role played by the state to the difficulty encountered by state representatives on board of directors who cannot distinguish between their functions as shareholders' representatives and their administrative tasks. Furthermore, the low supervisory performance of state investors might be a consequence of the divergent objectives between state and regular shareholders (Ramaswamy *et al.*, 2000; Olson, 1973). That is to say, state investment may have non-profit aims such as stabilising the stock market and controlling certain sensitive operational sectors for security purposes (Olson, 1973). Therefore, state investors do not always seek to maximise their income; hence, their efforts may not focus on improving firm performance and monitoring the opportunistic actions of top management with

regards to their remuneration packages (Olson, 1973). Olson's argument is a more reasonable interpretation as the data show that Saudi state investment is restricted to certain giant corporations in the energy and telecommunication sectors.

In terms of political connections and their influence on executive compensation practices in family and non-family firms, the findings are shown in Table 5.6. As can be seen, all models are statistically significant with R-squared figures ranging between 19%-24%. These moderate proportions of explanatory power are in line with the literature; for example, the R-squared statistics of García-Meca (2015) and Chizema *et al.* (2015) are 31% and 27%, respectively. In the context of KSA, where personal connections and tribal ties play a significant role in the process of hiring top managers and determining their wages (Budhwar and Debrah, 2013), such moderate R-squared statistics are not surprising. These behavioural characteristics, which are beyond the scope of this study, are not measurable.

Consistent with Hypothesis 10, the findings show that the presence of a politically connected member on boards of non-family firms is significantly related to higher **TOTAL PAY** and **SALARY**. The positive link between political connections (**PM**) and **TOTAL PAY** and **SALARY** in non-family firms does not match the finding of Chizema *et al.* (2015) who observe a contrary outcome. They find that top executives are less likely to receive higher compensation when the board of directors has at least one politically connected director. To the best of the author's knowledge, no study has yet examined the differences of roles of political connections in family and non-family firms separately, while Chizema *et al.* (2015) is the only study that directly investigates the relationship between political connections and executive compensation. In turn, García-Meca (2015), who examines the impact of political ties on the decisions related to board remuneration in Spain, observes a negative and significant reduction in remuneration level if the firm is politically connected. Although politically connected members are susceptible to serious political loss if their names are involved with financial scandals (Goldman *et al.*, 2009), they may perceive generous managerial compensation as unlikely to be considered to be a serious scandal as long as the financial position of the company is stable. Hence, this may account for the ineffective role of politically connected directors in curbing managerial pay.

The results also show that the magnitude of ownership of the politically connected members has a positive impact on executive compensation in non-family firms. In other

words, the higher the ownership that politically connected members hold in non-family firms, the higher the compensation paid to the top managers. Since controlling decisions related to executive compensation is considered a reflection of good corporate governance, this result implies that political connections might not be beneficial for governance purposes, particularly in non-family firms. This argument supports several prior studies (Ding *et al.*, 2014; Sun *et al.*, 2016; Wang, 2015), which find that political relationships do weaken the quality of corporate governance in emerging economies.

In contrast, although political connections have shown no significant association with **TOTAL PAY** and **SALARY** in family firms, they are found to perform an effective role in reducing **BONUS** remuneration. This is probably because managers' bonus compensation in family firms is high in general, compared with their counterparts in non-family firms. Thus, when politically connected directors use benchmarking criteria, they find that the suggested bonus compensation exceeds market bonus average. Another potential interpretation is that most politically connected directors on boards of family firms are royal family members, who have high stakes in the company equity, and therefore they perform supervision function more effectively. However, politically connected directors in non-family firms are usually government representatives with few stakes in the company's equity. Thus, they are less likely to perform an effective monitoring role in controlling managerial opportunism.

Table 5.6: Regression Analysis: Political Connections and Executive Compensation

	Full Sample				Family firms				Non-family firms			
	(1) TOTAL PAY	(2) SALARY	(3) BONUS	VIF	(4) TOTAL PAY	(5) SALARY	(6) BONUS	VIF	(7) TOTAL PAY	(8) SALARY	(9) BONUS	VIF
	Fixed effect	*Fixed effect*	*Tobit*		*Fixed effect*	*Fixed effect*	*Tobit*		*Fixed effect*	*Fixed effect*	*Tobit*	
PM	0.176*** (2.64)	0.220*** (3.18)	-1.059 (1.53)	1.51	0.045 (0.47)	0.120 (1.12)	-1.671* (1.77)	1.77	0.267*** (2.80)	0.260*** (2.99)	0.338 (0.34)	1.57
POWN	0.008** (2.02)	0.006 (1.36)	-0.023 (1.02)	1.65	-0.003 (0.42)	-0.005 (0.69)	-0.014 (0.42)	1.5	0.015*** (2.67)	0.011** (2.17)	0.017 (0.49)	2.24
FSIZE	0.333*** (5.14)	0.264*** (3.93)	1.434*** (4.70)	1.76	0.390*** (4.88)	0.247*** (2.72)	1.766*** (3.99)	1.23	0.283*** (2.48)	0.355*** (3.40)	0.717 (1.39)	3.58
LEV	0.002*** (3.10)	0.002*** (3.28)	0.016** (2.02)	1.18	0.003*** (3.88)	0.003*** (3.47)	0.016* (1.81)	1.06	-0.001 (0.32)	-0.001 (0.73)	0.042** (2.06)	1.92
FAGE	0.271*** (6.37)	0.293*** (6.64)	0.353 (1.08)	1.14	0.222*** (4.41)	0.286*** (4.99)	-0.012 (0.03)	1.23	0.410*** (5.11)	0.341*** (4.65)	1.482** (2.41)	1.18
ROA	0.010*** (4.31)	0.003 (1.14)	0.112*** (4.34)	1.04	0.013*** (3.75)	0.004 (1.11)	0.174*** (4.32)	1.14	0.006*** (2.02)	0.000 (0.13)	0.033 (1.02)	1.32
Constant	5.638*** (4.19)	6.804*** (4.87)	-22.905*** (3.57)		4.832*** (2.92)	7.454*** (3.96)	-28.995*** (3.09)		6.047*** (2.53)	4.487** (2.06)	-13.070 (1.24)	
Observations	819				467				352			
Adj. R2	.22	.24			.24	.19			.24	.23		
F-statistics	14.25***	13.05***			17.90***	12.88***			15.84***	14.86***		
Wald Chi2			27.17***				36.68***				21.31***	
Mean VIF				1.38				1.32				1.97
Hausman's Chi2	71.15***	68.26***			40.24***	32.56***			41.54***	48.44***		

All variables are defined in Table 5.2
***** p<0.01, ** p<0.05, * p<0.10**

5.5.4 Robustness Checks

In order to check how robust the findings are, further analyses is carried out. Although the results of correlation matrix and VIF test show that the models' variables are not affected by the multi-collinearity problem, these tests may have limitations in their accuracy. Thus, to ensure the findings are reliable, the research re-estimates the main regressions after eliminating any variable that has a likelihood of overlapping with another variable in the same model.

For the model that examines the relationship between corporate governance and executive compensation, there is potential for overlapping between chairman blockholder variable (**BLKCHR**) and director ownership (**DIROWN**). This because **BLKCHR** is a dummy variable that equals one if the chairman owns at least 5% of the company's outstanding shares, while at the same time, **DIROWN** is defined as the total shares held by board members including chairman. In this sense, if a chairman is a blockholder, then director ownership is likely to be high. However, there is also a possibility that director ownership is high although chairperson is not a blockholder. Therefore, the elimination of the problematic variable shows whether or not this variable affects the primary findings. Table 5.7 displays the regression results after excluding **BLKCHR**. As can be seen, the findings are qualitatively the same with a slight difference in the significance levels of few results.

With respect to the model of political connections and executive compensation, there is a potential overlap between the politically connected member (**PM**) and his/her ownership (**PMOWN**). This potential overlap is expected because if there is a politically connected member, the ownership variable (**PMOWN**) will be increased and vice versa. However, there is also a possibility that politically connected institutions or individuals are shareholders in the company, but are not members of the board of directors. After excluding the ownership of the politically connected member (**PMOWN**), Table 5.8 shows that the findings of the relationship between political connections and executive compensation are also qualitatively the same as the original analysis. Accordingly, it is clear from Table 5.7 and Table 5.8 that the findings are significantly robust and reliable even after eliminating the potential overlapping problems among the variables.

