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The effectiveness of corporate governance on corporate social responsibilities performance and financial reporting quality in Saudi Arabia's manufacturing sector

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ABSTRACT

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The aim of the study is to determine the effectiveness of corporate governance on corporate social responsibility (CSR) performance and financial reporting quality in Saudi Arabia's manufacturing sector. The data is collected through the database of Thomson Reuters from 30 manufacturing companies of Saudi Arabia over the period 2014-2020. Descriptive statistics and the generalized least square (GLS) model were applied. The dependent variable was calculated through residuals and was found as discretionary accruals (DA). The findings reveal that there was a positive influence of corporate governance on CSR performance and financial reporting quality. It was found that sample size was one of the biggest limitations because only data from 2014 to 2020 were collected and to make the study more reliable and authentic, larger data is required.

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1. Introduction

There is an independent role in communicating that either firms are behaving socially or to which extent the organizations should respect society and the environment. In addition to this, corporate social responsibility (CSR) disclosure is mainly argued as an important type of disclosure as it shows the operational impact over the resources of the world and human life and welfare. The global awareness related to social responsibility for the firms has enhanced the need for a high quality of CSR disclosure (Eyenubo, Mohammed & Ali, 2017). Simultaneously, it is observed that corporate governance (CG) objectives have been evolved to accommodate the new relationships with the increasing concern related to CSR disclosure. CG holds a balance among the goals that are aligned socially and economically as well as communal and individual goals. In addition to this, CG is mainly developed so that it can be incorporated into ethics, disclosure, and accountability and reporting (Alqatamin, 2018). The mechanisms of CG like a board of directors, auditors, and audit committees are mainly responsible for controlling and monitoring decisions and activities of a firm that affects the stakeholders and society. This is mainly used for revealing the correlation between CG and CSR performance (Habbash, 2019). An effective CG system is related to the disclosure and transparency along with disclosure in material activities which affects the environment and society particularly.

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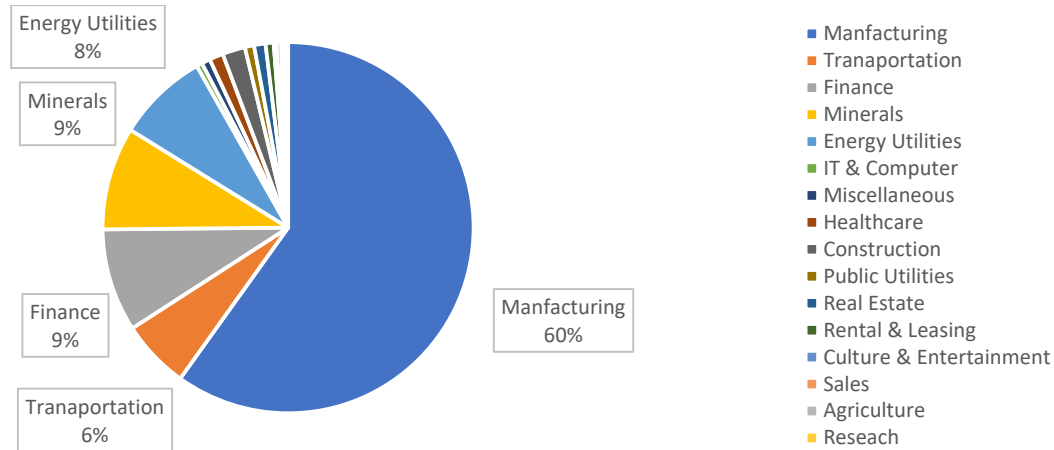


Fig. 1. CSR in Saudi Arabia Source: Alqatamin (2018)

It is analysed that Arab countries are no exceptions to CSR activities as the governments in Arab countries have espoused particular tenets of CSR. Particularly, there is an increasing emphasis over the sustainability of the environment. Arab countries are facing several challenges that are related to this which also affected their financial performance (FP). Saudi Arabia is one of the pioneering countries over the issues that are pertaining to urban planning, water conservation and organic culture which had affected FP of the country collectively. It is evaluated that the issues of business-like issues related to corporate social responsibility bridges the division among government and community of business. It is evaluated that there is a varied and broad awareness and understanding related to CSR in Saudi Arabia (Hunjra, Mehmood & Tayachi, 2020). There are a number of organisations in the manufacturing sector that have been involved in CSR related activities that lead towards enhancement in consumer trust, improvement in community, employee recruitment and retention as well as improvement in FP by formally organising such initiatives under CSR. These organisations face several challenges in implementation of corporate governance to the system as most of the organisations in the manufacturing sector are unaware of the effectiveness of corporate governance for the company socially and financially (Mahrani & Soewarno, 2018). This study is mainly conducted to fulfil this gap and focuses over effectiveness of corporate governance. It is estimated that there are very few studies that are focused on the manufacturing sector of Saudi Arabia that covers all the aspects of CG and CSR along with financial reporting quality, so this study is mainly conducted to contribute to literature related to this. The study is important as environmental concerns and corporate governance are considered to be very important for financial aspects of the organisations in the manufacturing sector. The major aim of the study is to analyse the effectiveness of CG over CSR performance and financial reporting quality in which case the manufacturing sector of Saudi Arabia is focused. The first section of the study covers the introduction section in which there is a brief description regarding the topic and the rationale for conducting the study. Whereas the second section consists of the review of literature that is relevant to the topic of the study and the third section consists of details related to the proposed method for the study. The fourth section consists of analysis of data and the fifth section entails the conclusion and recommendation for the study. The research question that is focused in the study is as follows:

