CORPORATE GOVERNANCE INDEX PROJECT

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Introduction

Saudi Arabia is in the midst of transformational economic change, with authorities in the process of allowing foreign institutional investors to invest directly in the domestic stock market. The government's aim is for the Kingdom to become one of the region's diversified economic centers, and to advance the performance of different sectors of the economy, including state-controlled enterprises and family businesses as they transition between generations. As part of this effort, authorities have now identified corporate governance as a risk factor that warrants special attention. In particular, the Saudi Arabian General Investment Authority (SAGIA), led by Eng. Abdullatif Al Othman, the Governor, and deputy governor HRH Prince Saud Bin Khalid Al Faisal, have backed the creation of a new corporate governance initiative at the College of Business of Alfaisal University, in Riyadh. The project promises to raise the profile of corporate governance in the Kingdom as well as produce graduates schooled in the subject. More broadly, the initiative can demonstrate the value of developing a domestic, intellectual resource trained on addressing Saudi, rather than international, conditions. The corporate governance initiative has the backing of Saudi regulators, such as the Ministry of Commerce and Industry and the Capital Market Authority as well as the support of a large segment of the business community and other stakeholders.

Saudi authorities see good corporate governance as of crucial importance for attracting both domestic and foreign investors, building and retaining their confidence in the economy, strengthening and developing capital markets, creating sustainable economic growth, and providing employment opportunities for young nationals. That perspective dovetails with the weight of international academic evidence, which tends to show that effective corporate governance aligns the interests of top management with those of investors, ensures optimal allocation of scarce resources in the economy, creates sustainable values for shareholders, and ensures that organizations have sound core values and high ethical standards. Van den Berghe and Levrau (2003) argue that investors pay a premium for well-run companies. As well, advocates contend, good corporate governance promotes business integrity and social responsibility and encourages companies to participate in projects that support charitable, educational and/or environmental causes. International bodies such as the Organization for Economic Co-operation and Development (OECD) and the World Bank Group, governance NGOs such as Hawkamah and the International Corporate Governance Network, and national regulators in the GCC region have gone further by issuing standards and best practices in governance behavior.

Alfaisal's project seeks to test the practical application of these standards in the Kingdom by establishing baseline data on how enterprises approach governance today. The Corporate Governance Index (CGI) project is to be implemented in three stages, with outside advice provided by Professor David Beatty of the Clarkson Center for Board Effectiveness at Rotman School of Management, University of Toronto, and Dr. Stephen Davis, senior fellow of the Harvard Law School Program on Corporate Governance and a senior fellow in governance at the Brookings Institution, in Washington, DC.

Baseline Governance Data

In the first stage of the project, researchers have constructed a corporate governance index—that is, a set of comparisons, not a stock market index—for listed Saudi companies. The CGI objective is to measure corporate governance disclosure and practices and assign a general score to each firm. The CGI score, in turn, compromises two components: mandatory disclosure and voluntary disclosure. Mandatory disclosure includes information that companies are required to report on by market regulations, namely the Listing Rules and Corporate Governance Regulations. On the other hand, voluntary disclosure includes information that companies voluntarily report in their efforts to promote transparency and accountability.

When released, CGI's reports comparing voluntary governance disclosures among listed Saudi firms are expected to encourage lagging companies to improve information output. Sponsors of the project hope that the initiative will enhance transparency and accountability and increase the attractiveness and competitiveness of the Saudi capital market both for domestic and foreign investors, particularly institutional investors, an essential ingredient for market development and maturity. The CGI report will be published on an annual basis, starting this year, by the newly- expected to be launched Corporate Governance Research Center at Alfaisal University.

Governance at Family Companies

In the second stage, over the next two to three years, the CGI project will be extended to include family-owned companies, particularly the large firms. Family-owned companies are the leading form of business organizations in Saudi Arabia. They represent about 95 percent of Saudi companies and they are the backbone of the Saudi economy.

There are more than 5,000 family businesses; less than 3 percent of them are listed on the stock market. According to Jeddah Chamber of Commerce and Industry, family businesses contribute about 25 percent of the gross domestic product (Economic Times, July 26, 2012). Their contribution to the non-oil GDP is a little bit more than 50 percent. This rate reflects the importance of family businesses to the Saudi economy.

The predominance of family companies in the Saudi market presents challenges and opportunities for corporate governance that are not always considered in publicly traded companies where ownership is dispersed and management is mainly in the hands of external and hired professionals.

In first and sometimes in the second generation, family businesses are managed by the founders and other family members. As a result, these businesses often face difficulties in attracting and retaining good professionals to assume management positions due to the resistance of family / managers to cede control of the business and change habits and ways of running the business. As well, family-owned businesses, particularly after the founding generations, face a multitude of challenges, such as succession planning, access to debt markets, and attracting and retaining highly qualified professionals as well as business success and family peace. These among others are unique governance issues that family-owned companies face that may threat their existence, but which are not well addresses in international governance codes and standards.