Table 5.7: Robustness Tests: Corporate Governance and Executive Compensation, excluding the Blockholder Chairman

	Full Sample			Family firms			Non-family firms		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	TOTAL PAY	SALARY	BONUS	TOTAL PAY	SALARY	BONUS	TOTAL PAY	SALARY	BONUS
	Fixed effect	*Fixed effect*	*Tobit*	*Fixed effect*	*Fixed effect*	*Tobit*	*Fixed effect*	*Fixed effect*	*Tobit*
FAMDIRs	0.005*	0.001	0.031	0.007**	0.001	0.094***			
	(1.84)	(0.43)	(1.48)	(2.10)	(0.17)	(3.13)			
BRDIND	0.004***	0.003**	0.022	0.005**	0.002	0.095***	0.005**	0.007***	-0.031
	(2.62)	(2.33)	(1.39)	(2.01)	(0.67)	(3.72)	(2.48)	(4.06)	(1.52)
DUAL	-0.078	-0.135**	-0.299	-0.020	-0.164	0.892	-0.133	-0.118	-1.185
	(1.25)	(2.06)	(0.42)	(0.23)	(1.63)	(0.91)	(1.48)	(1.46)	(1.22)
CHRMDs	-0.060	-0.079	0.453	-0.213***	-0.330***	1.133	0.087	0.156**	-0.704
	(1.10)	(1.40)	(0.77)	(2.67)	(3.64)	(1.27)	(1.12)	(2.25)	(0.86)
RCEXIST	0.115**	0.082	1.450**	0.029	0.031	0.808	0.140**	0.097	1.524**
	(2.39)	(1.63)	(2.40)	(0.40)	(0.37)	(0.84)	(2.11)	(1.63)	(2.13)
DIROWN	-0.004	-0.005*	0.035	-0.007**	-0.007**	0.025	0.009	0.005	0.389**
	(1.55)	(1.72)	(1.46)	(2.58)	(2.36)	(0.98)	(0.56)	(0.35)	(2.58)
PFOWN	0.037***	0.039***	0.118	0.037**	0.029	0.196**	0.022	0.021	0.156
	(3.48)	(3.45)	(1.85)	(2.24)	(1.57)	(2.01)	(1.47)	(1.57)	(1.70)
STATEOWN	0.002	-0.001	-0.050	-0.007	-0.010	-0.164**	0.009	0.005	0.002
	(0.37)	(0.29)	(1.87)	(1.13)	(1.32)	(2.18)	(1.28)	(0.74)	(0.06)
FSIZE	0.324***	0.262***	1.324***	0.321***	0.175	1.560***	0.386***	0.471***	0.544
	(4.97)	(3.86)	(4.45)	(3.94)	(1.89)	(3.50)	(3.35)	(4.56)	(1.12)
LEV	0.002***	0.002***	0.018**	0.003***	0.002***	0.017**	-0.001	-0.001	0.045**
	(3.21)	(3.25)	(2.30)	(3.65)	(3.00)	(2.00)	(0.59)	(0.86)	(2.30)
FAGE	0.219***	0.226***	0.334	0.226***	0.265***	0.307	0.276***	0.195**	1.599**
	(4.69)	(4.65)	(0.96)	(4.05)	(4.18)	(0.70)	(3.07)	(2.43)	(2.45)
ROA	0.011***	0.004*	0.099***	0.014***	0.005	0.170***	0.007**	0.001	0.027
	(4.96)	(1.86)	(3.87)	(3.99)	(1.22)	(4.23)	(2.42)	(0.48)	(0.88)
Constant	5.798***	6.973***	-24.934***	6.076***	9.297***	-35.563***	4.029*	2.092	-9.785
	(4.26)	(4.92)	(3.82)	(3.62)	(4.87)	(3.57)	(1.66)	(0.96)	(0.94)
Observations	819			467			352		
Adj. R2	.24	.20		.27	.22		.26	.28	
F-statistics	18.67***	14.86***		12.33***	9.32***		9.54***	10.33***	
Wald Chi2			68.09***			60.67***			42.18***

All variables are defined in Table 5.2

***** p<0.01, ** p<0.05, * p<0.10**

Table 5.8: Robustness Tests: Political Connections and Executive Compensation, excluding Ownership Variable

	Full Sample			Family firms			Non-family firms		
	(1) TOTAL PAY	**(2) SALARY**	**(3) BONUS**	**(4) TOTAL PAY**	**(5) SALARY**	**(6) BONUS**	**(7) TOTAL PAY**	**(8) SALARY**	**(9) BONUS**
	Fixed effect	***Fixed effect***	***Tobit***	***Fixed effect***	***Fixed effect***	***Tobit***	***Fixed effect***	***Fixed effect***	***Tobit***
PM	0.195***	0.234***	-1.234*	0.041***	0.114	-1.824**	0.305***	0.288***	0.371
	(2.96)	(3.41)	(1.83)	(0.43)	(1.06)	(2.09)	(3.20)	(3.32)	(0.37)
FSIZE	0.342***	0.270***	1.302***	0.389***	0.246***	1.742***	0.328***	0.389***	0.867**
	(5.27)	(4.02)	(4.70)	(4.87)	(2.71)	(3.98)	(2.87)	(3.74)	(2.11)
LEV	0.002***	0.002***	0.016**	0.003***	0.003***	0.016*	-0.001	-0.002	0.040**
	(3.08)	(3.27)	(2.03)	(3.87)	(3.45)	(1.80)	(0.73)	(1.07)	(2.00)
FAGE	0.270***	0.292***	0.355	0.222***	0.284***	-0.009	0.393***	0.328***	1.474**
	(6.33)	(6.62)	(1.09)	(4.41)	(4.97)	(0.02)	(4.86)	(4.47)	(2.41)
ROA	0.009***	0.002	0.113***	0.013***	0.004	0.177***	0.005*	0.000	0.034
	(4.16)	(1.03)	(4.36)	(3.79)	(1.16)	(4.44)	(1.76)	(0.07)	(1.04)
Constant	5.567***	6.754***	-20.266***	4.825***	7.443***	-28.552***	5.404**	4.008*	-15.941*
	(4.13)	(4.83)	(3.44)	(2.92)	(3.96)	(3.07)	(2.25)	(1.84)	(1.82)
Observations	819			467			352		
Adj. R2	.22	.18		.24	.18		.22	.22	
F-statistics	38.62***	165.85***		24.99***	17.96***		17.24***	16.68***	
Wald Chi2			45.25***			36.54***			21.21***

All variables are defined in Table 5.2
***** p<0.01, ** p<0.05, * p<0.10**

5.5.5 Sensitivity Tests

As discussed in the method section, the results of the Hausman test suggest that the fixed effect regression is the most appropriate approach by which to examine the models with dependent variables namely **TOTAL PAY** and **SALARY**. In contrast, **BONUS** is tested using the Tobit regression since the data are censored with many zeros that exceed 30% of the total observations. However, in order to check the findings' sensitivity to alternative estimation techniques, random effect regression (GLS) and pooled OLS regression are employed in this section.

5.5.5.1 Random effect regression

Using the random effect regression, Table 5.9 and Table 5.11 present the findings of the models related to corporate governance and executive compensation and political connections and executive compensation. Generally, the R-squares are virtually similar to those of the primary analysis, except for the model of **SALARY** which shows a significant increase in the random effect approach. In general, the directions of the relationships are similar and the outcomes are consistent across all models, with some differences in the significance levels. For example, according to the fixed effect regression, **FAMDIRs** and **BRDIND** are positively and significantly associated with **SALARY** in family firms. Furthermore, **PFOWN** has a positive and significant impact on **TOTAL PAY** and **SALARY** in the full sample and in family firms. However, Table 5.9 shows that these relationships are found to be non-significant under the random effect model. A similar scenario occurs with the model of political connections and executive compensation (see Table 5.10). While the fixed effect approach reveals that political connections have positive and significant association with **TOTAL PAY** in the full sample, the results of the random effect estimate show no significant relationship between the two variables. Although there are a few changes between the results of the two tests, especially in the significance levels, the two regressions in general demonstrate that the findings of fixed effect regression are consistent, reliable, and not sensitive to random effect estimation for all models.