What is the effectiveness of corporate governance on CSR performance and financial reporting quality in the manufacturing sector of Saudi Arabia?

2. Literature Review and hypotheses building

2.1 Corporate governance

There is a consensus on the definition of CG in the literature. In Sir Adrian Cadbury's view, CG refers to a balanced state between a corporation's economic and social goals as well as a corporation's and society interests (Sonmez & Yildirim, 2015). Moreover, CG has been described in terms of rights and responsibilities of a corporation's stakeholders (Zaman et al., 2022), and defined as a set of rules and regulations outlined to protect shareholders' values and interests (Samaduzzaman et al., 2015). Another definition of CG emphasized its key principles describing it as a management system utilized to enhance the work environment on the basis of four major principles related to transparency, accountability, reliability and fairness (Sonmez & Yildirim, 2015).

2.2 Corporate social responsibility

Definitions of CSR have been shifted to cover numerous dimensions. The focus of CSR from 1950's to 196's was on community development based on unregulated philanthropy activities and developed between 1970's and 1980's to regulated responsibilities based on setting social, economic, legal, and ethical priorities and protecting both community and stakeholders rights. Nowadays, CSR is concerned with issues like sustainability, competitive strategy, and CSR standards

(Hamidu et al., 2015). Hence, CSR has been conceptualized in terms of policies, practices, and processes that a firm followed to enhance stakeholders and society social state (Zaman et al., 2022).

2.3 Financial reporting quality

FRQ as one of a corporate disclosure outcome (Leuz & Wysocki, 2016) has been regarded as providing financial information about corporate overall performance considering three key characteristics, which are completeness, confirmatory and predictivity, and neutrality and error-free (Önce & Çavuş, 2019). Benefits of FRQ include assisting investors to assess investment decisions based on corporate financial position as high-quality financial information represents a signal of its good performance (Badawy, 2021). It is evaluated that CG is considered as the set consisting of rules that helps in governing the relationship among the creditors, shareholders, managers, employees, government and external and internal interest holders that are related to the obligations. It is analysed that CG rises from the interest of the company mainly which helps in ensuring the investors or principles that the funds which are invested should be used efficiently and appropriately. The study has argued that the existence of CG helps in preventing or reducing the earning which impacts the FP quality of the company because financial reporting is used in it which is considered as the incentive for management as it can served as the agent which act best in the interest of the company (Vitolla, 2020; Pillai & Al-Malkawi, 2018; Alqatamin, 2018). It is evaluated that good CG also plays a positive role in corporate social responsibility for the organisation because it mainly impacts the decisions and activities that are good for the environment and society. In addition to this, financial reporting quality is considered as the qualitative concept because it mainly requires the financial information to be relevant as well as faithfully represented in the statement because it helps in improving the decisions and their usefulness for the creditors and investors (Mahboub, 2017).

H₁: *There is a positive relationship between CG and CSR.*

H₂: *There is a positive relationship of CG on financial reporting quality.*

It is analysed that CSR has the ability to fulfil the needs of stakeholders. The stakeholders that lie internally are more dedicated so that they can contribute towards the company whereas the stakeholders that lie externally would provide good assessment for the organisation (Alhalalmeh et al., 2020; Al-Hawary & Al-Khazaleh, 2020). The purchase intentions of the consumers mainly affect the FP of the company which also affected the financial reporting quality of the company. (Al- Quran et al., 2020; Habbash, 2019; Alqatamin, 2018). It is evaluated that there are several determinants that are used to calculate corporate governance which includes board size, CEO duality and audit board committee. These indicators signal mixed findings as they are linked with corporate governance and provide distinct results (Eyenubo, Mohammed & Ali, 2017). Leverage and firm size also play a major role in controlling corporate governance. So it is analysed that exposing such activities would help the companies for gaining the support of the society so that the company can operate calmly (Hunjra, Mehmood & Tayachi, 2020; Vitolla, 2020; Mahboub, 2017). The disclosure of CSR would make financial reporting quality more transparent which encourages the managers and business owners to adopt such measures. The hypothesis of the study is given as follows:

