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BOARD CHARACTERISTICS AND THE VALUE RELEVANCE OF FAIR VALUES - THE CASE OF SAUDI ARABIA

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ABSTRACT

While previous studies have focused on an aggregated measure of corporate governance, we aim to provide a more comprehensive view of one of the most important determinants of corporate governance, namely board characteristics. We will focus on whether the value relevance of fair values is affected by board characteristics (i.e., board independence, size, gender diversity, audit committee). It seems that after the adoption of a new fair value accounting regulation, investors have higher trust in fair value estimates made by firms with stronger boards. Saudi Arabia's context presents an interesting setting for addressing the ability of board characteristics to improve the value relevance of fair value measurements.

Keywords: Board Characteristics, Fair Value, Value Relevance, Saudi Arabia

INTRODUCTION

Over the last decades, fair value has increasingly been used in financial reporting, causing a debate on the usefulness of fair value accounting (Ramírez & Díaz, 2018). In September 2006, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standard or SFAS 157 Fair Value Measurements, now named ASC 820 stands for Accounting Standards Codification 820, providing a uniform definition of fair value and expands disclosure about fair value measurements. In response to the need for a comprehensive framework for measuring fair values, in June 2011, the International Accounting Standards Board (IASB) completed its joint project with the FASB and issued the International Financial Reporting Standards (IFRS) 13 Fair Value Measurement, which is effective for annual periods beginning on or after January 2013. More specifically, SFAS 157 and IFRS 13 require firms to disclose a fair value hierarchy containing three Levels: Level 1 (quoted prices in active markets for identical assets or liabilities that the entity can access at the measurement date), Level 2 (inputs other than quoted prices that are observable for the assets or liabilities either directly or indirectly) and Level 3 (unobservable inputs generated by entities). Standard setters and the majority of academics claim that fair value accounting provides the most relevant information for investors, mainly focused on financial instruments. In fact, the increase in the use of fair value is generally justified in relation to the Utility Paradigm (Siekkinen, 2017; Guiselin & Maati, 2018). While opposing academics and practitioners blame fair value accounting for the recent financial crisis (Laux & Leuz, 2009). Couch, et al., (2017) argue that fair value accounting makes earnings more volatile. The increased volatility is explained by the adoption of principle-based accounting standards (*i.e.,* IFRS) which led to more managerial discretion (Horton et al., 2013).

Proponents of fair value accounting emerges within the framework of the Utility Paradigm and argue that fair value information has greater relevance, more accurately, and simplifies financial reporting (Song et al., 2010). These authors use usually statistical model

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(especially Ohlson's Model) under which it is assumed that the company's quoted value is explained by the sum of the value of the assets and liabilities, including the effect of goodwill. In contrast, opponents of fair value accounting argue that fair value measurements prone to greater management discretion. That is, opportunistic managers can abuse discretion allowed under IFRS to meet self-interests such as earnings and bonus thresholds at the expense of shareholders e.g. hedge accounting (Chong et al., 2012). This downside to fair value accounting creates information asymmetry between investors and managers that can be a serious threat to the reliability and, above all, the relevance of the fair value since these were the two characteristics upon which the IASB started to be based in order to choose between alternative policies. These problems are expected to become more frequent and severe as fair value inputs become less verifiable by investors, and subject to greater estimation error and subjectivity by management in measuring and reporting fair values (Aboody et al., 2006; Bartov et al., 2007).

Furthermore, a line of research focuses on analyzing whether corporate governance can be used to mitigate management's opportunistic behavior and increase the relevance of fair values by issuing useful information for investment decision making and for the future cash-flows estimates (Habib & Azim, 2008; Bowen et al., 2008). In addition, Song, et al., (2010) show that managers in weaker corporate governance mechanisms use more discretion. They agree that information asymmetry problems associated with fair values may be greater leading to more severe hazard problems and therefore lower value relevance of these disclosures. While original work on corporate governance focusing on an aggregated measure of corporate governance, recent research has supported the idea that board characteristics are important elements affecting the reliability of financial reports (Anderson et al., 2004; Bhagat & Bolton, 2008). The basic objective of this line of research is to investigate whether strong board characteristics can mitigate the problems related to fair value accounting. Bowen, et al., (2008) show that stronger boards are assumed to decrease incentives for opportunistic behavior due to more efficient monitoring and firms are expected to have a higher trust in accounting numbers. Siekkinen (2017) conclude that board independence and gender diversity have a positive effect on the value relevance of fair value estimates. In addition, firms with larger boards have lower information quality of firm-generated fair value estimates.