5.5.5.2 Pooled OLS regression with robust standard error

As discussed in the descriptive statistics section, due to the nature of the study's data, the assumptions of parametric testing are not met, especially in relation to the

requirement that data is normally distributed. Therefore, after adopting different diagnostic checks, the results reveal that the fixed effect approach is the most relevant technique by which to estimate the empirical models. Although both approaches, the fixed effect and random effect, have delivered roughly similar results, the study employs OLS regression with robust standard error for the pooled data for further checks. In general, Table 5.11 and Table 5.12 show that the findings of the primary regression are sensitive to the OLS estimation. For example, while the fixed effect regression demonstrates positive and significant relationships between **BRDIND** and **LEV** on one hand, and the dependant variables namely **TOTAL PAY** and **SALARY** on the other, the OLS findings show negative and significant associations. **PM** and **POWN** variables in political connections' models also suffer from similar contradictory results (see Table 5.12). In summary, the fixed effect regression shows a number of positive and significant effects on managerial pay, whereas, the OLS delivers opposite findings.

The divergence between the findings of the two regressions may be attributed to the OLS regression not capturing the variation of time in the study's observations (Habbash, 2010) and OLS treats the different observations as one unit without distinguishing between the different groups of data as does the panel data (Iskander, 2008). Furthermore, since the OLS assumptions are not met, the test may generate misleading and unreliable results (Baltagi, 2008; Greene, 2008). It can be concluded that even if the pooled OLS regression provides inconsistent results with those of the main regression, the findings of the main regression are still reliable and consistent with the random effect regression approach which properly deals with panel data. As mentioned previously, the OLS regression is conditioned by the meeting of a number of conditions; therefore, it is inappropriate to rely on its results and it cannot be utilised to assess the findings of the main regression.

Table 5.9: The Sensitivity Tests (GLS): Corporate Governance and Executive Compensation in Family and Non-Family Firms

	Full Sample			Family firms			Non-family firms		
	(1) TOTAL	(2) SALARY	(3) BONUS	(4) TOTAL	(5) SALARY	(6) BONUS	(7) TOTAL	(8) SALARY	(9) BONUS
	Random effect			*Random effect*			*Random effect*		
FAMDIRs	0.003	0.000	0.003*	0.001	-0.004	0.079***			
	(1.52)	(0.14)	(1.68)	(0.51)	(1.35)	(3.28)			
BRDIND	0.003***	0.003***	0.016	0.003	0.000	0.069***	0.004**	0.005***	-0.019
	(2.58)	(2.51)	(1.20)	(1.20)	(0.21)	(3.36)	(2.15)	(3.43)	(1.28)
DUAL	-0.137**	-0.191***	-0.167	-0.107	-0.248***	0.615	-0.178**	-0.161**	-0.896
	(2.30)	(3.18)	(0.44)	(1.26)	(2.74)	(0.79)	(2.07)	(2.08)	(1.19)
BLKCHR	0.106	0.227***	-0.733	0.183**	0.307***	-1.152	-0.041	0.081	0.427
	(1.51)	(3.28)	(1.01)	(2.04)	(3.17)	(1.36)	(0.35)	(0.82)	(0.44)
CHRMDs	-0.031	-0.033	0.319	-0.130*	-0.193**	1.961	0.070	0.117	-0.473
	(0.61)	(0.66)	(0.79)	(1.70)	(2.35)	(1.33)	(0.98)	(1.86)	(0.77)
RCEXIST	0.181***	0.150***	1.187***	0.073	0.064	0.981	0.229***	0.190***	1.090**
	(3.76)	(3.02)	(2.46)	(0.95)	(0.76)	(1.23)	(3.66)	(3.34)	(1.98)
DIROWN	-0.003	-0.005**	0.030	-0.005**	-0.007***	0.024	0.007	-0.005	0.279**
	(1.11)	(2.29)	(1.58)	(2.07)	(2.89)	(1.17)	(0.48)	(0.36)	(2.28)
PFOWN	0.008	0.006	0.089*	0.013	0.010	0.131	-0.003	-0.007	0.128*
	(1.23)	(0.95)	(1.67)	(1.17)	(0.96)	(1.63)	(0.34)	(0.99)	(1.85)
STATEOWN	-0.007**	-0.006**	-0.040*	-0.005	-0.005	-0.112**	-0.006*	-0.004	-0.007
	(2.40)	(2.15)	(1.81)	(0.89)	(0.75)	(2.21)	(1.88)	(1.47)	(0.27)
FSIZE	0.352***	0.275***	1.167***	0.428***	0.330***	1.324***	0.373***	0.304***	0.629*
	(11.04)	(9.44)	(4.53)	(8.56)	(6.81)	(3.78)	(8.67)	(8.34)	(1.75)
LEV	0.002***	0.002***	0.015**	0.003***	0.003***	0.015**	-0.002	-0.003	0.032**
	(3.54)	(3.41)	(2.31)	(4.58)	(4.13)	(2.10)	(1.39)	(1.85)	(2.13)
FAGE	0.108***	0.088***	0.286	0.071*	0.048	0.225	0.160***	0.104**	1.337***
	(3.25)	(2.75)	(0.96)	(1.68)	(1.11)	(0.66)	(2.74)	(2.07)	(2.71)
ROA	0.011***	0.005**	0.081***	0.014***	0.006	0.142***	0.008***	0.003	0.022
	(5.31)	(2.27)	(3.83)	(4.21)	(1.52)	(4.31)	(2.83)	(1.14)	(0.91)
Constant	5.500***	6.969***	-19.388***	4.150***	6.287***	-26.882***	5.029***	6.303***	-9.788
	(8.07)	(11.12)	(3.86)	(3.87)	(5.97)	(3.45)	(5.52)	(8.14)	(1.28)
Observations	819			467			352		
Adj. R2	.37	.31	.20	.27	.25	.16	.56	.50	.25
Wald Chi2	271.35***	212.90***	78.58***	155.92***	124.64***	67.60***	164.36***	148.04***	48.38***

All variables are defined in Table 5.2

***** p<0.01, ** p<0.05, * p<0.10**

Table 5.10: The Sensitivity Tests (OLS): Corporate Governance and Executive Compensation in Family and Non-Family Firms

	Full Sample			Family firms			Non-family firms		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
	TOTAL PAY	SALARY	BONUS	TOTAL PAY	SALARY	BONUS	TOTAL PAY	SALARY	BONUS
	OLS			*OLS*			*OLS*		
FAMDIRs	-0.003**	-0.003**	0.008*	-0.008***	-0.006***	0.030***			
	(2.29)	(1.97)	(0.71)	(3.84)	(3.14)	(3.28)			
BRDIND	-0.002	-0.001	0.008	-0.006***	-0.004**	0.041***	-0.000	0.000	-0.015
	(1.51)	(1.03)	(0.76)	(2.71)	(1.99)	(3.36)	(0.10)	(0.06)	(1.28)
DUAL	-0.201***	-0.232***	-0528	-0.282***	-0.309***	0.032	-0.149*	-0.169**	-1.985 **
	(3.37)	(4.29)	(1.14)	(3.49)	(4.08)	(0.79)	(1.63)	(2.16)	(1.19)
BLKCHR	-0.014	0.102**	0.409	0.088	0.142	1.661	-0.072	0.085	-0.073
	(0.25)	(2.04)	(0.95)	(0.94)	(1.62)	(1.36)	(1.10)	(1.54)	(0.44)
CHRMDs	-0.051	0.002	0.210	-0.079	-0.044	0.742	-0.036***	-0.005	0.758
	(1.07)	(0.05)	(0.57)	(1.00)	(0.60)	(1.33)	(0.57)	(0.10)	(0.77)
RCEXIST	0.318***	0.239***	1.947***	0.371***	0.273**	1.025	0.282	0.210***	2.185***
	(4.08)	(3.38)	(3.22)	(2.90)	(2.28)	(1.23)	(3.19)	(2.78)	(1.98)
DIROWN	0.003*	-0.002*	0.033***	0.001	-0.004**	0.037	-0.006***	-0.018*	0.064
	(1.74)	(1.69)	(2.63)	(0.43)	(2.34)	(1.17)	(0.54)	(1.77)	(2.28)
PFOWN	-0.011***	-0.009**	0.095***	-0.010	-0.002	0.194	-0.018***	-0.017***	0.054
	(2.66)	(2.47)	(3.09)	(1.32)	(0.36)	(1.63)	(3.94)	(4.51)	(1.85)
STATEOWN	-0.008**	-0.004***	-0.038***	0.005	0.006	-0.080**	-0.011***	-0.005***	-0.051***
	(5.25)	(2.90)	(3.26)	(1.17)	(1.36)	(2.21)	(6.14)	(3.36)	(0.27)
FSIZE	0.319***	0.240***	1.006***	0.338***	0.279***	0.855***	0.413***	0.290***	1.387 ***
	(18.09)	(15.05)	(7.36)	(12.17)	(10.74)	(3.78)	(16.31)	(13.42)	(1.75)
LEV	0.003***	0.001	0.016**	0.005***	0.003***	0.023**	-0.005	-0.005***	-0.015
	(3.30)	(1.60)	(2.39)	(5.19)	(3.57)	(2.10)	(3.15)	(3.44)	(2.13)
FAGE	-0.057**	-0.059**	0.030	-0.157***	-0.137***	-0.266	0.056***	0.003	1.126***
	(2.37)	(2.69)	(0.16)	(4.84)	(4.52)	(0.66)	(1.46)	(0.08)	(2.71)
ROA	0.021***	0.010***	0.139***	0.022***	0.009**	0.147***	0.017***	0.010***	0.089***
	(8.35)	(4.51)	(7.31)	(5.61)	(2.48)	(4.31)	(5.57)	(3.89)	(0.91)
Constant	6.887***	8.342***	-16.431***	6.872***	7.853***	-16.001***	4.852***	7.308***	-24.740***
	(17.02)	(22.82)	(5.25)	(10.47)	(12.76)	(3.45)	(8.80)	(15.51)	(1.28)
Observations	819			467			352		
Adj. R2	.46	.37	.21	.43	.57	.20	.60	.54	.30
F-statistics	53.96***	38.38***	18.19***	27.57***	19.06***	9.81***	44.02***	35.46***	13.65***