3. Theoretical framework

The theory that can be applied to the study is agency theory as it mainly describes the relationship among the owner which is known as principle and the agent in which there is an authority related to decision making to the agent. In the relationship of an agency, a conflict of interest is raised among the agent and the rules (Panda & Leepsa, 2017). The demand of shareholders enhances the corporate profitability as well as dividends whereas the manager is responsible for motivating so that economic and psychological needs are fulfilled. By relying over agency and principal relationships, management is mainly encouraged for performing the financial reporting (Mahrani & Soewarno, 2018). For this there are several ways out of which the way that results with best quality should be focused on the companies so that desired outcomes can be collected (Bosse & Phillips, 2016). The conceptual framework of the study is designed in Fig. 2.

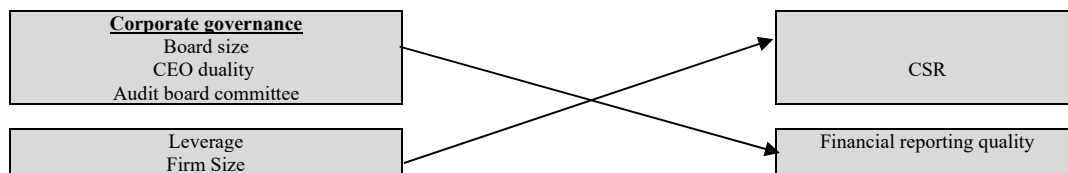


Fig. 2. The proposed study

4. Methodology

4.1. Variables and Data Collection Procedure

The main aim of the study is to analyse the effectiveness of CG over CSR and financial reporting quality. The effectiveness is analysed in the context of the manufacturing sector of Saudi Arabia. It is evaluated that credibility and reliability of data can be ensured by using data from valid sources (Beins, 2017). The data is collected by Thomson Reuters. The data of 30

manufacturing companies of Saudi Arabia for 4 years (2014-2020). Corporate governance is considered as the dependent variable of the study and the determinants affecting CG are Board size, CEO duality and Audit board committee. There are two control variables in the study: leverage and firm size. The

4.2. Data Analysis

The data collected by secondary sources is mainly analysed by using Panel data analysis. Panel data analysis is considered as the statistical method that is mainly used in social science, econometrics and epidemiology in order to analyse the panel data that is two dimensional. This type of data is mainly collected over time and over the same people and the regression takes place over the two dimensions. In this study the data for the same companies is collected for 4 consecutive years. The data is also analysed by descriptive and correlation by using Stata.

$$CSR_i = \alpha + \beta_1 BS + \beta_2 CD + \beta_3 ABC + \beta_4 LEV + \beta_5 FS + \varepsilon_i$$

5. Results

5.1 Descriptive statistics

Table 1
Descriptive statistics

Variable	Obs	Mean	Std.	Min	Max
CSR	186	129294.6	323688.6	2403	2257268
Board Size	186	9.172043	2.669644	1	20
CEO board	186	0.483871	0.501089	0	1
Audit Board	186	0.903226	0.296448	0	1
da	155	974264.4	2262140	775.9767	1.24E+07

Descriptive statistics of the data is analysed to summarise the data and determine the statistical characteristics of the data. The purpose of using descriptive statistics is to find out the average values obtained of each variable used in this study. The data was collected from the World Bank's website and only the available data from 2014 to 2019 was obtained. A large data is summarised in a synchronised manner through the descriptive statistics. The average value of CSR from 2014 to 2019 was \$129294.6 whereas board size had a mean value of 9.172043 which approximately means that 9 board members were on average in the manufacturing sector of Saudi Arabia. Similarly, the other variables include CEO board and audit board which had 0.483871 and 0.903226 respectively.

5.2 GLS Model

In order to determine the Effectiveness of Corporate Governance on CSR Performance and Financial Reporting Quality in Saudi Arabia's Manufacturing Sector, a fixed and random effects model was computed. Hausman tests were also carried out for this and it was suggested from the results of Hausman tests that a fixed effects model will be used for the research. The dependent variable was calculated through residuals and was found as discretionary accruals (DA). Some of the diagnostics test were also carried out and the table below shows the results obtained for the tests conducted for finding the heteroscedastic in variables:

Table 2
WALD Test

	CSR	DA
chi2	39000000.00	13000000.00
Prob>chi2	0	0

Table 2 clearly shows that for both the dependent variables of the study, that is CSR and financial reporting quality, the value of probability obtained is less than 0.05 which shows clearly that the null hypothesis is rejected by Wald Tests. This leads to the fact that there is presence of heteroscedasticity in variables. On the basis of the results obtained, the fixed effect model was not suitable therefore, the researcher, in order to achieve the aim and objectives of the research, proceeded with the Generalised Least squares model (GLS). The results shown in Table 3 are of both dependent variables (CSR and financial reporting quality).