According to the Family Business Institute, the survival rate of family businesses into the second and third generations is 30 percent and 12 percent, respectively. However, only 3 percent of family businesses survive to reach the fourth generation. This statistic strongly suggests that 90 percent of today Saudi family companies will not survive after the second generation.

Thus, for the Saudi market, any discussion of corporate gover nance improvements must address the unique governance challenges that family companies face. Establishing the right corporate governance structure for family-owned businesses will help improve their corporate governance practices, succession planning, and ensure their continuity and sustainability. Good corporate governance improves internal control systems and risk management of family companies and provides assurances to debt investors that their interests and concerns will be recognized and addressed. This enhances the ability of these companies to attract debt financing, while reducing their cost of capital (e.g., Williamson, 1975). As well, the right governance structure improves the image of family businesses and strengthens their appeal to equity investors should these companies go public in the future.

Governance at SOEs

In the third stage, in the next four to five years, the CGI project will be extended to include government departments and agencies. Good corporate governance is fundamental to any effective organization and is the hallmark of any well-run entity, project founders believe.

Government departments have a long history in propelling economic, educational, industrial, and social developments in Saudi Arabia. They have acted as engines of change, provided important services, created jobs, and contributed to developing the Kingdom's national identity. Governance in public sector bodies is about the process and structure for overseeing the direction and management of these departments so that they effectively fulfil their mandates.

To fully understand the role of a specific Saudi government department, it is important to first understand the interests and mandates of this entity and its involvement in program delivery. There are more than 30 government departments and agencies that have unique and sometimes overlapping responsibilities. As all levels of government hold key policy and regulatory levers, a central governance challenge in the public sector is to ensure that these levers are developed and used collaboratively and effectively to serve the public interest, deliver programs, and achieve the strategic policy objectives of these departments.

Good governance systems in government departments promote a culture of integrity, transparency, and accountability, improve planning and performance monitoring, and improve public faith, confidence, and trust in the political system, government departments, and public servants (Deloitte, 2014). As well, project founders contend, quality governance structure will enhance government departments' ability to attract highly qualified professionals, improve their strategic clarity, and enhance their sustainability. Over time, the CGI project intends to draw lessons from its research in listed and family company sectors in developing analysis tools relevant to the study of Saudi state owned enterprises.

Partnership with the Business Community

For the success of the CGI project, there must be a genuine partnership between Alfaisal University and the business, regulator, and corporate governance communities as well as other interested parties, such as the Big Four accounting firms and accounting professionals. The aim of this partnership is to improve the corporate governance culture in Saudi Arabia in a well-guided, long-term, incremental approach that seeks feedback and wisdom from all directions. To this end, Alfaisal has been in regular communication with these diverse interested parties to share the project's corporate governance model and rating criteria, and to seek their collective wisdom in creating the most credible corporate governance research program for the Saudi market.

Conclusion

Markets generally achieve comparative advantage in meaningful corporate governance progress when they feature multiple centers of information and advocacy, whether from media, regulators, investors, professional bodies or academic institutions. In this sense, Alfaisal's decision to open its center represents an historic opportunity for Saudi Arabia, as it gives the Kingdom one of its first home-based, independent research, policy analysis and teaching capacity dedicated to corporate governance. Moreover, the decision to address family and state-owned enterprises, in addition to listed companies, better equips the CGI project to tackle real-world characteristics of Gulf markets.

SAGIA's investment in the Alfaisal initiative is designed to provide seed capital until the corporate governance initiative finds additional funding streams. Alfaisal University and SAGIA have ambitious hopes for the CGI project as a catalyst for improvement in Saudi corporate governance. Alongside the government, and in line with research, they believe that corporate governance has become a common theme and guiding principle for the global investment community, and is widely used by investors as a screening tool to identify good investment opportunities. Demonstrated attention to best practices could draw greater internal and external capital to the country. Moreover, focus on the topic could be expected to generate demand for local corporate governance expertise and consulting services. This could trigger the emergence of a domestic corporate governance industry, expanding accounting and financial services in the Saudi market into new territory and creating fresh professional jobs for young Saudis. With the newly-expected to be inaugurated Center, the Alfaisal College of Business will emerge as a peek training ground for such skills as students gain hands-on experience in practical and professional aspects of corporate governance.

In addition to conducting corporate governance research, the Center is to serve as a means to raise the profile of corporate governance among business leaders and regulators. For this reason, one of the Center's mandates is to organize public lectures, industry roundtables, training programs, and academic conferences on governance-related areas.

Finally, founders expect the Center to serve as a think tank function by periodically issuing public policy recommendations to address corporate governance challenges. The aim of these recommendations is to help regulators and policy makers strengthen market corporate governance regulations and improve corporate governance practices in Saudi Arabia..