All variables are defined in Table 5.2

***** p<0.01, ** p<0.05, * p<0.10**

Table 5.11: The Sensitivity Tests (GLS): Political Connections and Executive Compensation in Family and Non-Family Firms

	Full Sample			Family firms			Non-family firms		
	(1) TOTAL PAY	(2) SALARY	(3) BONUS	(4) TOTAL PAY	(5) SALARY	(6) BONUS	(7) TOTAL PAY	(8) SALARY	(9) BONUS
	Random effect			*Random effect*			*Random effect*		
PM	0.080	0.110*	-0.857	-0.092	-0.008	-1.471	0.266***	0.237***	0.374
	(1.30)	(1.78)	(1.57)	(1.08)	(0.09)	(1.94)	(2.98)	(2.93)	(0.48)
POWN	-0.002	-0.003	-0.019	0.001	-0.001	-0.005*	-0.004	0.002	0.003
	(0.95)	(1.19)	(1.14)	(0.31)	(0.38)	(0.19)	(1.44)	(0.87)	(0.11)
FSIZE	0.337***	0.268***	1.212***	0.447***	0.353***	1.469***	0.321***	0.251***	0.788**
	(10.48)	(9.25)	(5.23)	(9.01)	(7.16)	(4.23)	(7.49)	(6.82)	(2.14)
LEV	0.002***	0.002***	0.013**	0.003***	0.003***	0.014*	-0.002	-0.002	-0.030*
	(3.47)	(3.48)	(2.11)	(4.65)	(4.33)	(1.90)	(0.97)	(1.33)	(1.92)
FAGE	0.149***	0.133***	0.292	0.104***	0.116***	-0.000	0.224***	0.158***	1.246***
	(4.87)	(4.53)	(1.17)	(2.77)	(2.96)	(0.00)	(4.19)	(3.37)	(2.69)
ROA	0.011***	0.004*	0.094***	0.014***	0.005	0.151***	0.007**	0.002	0.029
	(5.03)	(1.82)	(4.72)	(4.26)	(1.41)	(4.63)	(2.41)	(0.71)	(1.18)
Constant	6.077***	7.314***	-17.301***	3.909***	5.608***	-22.094***	6.168***	7.596***	12.514
	(9.05)	(12.04)	(3.54)	(3.77)	(5.43)	(3.01)	(6.98)	(10.01)	(1.65)
Observations	819			467			352		
Adj. R2	.32	.27	.17	.29	.21	.16	.52	.45	.19
Wald Chi2	223.41***	165.85***	56.28***	140.28***	91.37***	41.63***	142.22***	116.11***	27.83***

All variables are defined in Table 5.2

***** p<0.01, ** p<0.05, * p<0.10**

Table 5.12: The Sensitivity Tests (OLS): Political Connections and Executive Compensation in Family and Non-Family Firms

	Full Sample			Family firms			Non-family firms		
	(1) TOTAL PAY	(2) SALARY	(3) BONUS	(4) TOTAL PAY	(5) SALARY	(6) BONUS	(7) TOTAL PAY	(8) SALARY	(9) BONUS
	OLS			*OLS*			*OLS*		
PM	-0.100*	-0.016	-0.850**	-0.313***	-0.078	-1.620***	0.006	-0.031	0.705
	(1.86)	(1.78)	(2.06)	(4.13)	(1.08)	(2.83)	(0.07)	(0.44)	(1.00)
POWN	-0.002	-0.001	-0.018*	0.009***	0.002	0.010	-0.011***	-0.004***	-0.047***
	(1.57)	(1.19)	(1.91)	(4.48)	(1.24)	(0.64)	(6.64)	(3.09)	(3.44)
FSIZE	0.304***	0.235***	1.158***	0.382***	0.300***	1.213***	0.403***	0.285***	1.561***
	(17.46)	(9.25)	(8.72)	(13.80)	(11.26)	(5.79)	(15.77)	(12.82)	(7.04)
LEV	0.003***	0.001*	0.015**	0.005***	0.004***	0.024***	-0.006***	-0.005***	-0.021
	(3.23)	(3.48)	(2.15)	(5.27)	(3.60)	(3.05)	(3.34)	(3.53)	(1.38)
FAGE	-0.076***	-0.066***	-0.099	-0.095***	-0.078***	-0.375*	0.048	-0.025	0.890***
	(3.32)	(4.53)	(0.57)	(3.20)	(2.74)	(1.67)	(1.33)	(0.82)	(2.87)
ROA	0.019***	0.008***	0.164***	0.024***	0.008**	0.173***	0.015***	0.007	0.121***
	(7.95)	(3.91)	(9.18)	(6.44)	(2.27)	(6.09)	(4.88)	(2.79)	(4.64)
Constant	7.363***	8.570***	-15.757***	5.636***	7.160***	-16.452***	5.248***	7.668***	-26.440***
	(19.98)	(25.99)	(5.61)	(9.43)	(12.47)	(3.64)	(10.30)	(17.34)	(5.98)
Observations	819			467			352		
Adj. R2	.42	.34	.18	.41	.28	.17	.58	.50	.26
F-statistics	98.47***	71.52***	31.48***	55.62***	31.94***	16.35***	80.71***	60.56***	21.73***

All variables are defined in Table 5.2
***** p<0.01, ** p<0.05, * p<0.10**

5.6 CONCLUSION

This research uses a unique set of data from family and non-family firms operating in Saudi Arabia between 2008 and 2015. This allows the investigation of the behavioural differences between family and non-family firms towards executive compensation. Specifically, it shows how corporate governance practices and the need for political connections vary between these two types of firms and their implications for the practice of executive compensation. The research contributes significantly to the literature on family business in several ways. First, it extends the understanding of the behaviours of family firms, illustrating the challenges and conflicts of interests among shareholders. Second, it provides evidence that the practices of corporate governance and the need for political connections differ between family-controlled firms and non-family firms. Third, as the majority of corporate governance literature focuses on managerial opportunism and its consequences on the agency problem (Type I), this research sheds light on how controlling shareholders and politically connected members also exacerbate agency conflict (Type II). Finally, previous studies of political connections prove that political connectedness benefits organisation; however, this research extends the understanding of this phenomenon and shows that political connections are not always advantageous.