Table 3 shows the GLS model that was found to be significant because the probability value was 0.000 which indicates the significance of independent variables. Some of the variables such as CEO Board member and audit board committee show negative influence on CSR and financial performance through the negative sign of the coefficient values (-18467 and -433525). The 95% confidence interval values show that this is significant. Apart from board size, all other variables have significant results as the P value is less than 0.05 (P =0.000).

Table 3
GLS Model of DA (Discretionary Accruals)

Estimated covariances	31	Number of obs	155
Estimated autocorrelations	0	Number of groups	31
Estimated coefficients	5		5
Wald chi2(4)	299.23		
Log likelihood	-2068.48	Prob > chi2	0

Discretionary Accruals	Coef.	Std.	z	P> z	[95% Conf. Interval]	
BoardSize	1056.865	916.3871	1.15	0.249	-739.22	2852.951
CEOboardMember	-18467	3228.041	-5.72	0	-24793.9	-12140.2
AuditBoardCommittee	-433525	69544.3	-6.23	0	-569829	-297221
ROA	204402.9	19378.63	10.55	0	166421.4	242384.3
cons	466107.2	69828.44	6.68	0	329245.9	602968.4

Table 4
GLS Model

Estimated covariances	31	Number of obs	186
Estimated autocorrelations	0	Number of groups	31
Estimated coefficients	5		6
Wald chi2(4)	1003.28		
Log likelihood	-2094.94	Prob > chi2	0

Discretionary Accruals	Coef.	Std. Err	z	P> z	[95% Conf.Interval]	
CSR	2149.269	121.064	17.750	0.000	1911.989	2386.549
BoardSize	-11778.670	701.451	-16.790	0.000	-13153.490	-10403.850
CEOboardMember	-13644.320	1740.391	-7.840	0.000	-17055.430	-10233.220
AuditBoardCommittee	43487.060	2296.418	18.940	0.000	38986.170	47987.960
ROA	10108.730	1893.459	5.340	0.000	6397.619	13819.840

From Table 4, it is clear that the overall model is significant and the aim of the study is to prove that there is an impact of Corporate Governance on CSR Performance and Financial Reporting Quality in Saudi Arabia's Manufacturing Sector. Since the P value is again less than 0.05 therefore, the model significance can be assessed. In the second model of GLS, all the P values of variables (CSR, Board size, CEO board member, Audit board committee and ROA) is 0.000 that shows a strong and highly significant impact on firm performance. Based on the above data that was collected from the World Bank's website from 2014 to 2019, and on the basis of the results, it was evident that there is a positive influence of corporate governance on CSR performance and financial reporting quality.

6. Discussion

On the basis of the findings of this study, it was suggested that the hypothesis developed for the models were accepted. From the results of GLS models applied, it was clear that corporate governance plays a significant role in affecting the overall performance of the firm in terms of CSR activities as well as financial reporting quality. The reporting quality of any firm is analysed from their annually published reports that are reviewed by the stakeholders as well as the general public. On the other hand, CSR performance of the firm is measured through their number of projects as well as other CSR activities conducted by the firm. In the case of Saudi Arabia, the manufacturing companies are involved in conducting CSR activities as they want to reach out to the general public and increase their presence for the stakeholders. Therefore, it is essential to understand that Saudi Arabia focuses more on oil drilling and other oil related activities due to which their main focus is to aspire to their stakeholders and their oil partner countries who import oil from them. Therefore, the manufacturing sector of Saudi Arabia is not ignored but they try to use their CSR activities for engaging their stakeholders and improving their firm performances.

7. Limitations and future Implications

Despite the fact that the researcher tried to collect the data in a systematic manner still, there were some limitations and barriers encountered during the process of data collection and research analysis. It was found that sample size was one of the biggest limitations because only 2014 to 2020's data was collected and in order to make the study more reliable and authentic, large data is required. Secondly, the research was undertaken in the context of Saudi Arabia only and no other country's data was used therefore, the findings cannot be generalised and applied in the context of other countries for improving the policies or frameworks. Therefore, for future studies in this area, it is necessary that researchers either compare two or more countries or use data from different countries so that the overall idea can be obtained. Similarly, this study has used some limited number of variables of performance and not all financial indicators were used. For the future, the researcher can improve the study by undertaking some more financial variables that measure the performance of the company and compare it with other countries too. Also, this study can conclusively focus on different industries so that the results can be analysed in context of different industries of a country or more than one country.

8. Conclusion

In order to conclude the study, it can be stated that based on the quantitative data and statistical results obtained, there is a positive and significant relation between corporate governance and CSR performance and financial reporting quality. The data was collected from the world bank from 2014 to 2020. The data was limited and only the manufacturing industry of Saudi Arabia was focused.

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