The study findings in general demonstrate that implementing corporate governance based on the traditional agency model does not resolve agency problems in Saudi Arabia. For example, agency theory suggests that the presence of large shareholders will reduce the separation between ownership and control and thereby reduce agency costs (Fama and Jensen, 1983b). However, the study finds that the presence of family members on the board of directors, in fact, increases agency costs through granting higher managerial remuneration. Large shareholders are also found to chair most companies' boards indicating significant direct involvement in monitoring management. This denotes that the separation between ownership and control is low in Saudi Arabia in contrast to the West. Furthermore, appointing independent directors, which is a key recommendation in global best practice of corporate governance, is also found to increase executive compensation in family and non-family firms in the KSA. These outcomes indicate the significant presence of principal-principal conflict in Saudi Arabia. The principal-principal problem results from the high concentration of

ownership in hands of certain bodies (families and government agencies) and the absence of effective formal institutions (Young *et al.*, 2008).

Indeed, adopting governance mechanisms developed in the West with no consideration to the cross-cultural and institutional differences will lead to unfavourable consequences. For instance, business policy in Saudi Arabia is significantly influenced by *wasta* (Tlaiss and Kauser, 2011). *Wasta* is a key cultural characteristic of the Arab world and is widely used in the employment process, in business and government contracts, and in general daily transactions (Tlaiss and Kauser, 2011; Budhwar and Debrah, 2013). Therefore, there is a high likelihood of appointing unqualified managers, especially in family-controlled firms. As a result, the firm may perform poorly and incur higher agency costs at the expense of minority shareholders. *Wasta* is also practised through political connections as it provides many benefits for the organisation including government subsidies, contracts and protection from regulatory sanctions (Goldman *et al.*, 2009; Faccio, 2010; Wang, 2015; Sun *et al.*, 2016). Even though Saudi Arabia's National Anti-Corruption Commission considers the use of *wasta* to be a form of corruption (National Anti-Corruption Commission, 2016), the scope of the Commission's authority is limited to government bodies. The Ministry of Commerce and Investment (MCI) and the CMA, which supervise publicly traded firms, do not explicitly criminalise *wasta* practices within and across organisations. Accordingly, without considering these domestic cultural and institutional challenges, corporate governance regulations will not be effective in protecting shareholders' rights especially those of small investors.

Surprisingly, the study also finds that executive compensation practices in family and non-family firms are different in form but not in substance. Given that non-family firms are observed to grant higher bonus packages to their managers than their counterparts in family firms, the total compensation in family and non-family firms have shown similar upward trends from 2008 to 2015. This implies that non-family firms confirm their legitimacy by using such signalling tools to reassure shareholders that managers are paid according to their performance. However, this is not totally accurate since the results reveal that in some years, such as 2009 and 2011 (see Figure 5.2), firm performance was poor while the total compensation continued in an upward direction. To put differently, both family and non-family firms grant their managers similar levels

of total compensation; however, executive compensation in non-family firms is mostly consisted of bonus component, though there is less link to firm performance.

Practically, the research has significant implications that can assist firms and regulators to enhance governance quality and executive compensation arrangements. First, the findings show that board characteristics are key determinants of executive compensation both in family and non-family firms. Therefore, it is important to develop mechanisms and regulations that enhance the authority and independence of board of directors. Second, the role of independent directors is found to be ineffective in reducing managerial pay levels. This finding makes the independence of board of directors questionable and provides an opportunity for regulators to revise criteria and process of appointing outsider directors. Third, even if family and non-family firms show high compliance with the current regulations of corporate governance, executive compensation has followed upward trend, even in years of poor performance. This finding indicates to regulators and firms that governance regulations are not practised as intended. Fourth, the study illustrates how political connections are inextricably involved in business policy and exist in the majority of listed firms. Indeed, the informal requirement of building political connections in order to obtain competitive privileges, allied to weak governance practices will not attract investors, especially foreign investment. Finally, the findings demonstrate that executive compensation is paid with no consideration to firm performance in both family and non-family firms. This finding should encourage regulators and firms to design and develop optimal means that ensure a strong link between managerial pay and firm performance.

CHAPTER SIX:

CONCLUSION

This chapter is the final part of the thesis and highlights the conclusions of the three studies. After restating the research problem and questions, the chapter provides a summary of the findings of each of the empirical studies and draws the final conclusions. Furthermore, it shows the implications of the studies and how they benefit interested parties such as companies, regulators and practitioners. Finally, the potential limitations of the research are acknowledged and thoughts for future research are recommended.

Executive compensation is one of the most controversial topics in the literature related to corporate governance (Conyon, 2014; Jensen *et al.*, 2004). Although executive compensation is treated as a solution for the divergence of interests between shareholders and managers, it can be a problematic if abused (Méndez *et al.*, 2011). Studies conducted in the West find that the adoption of effective corporate governance mechanisms controls managerial opportunism and produces well-structured executive compensation (Core *et al.*, 1999; Fama and Jensen, 1983b). However, the success of such mechanisms is conditioned by the effectiveness of other formal institutions (Young *et al.*, 2008). Despite the implementation of such regulations in less developed economies, such as the KSA, which lack effective formal institutions and therefore may lead to adverse results, the majority of emerging economies including Saudi Arabia have imported and adopted the Anglo-American model of corporate governance (Fallatah and Dickins, 2012).

The development of corporate governance in Saudi Arabia is still immature since it only started to be developed in late 2006. Therefore, this has enabled the thesis to investigate the effectiveness of the recommendations of international best practice of corporate governance from the first stage of enforcement, when only few firms complied, to full compliance at present. Furthermore, Saudi Arabia is assessed as being 75% collectivist and having a power distance of 95% (The Hofstede Centre, 2014). In addition, government investment in the Saudi market is significantly influential. These domestic norms of the Saudi context have led to the emergence of the phenomenon of political connections and make this a key influence in terms of business policy. Furthermore, the collectivist-oriented context results in *wasta* (i.e. interpersonal relationships) playing a significant role in business policy in general and in human resource practices in particular (Tlaiss and Kauser, 2011; Budhwar and Debrah, 2013). This leads to family considerations outweighing qualification criteria when appointing top executives.

Therefore, in order to investigate to which extent these characteristics may influence the decisions in relation to executive compensation, three empirical studies have been conducted. The studies are integrative and collectively analyse the effects of both formal and informal institutions on executive compensation practices. More specifically, four related dimensions over executive compensation arrangements are examined: effectiveness of board of directors; ownership structure; phenomenon of political connections; and family control. Methodologically, the studies adopt panel data analysis through employing fixed effect and Tobit model techniques in order to analyse a sample of 114 non-financial firms that operated between 2008 and 2015 in the Saudi Stock Exchange.The first empirical study (Chapter Three) investigates the relationship between corporate governance and executive compensation. More specifically, it analyses the effect of two dimensions of corporate governance: board of directors and ownership structure. The study addresses the two questions: *a) Do corporate governance mechanisms restrain the opportunism of top managers in Saudi Arabia by reining in their compensation?* and *b) Is the Anglo-American model of corporate governance generalizable in emerging countries?*

With respect to the board of directors, the study finds that when the board is chaired by a blockholder, top executives are more likely to receive more generous compensation. This finding invalidates the assumption of the agency model that the participation of large shareholders in the monitoring function reduces managerial expropriation (Fama and Jensen, 1983b). The outcome can be attributed to large shareholders' connivance because the employment culture in Saudi Arabia is influenced by nepotism and cronyism (Budhwar and Debrah, 2013). In other words, those generously paid managers are likely to be relatives or friends of blockholder chairmen. Furthermore, board independence and the remuneration committee, which are key elements in international corporate governance (Ntim *et al.*, 2015; Méndez *et al.*, 2011; Fama and Jensen, 1983b), are found to be ineffective in controlling managerial incentives. Indeed, they are found to boost executive compensation. This implies that corporate governance regulations in the KSA are followed in form but not in substance for regulatory and legitimating purposes. In contrast, the impact of CEO/Chairman role duality is low and negligible in Saudi Arabia and has no significant influence on managerial incentives. This is because Saudi corporate governance regulations prohibit the combination of the positions of CEO and board chairman in a single individual.

In terms of ownership structure and its influence on decisions related to executive pay, the findings show that board directors are key shareholders in the Saudi market. However, their ownership only has a partial impact on managerial pay. Although their equity holdings show no relationship with total executive compensation, it significantly reduces fixed compensation and expands the use of bonus packages. This indicates that when members of board of directors hold stakes in the company, they become more incentivised to protect their own investment; therefore, they perform their supervisory roles more stringently. Furthermore, pension fund investment, which is akin to institutional investment and is believed to promote governance quality (Colpan and Yoshikawa, 2012; Ozkan, 2007), is surprisingly found to escalate the pecuniary rewards of top management. A potential cause of the ineffective role played by pension funds in the KSA is that these institutions are semi-government. Their representatives on the companies' boards are government officials who find difficulty in distinguishing between their functions as shareholders' representatives and their administrative tasks (Conyon and He, 2012).

This interpretation is supported by the additional finding that state ownership is not related to executive pay-setting. This result, despite the state being a dominant investor in the SSE, demonstrates that state equity in general has no significant relationship with the levels of executive remuneration. This poor supervisory role of the state might be a consequence of the divergent objectives between state and regular shareholders (Ramaswamy *et al.*, 2000; Olson, 1973). This is because state investment can have non-profit aims, such as stabilising the stock market and controlling certain sensitive operational sectors for security purposes (Olson, 1973). Therefore, state investors do not always seek to maximise their income; hence, their efforts may not focus on improving firm performance or controlling the opportunistic actions of top management with regards to their remuneration packages (Olson, 1973).

Accordingly, the first empirical research provides evidence that Saudi companies comply with regulatory requirements of corporate governance but with no real conviction. This situation supports the institutions-based view which argues that the adoption of the Western governance model in emerging economies, where formal institutions are weak, leads to an adherence to governance requirements in form rather than in substance (Young *et al.*, 2008). However, certain informal institutional

arrangements such as *wasta* play a more significant role than individual merit in the design of executive compensation. That is to say, the board of directors, which is controlled by blockholders, rather than the remuneration committee, retains the right to reward top managers, who are usually appointed on the basis of nepotism and cronyism (Budhwar and Debrah, 2013). This situation leads to the emergence of principal-principal conflict, which results in minority shareholders' equity being threatened with expropriation. Consequently, it is evident that the Anglo-American model of corporate governance lacks generalizability in emerging economies such as Saudi Arabia and must be contextualised in a way that considers and captures the domestic cultural and institutional settings; otherwise, it will not function as intended.

Based on this finding, the second empirical study (Chapter Four) goes beyond the formal institutions and investigates other informal institutions to complement the findings and complete the picture on executive pay-settings. This study considers the consequences of having political connections, which is a vital source of *wasta*, on the practices of managerial compensation. Chapter four addresses the following question: *Do political connections enhance governance quality through controlling executive compensation?* Using the same sample, the study finds that the phenomenon of political connections is prevalent in Saudi Arabia and most firms are politically connected. This evidence supports the conclusion of Faccio (2010) that political ties are significant in emerging economies. The results also show that if firms do not have a direct relationship with the state, they tend to build connections through inviting members of the royal family or *Shura* Council to serve on their boards of directors. Therefore, it is clear that board political capital is a pillar of business policy in Saudi Arabia. This supports the view of institutional theory, which argues that political relationships act as a substitute for the absence of effective formal institutions to protect the interests of related parties and ensure the smooth running of business (Faccio, 2010; Young *et al.*, 2008).

Although studies find that political relationships assist enterprises to access vital resources (Civilize *et al.*, 2015; Goldman *et al.*, 2009; Pfeffer and Salancik, 1978), this study finds evidence that they could also be costly. That is to say, politically connected firms facilitate higher executive compensation. Since the Saudi market is significantly dominated by family companies, the process of designating top managers is influenced by nepotism and cronyism (Budhwar and Debrah, 2013). Indeed, the appointment of

unqualified-managers in leading positions is likely to increase agency costs resulting from weak firm performance. Furthermore, political connections can be utilised to provide regulatory protection for blockholders, if the latter abuse their power. However, the outcome is subject to the type of political connection. This is because after re-classifying affiliated directors into three categories based on connection type—royal family member, *Shura* Council member and state representative—the findings show that only state representatives are found to boost executive pay. In contrast, royal family and *Shura* Council affiliated directors show no significant association with decisions related to managerial incentives. This evidence demonstrates that none of political connections sources is effective in enhancing governance quality, in particular the ones related to executive pay-setting.

However, these results should not be interpreted as a conspiracy between dominant shareholders or top managers and politically connected directors against small investors (Sun *et al.*, 2016). To illustrate this point, the results do not necessarily mean that these connected members explicitly approve the expropriation of minority shareholders by rewarding top related-managers with high non-merited compensation. However, their political power might be exploited by dominant shareholders or senior executives to achieve private benefits, such as extracting high non-merited compensation for the executive team, who often are family-affiliated, without concern for any legal liability.

Since Saudi Arabia is a family-firm-dominated economy, it is essential to understand the role and impact of family involvement in decisions making and the consequences on executive compensation. The dataset allows an analysis of the differences between family-controlled firms and their non-family counterparts in terms of corporate governance attitudes and the need for political connections and their implications on executive pay arrangements. Thus, Chapter Five investigates the roles of corporate governance and political connections in designing managerial incentives, but with a focus on the role of family and the principal-principal conflict. The third empirical study addresses the following questions: a) *Do the structure of corporate governance and the need for political connections differ in family and non-family firms?* and *b) What are the implications of this variation for executive compensation practices in family and non-family firms?*

Confirming the conclusions of the first empirical study, the findings of the third study demonstrate overall that the traditional agency model does not resolve agency problems in Saudi Arabia in either family-controlled firms or their non-family counterparts. For example, agency theory suggests that the presence of shareholders in management reduces the gap between ownership and control and thereby lowers agency costs (Fama and Jensen, 1983b). However, the study finds that the presence of family members, in fact, increases agency costs through granting higher managerial remuneration. Large shareholders are also found to chair most companies' boards indicating a significant direct involvement in monitoring management. This highlights that the separation between ownership and control is low in Saudi Arabia in contrast to the West. Furthermore, appointing independent directors, which is a key recommendation in the global best practice of corporate governance, is also found to increase executive compensation in family and non-family firms. These outcomes indicate the significant presence of principal-principal conflict in Saudi Arabia. Principal-principal conflict results from the high concentration of ownership in hands of certain bodies, families and government agencies and the absence of effective formal institutions (Young *et al.*, 2008).

Indeed, adopting governance mechanisms developed in the West with no consideration for the cross-cultural and institutional differences leads to unfavourable consequences (Young *et al.*, 2008). For instance, business policy in Saudi Arabia is significantly influenced by personal connections (Tlaiss and Kauser, 2011). *Wasta* is a key cultural characteristic of the Arab world and is widely used in the employment process, in the awarding of business and government contracts and in normal daily transactions (Tlaiss and Kauser, 2011; Budhwar and Debrah, 2013). Therefore, in the KSA, there is a strong likelihood of appointing unqualified managers, especially in family-controlled firms. As a result, the firm may perform poorly and incur higher agency costs at the expense of minority shareholders. *Wasta* is also practised through political connections as it provides many benefits for the organisation including government subsidies, contracts and protection from regulatory sanctions (Goldman *et al.*, 2009; Faccio, 2010; Wang, 2015; Sun *et al.*, 2016). Although the Saudi National Anti-Corruption Commission (NACC) considers *wasta* to be a form of corruption (NACC, 2016), the scope of the Commission's authority is limited to government bodies. In contrast, MCI and CMA, which supervise publicly traded firms, do not explicitly criminalise *wasta* practices within and

across organisations. Accordingly, without considering these domestic cultural and institutional challenges, corporate governance regulations will not be effective in protecting shareholders' rights, especially small investors.

Surprisingly, the study also finds that executive compensation practices in family and non-family firms are different in form but not in substance. Although non-family firms grant higher bonus packages to their managers than do their counterparts in family firms, the total compensation in family and non-family firms show a similar upward trend during the years 2008-2015. This implies that non-family firms confirm their legitimacy by using such signalling tools to reassure shareholders that managers are paid according to their performance. However, this is not totally accurate since the results reveal that in 2009 and 2011 (see Figure 5.2) firm performance was weak but total compensation continued to increase.

Overall, several conclusions can be drawn from the thesis findings. In terms of corporate governance regulations, the current situation in Saudi Arabia indicates that there is lack of effectiveness in practice. This can be attributed to the fact that the governance regulations have not taken into account the influence of the domestic institutional settings of Saudi Arabia, such as *sharia*, political economy and the strong use of *wasta* in the business field. In other words, the current practices imply that corporate governance regulations in the KSA are followed in form but not in substance for regulatory and legitimating purposes. As long as the corporate governance regulations do not recognise the domestic challenges and explicitly acknowledge the conflict of interest among the three most influenced parties (top management, controlling shareholders and minority investors) within the regulations, they will not function as intended. Adopting the Anglo-American model of corporate governance which has been developed according to a specific institutional background (e.g. a strong and effective legal system) will not necessarily lead to the same success when adopted elsewhere while the fundamental institutions are absent.

It is obvious that Saudi Arabia is attempting to follow the best practice of other developed economies; however, the divergence of the institutional characteristics between the Saudi context and the other Anglo-American counterparts will not lead to the desired destination, i.e. homogeneous regulations. For instance, how would the CMA require firms to link executive compensation with long-term firm performance, while the

stock options, which are the main instrument of the long-term link, are not allowed under the Saudi *sharia*-based regulations? The regulations should acknowledge that the available methods of paying top management are restricted to fixed and short-term compensation. Therefore, instead of adopting full regulations that developed in other contexts, the regulators should create new techniques that fit with *sharia* principles and local laws, in order to provide proper executive compensation recommendations that can be linked to long-term performance.

Another dimensional point is that the political economy of Saudi Arabia is significantly different from the West. That is to say, while the economy in the West is market-oriented, it is network-oriented in Saudi Arabia with high involvement of state investments. This, indeed, leads to the emergence of the phenomenon of political connections. The presence of politically connected members in companies' boards is significantly prevalent since the majority of firms have board political capital. Even though such directors can bring vital benefits to the firm, their presence also has a dark side from the economic point of view. That is to say, the high dependence on political connectedness affects the shape and custom of the business norms and exacerbates the network-orientation of the economy in general. This, indeed, threatens the ambitious Saudi plans, namely Saudi Vision 2030, which aims to diversify Saudi Arabia's sources of income and attract further foreign investments. The threat comes from uncertainty and the fact that in such a situation equal competition is less attainable, which increases investment risks. Foreign investors are rational and seek stable and transparent markets that provide equal opportunities for all investors, rather than for certain parties, i.e. those which are politically connected.

Moreover, as the majority of inflow cash of the Saudi economy emerges from oil revenues, this means the structure of the economy is based on government expenditure rather than on a contributing private sector. In this context, while the tendency of market-oriented economies is centred on privatisation, the investment and involvement of government and semi-government in the Saudi market are significantly high, implying that the enforcement of governance regulations is unlikely on these parties. The OECD (2015b) warns that boards connected to governments may find it difficult to balance between their duties as a representative of the shareholders and their commitment to achieving government goals, which may lead to interference in the management of the

company. The OECD (2015b, p. 35) also suggests that: "in order to minimise possible conflicts of interest, the ownership entity should avoid electing an excessive number of board members from the state administration. This is particularly relevant for SOEs engaged in economic activities, where limiting board membership by representatives of the ownership entity or by other state officials can increase professionalism, help prevent excessive government intervention in SOE management and it may help limit the state's responsibility for decisions taken by SOE boards". Therefore, the regulators should acknowledge this fact and find governance techniques that help to govern dominant shareholders rather than just focusing on one issue: managerial opportunism. Alternatively, the government may minimise the influence of political connections by reducing its ownership levels in publicly-traded firms and electing limited numbers of board members from the state administration to prevent excessive intervention in firms' management (OECD, 2015b).

The absence of the role of financial institutions is another critical issue in the Saudi economy. Such institutions have an influential contribution in the governance matters in developed economies, while their presence in the Saudi market is almost negligent due to regulatory restrictions, as the Saudi Banking Control Law prevents financial institutions from owning in excess of 10% of a company's shares (SAMA, 1966). The neutralisation of the financial institutions should be altered at least by involving other interested parties to fill the gap of this absence, e.g. other stakeholders' parties such as employees (German Model).

6.1 IMPLICATIONS OF THE RESEARCH

Practically, the thesis findings have several significant implications that may assist firms and regulators to understand the current practices of corporate governance, the phenomenon of political connections and the determinants of executive compensation.

First, the thesis sheds light on the practices of executive compensation in Saudi listed firms and illustrates the challenges that boards of directors encounter when designing managerial incentives. It shows that boards of directors have very limited methods by which to compensate top managers namely salary, bonus and other non-pecuniary compensation which are linked to short-term incentives. However, long-term incentive plans such as stock options are not possible in the Saudi context because of

regulatory constraints. Hence, the findings highlight the need for creating new contextualised means by which to strengthen the link between managerial pay and long-term performance.

Second, even though the SCGRs state that managers should be paid according to firm performance, the study demonstrates that executive compensation increased faster than firm performance between 2008 and 2015. The upward trend of executive pay with a weak correlation with firm performance indicates that firms have a low level of compliance with the SCGRs; thus, the SCGRs need stronger enforcement.

Third, the study highlights the potential conflict of interests that may result from the combining the nomination and remuneration committees in Saudi Arabia. Unlike in developed economies, which require a separate remuneration committee comprised entirely of independent directors, under the SCGRs members of the executive team including the CEO can participate in the nomination and remuneration committee. As this committee is responsible for two vital functions i.e. designing managerial pay and nominating members of board of directors, there is a possibility that the CEO can directly influence his/her own compensation. Furthermore, CEOs may use his/her position on the committee to pressurise and control independent directors, who rely on the CEO to be re-appointed. In this context, the study assesses the legal setting that frames executive compensation and highlights the legal loopholes; thereby enabling regulators to resolve the issue.

Fourth, with regards to corporate governance, the study finds evidence that the Anglo-American model of corporate governance lacks transferability to emerging economies such as the KSA and is inadequate in constraining executive compensation in these settings. For example, although Saudi corporate governance regulations have been enforced since 2006, there was a boom in executive compensation between 2008 and 2015. Furthermore, international best practice of corporate governance suggests that ownership concentration and the presence of controlling shareholders on boards of directors mitigate agency costs (Combs *et al.*, 2010; Fama and Jensen, 1983b). However, this research demonstrates that ownership concentration in the hand of certain investors combined with the presence of blockholders on companies' boards, especially in economies with weak formal institutions, leads to principal-principal conflict and higher agency costs. Consequently, governance regulations should acknowledge and consider

the potential conflict among shareholders themselves and create tools that prevent blockholders' opportunism and provide strong protection for all shareholders.

Fifth, the outcomes show that independent directors are ineffective in controlling managerial perks, making the independence of board of directors questionable. This helps regulatory bodies to review their definition of independent members and encourages firms to undertake periodic assessments in relation to the status of independent directors. Additionally, the role of remuneration committee, which is assumed to control the levels of executive pay and set well-structured pay packages (Girma *et al.*, 2007; Méndez *et al.*, 2011), is found to be weak in controlling executive compensation. This evidence confirms the argument of Young *et al.* (2008) that firms in emerging economies only comply in form with regulatory requirements of corporate governance rather than in substance. Accordingly, the study findings provide an opportunity for the authorities to review current regulations of corporate governance taking into consideration the domestic cultural and institutional challenges in the KSA.

Sixth, in terms of political connections, Saudi law forbids ministers from being members of corporate boards in order to reduce the abuse of political power in the business field (BECM, 1993). However, this study shows that firms are still able to establish political connections by other means and provides evidence that most Saudi listed firms are politically connected. As the Saudi government is reliant on foreign investment to achieve the objectives of the 'Saudi Vision 2030', the study sheds light on the obstacles that may repel foreign investment from entering the Saudi market. Typically, foreign investors look for low risk markets and avoid countries where there is a high degree of uncertainty. However, if business is highly dependent on political connections, then foreign investors are required to establish political ties to enjoy a competitive environment. Undoubtedly, the norms of political connections are seen as a risk for foreign investors.

Seventh, from the governance perspective, politically connected directors are found to be ineffective in enhancing the quality of corporate governance. On the contrary, their presence on board of directors is associated with higher executive remuneration. In contexts that are strongly influenced by principal-principal conflict such as the KSA, there is a concern that controlling shareholders may exploit minority shareholders and use political connections to prevent any regulatory sanctions. Thus, the study provides an

overview of how political connections interact with corporate governance mechanisms. Indeed, an understanding of this interaction assists the authorities to reform corporate governance regulations, taking into consideration boards' political power. This enables a re-balancing of power among the parties to ensure that no single party is exploited due to a lack of control.

Finally, the third empirical study demonstrates that most Saudi listed firms are family dominated and almost 85% of corporate boards have at least one blockholder member. Furthermore, it provides a comparison of attitudes between family and non-family firms in terms of corporate governance practices, the use of political connections and the policies of corporate governance. This comprehensive overview of the key distinctions between family and non-family firms offers a solid basis for regulators and practitioners to specify the needs of both type of firms in the aforementioned aspects. It also highlights the need for regulations that reduce family control and decreases the likelihood of their interference in company management. Furthermore, it provides evidence that, unlike the diffused ownership structure in the West (Rashid, 2013), the ownership structure in Saudi Arabia is highly concentrated with a low level of separation between ownership and control. Therefore, the finding should stimulate regulators to reconsider the validity of the Anglo-American model of corporate governance, which disregards the weak institutional settings in emerging economies.

6.2 POTENTIAL LIMITATIONS OF THE RESEARCH

Although the thesis findings have a high degree of objectivity, there are a number of theoretical and methodological limitations that should be taken into account when interpreting the results. First, the results are analysed and interpreted as an aggregate for the entire sample based on the contextual setting. However, some firms might have different internal characteristics that make them subject to other theoretical interpretations. For example, when the discussion concentrates on principal-principal conflict in most firms, this does not mean that all the firms are affected to the same degree by principal-principal conflict.

Second, the study is based on a sample from a single country, namely Saudi Arabia. Although the findings enjoy a high degree of generalizability to other economies that have similar institutional features in common with Saudi Arabia, such as the GCC countries and

some other Arab economies, the study findings may lack generalizability outside the MENA region. Additionally, the study sample is limited to non-financial listed firms operating between 2008 and 2015 and does not cover financial firms. This is because financial firms are subject to different accounting practices, governance regulations and supervisory bodies (Wang and Shailer, 2015). Moreover, unlisted firms are not included in the study sample. Thus, the reader should be careful when interpreting results and should not assume that their implications are the same for the financial sector or in unlisted firms.

Third, with regards to the dependent variable, the scope of the investigation is limited to one governance mechanism, namely executive compensation. Thus, other governance characteristics and practices are not examined. Relatedly, it is also worth noting that the thesis uses only the three components of executive compensation existing in the KSA, namely salary, bonus and non-pecuniary packages. Therefore, it does not analyse other pay forms that are used internationally such as long-term incentive plans, because stock options are not allowed for regulatory reasons. That is to say, there is no legislation in Saudi Arabia that permits firms to repurchase their own stock from the market.

Fourth, an important limitation is related to the independent variables of corporate governance, political connections and family members. In terms of corporate governance, the study uses a very limited set of variables that mainly focus on certain internal governance mechanisms, the board of directors and the type of investor. However, other particularities of the political economy and internal and external governance mechanisms, such as the effectiveness of the legal framework, takeover activities, market efficiency and so on, are not examined. Hence, the findings should be interpreted within the context of the selected areas of internal corporate governance. With respect to political connections, the research uses a context-based definition for political connectedness that consists of certain types of connections, namely royal family members, *Shura* Council members and state representatives. However, there might be other potential channels to establish political ties that are not observed by this study. In addition to this, the study focuses only on the influence of the presence of politically connected members in the board of directors over governance quality; however, there are many particularities of political economy that may have a political impact on corporate governance and are not investigated in this thesis. Furthermore, with regards

to family-controlled firms, the study investigates the influence of family members on governance quality according to certain criteria, i.e. level of ownership and the presence in the board of directors. However, other related variables that measure the family influence, which considers other factors such as generations, family-related managers and family altruism, are beyond the scope of this thesis. Consequently, the reader should be cautious when generalising the findings to other countries which have different political regimes and institutional settings.

Fifth, it is also worth noting that the study does not capture the influence of *sharia*, which is a key contextual characteristic of Saudi Arabia, on governance quality due to two reasons. First of all, although there are some attempts to model ICG, they are limited to financial institutions such as Islamic banks. Thus, no well-developed model is available for non-financial firms which have different structures and nature of business from those of banks. Second, *sharia* influence cannot be precisely measured using secondary data and perhaps needs an alternative methodological approach, e.g. qualitative investigation. Furthermore, it should be acknowledged that even theoretical perceptions of *sharia* are not considered in this thesis due to its irrelevance to the adopted model of corporate governance in Saudi Arabia, which is mainly based on the Anglo-American model (shareholder model).

Sixth, in terms of control variables, the study employs the most common variables of firm characteristics that are found to influence executive compensation, namely firm size, firm age, firm performance and firm leverage. However, there is a possibility that other unobserved firm characteristics may affect executive compensation. It is also essential to mention that human capital characteristics of executive members such as education, age and years of experience are not included in the study models due to lack of disclosure.

Seventh, the study adopts a quantitative approach through secondary data, which are collected from the financial statements and the reports of boards of directors, to answer the research questions. Thus, statistical analysis is the most appropriate technique to analyse the effects of corporate governance and political connections on the setting of executive compensation. However, it is necessary to be aware that the study does not investigate the phenomena qualitatively. In other words, the data cannot provide answers for why and how these behaviours, attributes and practices occur.

Finally, Chalevas (2011) and Chen *et al.* (2010b) report that the endogeneity problem exists between the variables of firm performance and executive compensation. In other words, there is a reverse causality between the two variables i.e. firms with a better performance offer higher executive compensation; at the same time, generous executive compensation incentivises managers to increase firm performance. One of the best suggested solutions for this problem is to use instrumental variables methods such as Two-Stage Least Squares (2SLS) (Chen *et al.*, 2011; Murray, 2006). To do so, such models are conditioned by the use of a valid instrumental variable that is correlated with the endogenous regressor but uncorrelated with the error (Chen *et al.*, 2011). However, this study failed to find a valid instrumental variable because the relationship between firm performance and executive compensation is very interlocked and most variables that affect firm performance also impact executive compensation. Furthermore, adopting an invalid instrumental variable produces biased and misleading outcomes (Murray, 2006). In order to address the endogeneity problem between the two variables, the study follows other research (Colpan and Yoshikawa, 2012; Méndez *et al.*, 2011; Chen *et al.*, 2010b; Weir *et al.*, 2002) and uses lagged value of firm performance. Typically, managers are compensated according to their past performance (Chen *et al.*, 2010b). Therefore, lag firm performance is expected to affect current and future executive compensation; however, it is irrational to believe that current or future compensation influences past performance.

6.3 RECOMMENDATIONS FOR FUTURE RESEARCH

The research only uses a sample of non-financial firms in the KSA. Thus, it is worth investigating the same phenomena in financial firms which have different accounting practices and are subject to different supervisory bodies and different corporate governance requirements. This will enable a comparative analysis between the effectiveness of corporate governance, the impact of political connections and the practices of executive compensation between financial and non-financial firms.

Additionally, there is a gap in the literature related to private business firms which needs attention. Private family firms are closed businesses and have norms and cultural behaviours that differ from listed firms. Hence, studying private family businesses would enhance the understanding of the roles of corporate governance and political connections on determining executive incentives in both family and non-family firms.

Furthermore, this study relies on a quantitative method to investigate the impact of corporate governance and political connections on the levels of executive compensation. However, the process of designing executive compensation and the roles of corporate governance and political connections can be also investigated qualitatively using interviews in order to obtain the perceptions of all the main stakeholders. This would make a worthwhile contribution to the understanding of this area and increase the reliability and validity of previous empirical findings.

Although the findings of this research reflect the role of a number of chosen variables in constraining executive compensation, this does not mean that these variables have the same implications for other firm characteristics. Therefore, it is worth investigating the effects of these attributes on other business aspects such as firm performance and earnings management. This would provide a comprehensive understanding of the role of corporate governance and political connections in Saudi Arabia.

Finally, the research develops a contextualised definition for political connections. This definition can be employed to analyse the implications of political relationships on other economic and governance characteristics in Saudi Arabia or in countries, such as the GCC economies, which share similar institutional settings. This would enhance the understanding on the interaction between the phenomenon of political connections and business elites.

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