Saudi Arabia's context presents an interesting setting for addressing the ability of board characteristics to improve the value relevance of fair value measurements. In 2013, the Saudi Organization for Charted and Professional Accountants (SOCPA) had approved an IFRS transition plan. According to the transition plan, SOCPA has endorsed the pronouncements of the IASB after subjecting them to a due process to thoroughly examine the pronouncements with the involvement of key constituents. We have seen the first IFRS quarterly report by listed companies for Q1 2017 and the first annual report for 2017. Move towards IFRS can have a significant impact on certain companies opting for fair value accounting of assets and could see major changes in their balance sheet, as IFRS gives companies the option to account fixed assets like property, plant, and equipment, investment property, biological assets and other investments using fair value method. As a result, the adoption of IFRS will give listed companies an opportunity to revalue their assets to reflect a more current financial position of their assets. Revaluation could increase the asset values of most Saudi companies due to their cost-based treatment, resulting in lower leverage ratios, expanding balance sheets, giving a better picture of profit generation capability. Adoption of IFRS will be beneficial for listed companies with international operations as this will allow them to streamline accounting policies across respective groups as most countries allow IFRS already.

Goh, et al., (2015) investigate how investors price US banks' fair value assets since the 2008 financial crisis. They observe that financial instruments valued Level 3 fair value estimates are typically priced lower than Level 1 and Level 2 fair value estimates between 2008 and 2011 due to substantial management discretion and because of the high risk of the lack of information. Further, coefficients are more significantly so in Levels 2 and 3 suggesting that assets valued with mark-to-model are overvalued to their market value. As market conditions

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stabilize in the aftermath of the 2008 financial crisis, reliability concerns about Level 3 estimates have dissipated. Song (2015) examines empirically the effects of market volatility on the value relevance of fair values. Using a sample of 670 U.S. financial companies for the period of 2008 to 2013, He shows that fair values are priced at a significant discount when market volatility is high, especially fair value based on market inputs (Level 1 and Level 2 fair values). The findings of this study suggest that investors understand the effects of market volatility on fair values and price them accordingly. This study shed light that fair value accounting acknowledge the limitations of the market as a source of fair values by offering a three-level hierarchy with provisions for fair values to deviate from market prices.

Lawrence, et al., (2016) reevaluate the conclusion that Level 3 fair value measurements are significantly less value-relevant than Level 1 and Level 2 fair value measurements, using the closed-end fund setting in which substantially all assets are measured at fair value. Findings suggest that Level 3 fair values are of similar value relevance to Level 1 and Level 2 fair values. They suggest that contrary results in previous research are attributable to correlated omitted variable bias arising from the absence of fair value data for most assets. Aladwan (2018) examine whether the adoption of accounting measurement of AIS/IFRS standards gives investors and lenders more power in their decision-making. More specifically, if the use of fair value measurement on the value of financial instruments captures any effect on the market value of financial companies. Using a sample of Jordanian financial companies for the period 2012-2016, he provides conclusive evidence about the significant relationship that exists between fair value measurements and market value. Overall results assure that fair value measurements are relevant, reliable, and serve the primary objective of accounting information for decision making. For the sample of S&P 1,500 financial institutions for the first three quarters of 2008, Kolev (2019) examine the equity market's perception of the reliability of internally generated fair value estimates. Despite the fact that valuation coefficients generally increasing in the observability of the measurement inputs, he documents a significantly positive association between stock price and three-level fair value hierarchy. Also, he reports a significantly positive association between Level 3 net gains and quarterly returns when does he examine the periodic re-measurement of the fair value estimates. This result manifests that mark-to-model fair value estimates can be used quite reliable and not discarded.

The difficulty with focusing on the relationship between board characteristics and the relevance of fair values is that the division of power and ownership of entities has created a conflict of interest about risks and return on investment. According to Goo & Carver (2003), it is essential to have better transparency in the procedures through which a company is managed and organized, and appropriate and regular communication of vital corporate information to shareholders and prospective shareholders.

The board of directors occupies a privileged place to protect the interests of stakeholders from possible abuse by managers (Gouiaa & Zéghal, 2014). Indeed, the board plays a central role in the resolution of conflicts of interest, reduces information asymmetry, and promotes the increase of firm value. In other words, the mitigation of incentives for opportunistic behavior leads to a higher trust in financial statements which leads to a higher reflection of book values to market values, which consequently leads to a higher value relevance of book values. Thereby, firms with stronger and more effective boards are assumed to have a higher value relevance of financial statements (Siekkinen, 2017). Bhagat & Bolton (2008) consider the specific characteristics of the board as determinants of the quality and the effectiveness of corporate governance, they find that stock ownership by board members and CEO (Chief of Executive Officer) duality are positively correlated to better operating performance and a negative correlation between board independence and corporate operating performance. Song, et al., (2010) argue that the value relevance of Level 3 fair values is greater for firms with stronger corporate governance mechanisms in financial firms. They also show that board independence solely affects only the value relevance of Level 3 assets and, thereby, does not affect the value relevance of Levels 1 and 2 assets.

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In Saudi Arabia, The Capital Market Authority (CMA) has released novel regulations on corporate governance in 2017 for the companies listed on Saudi Arabia Exchange replacing the 2006 version and provides boards members and shareholders with better rights, greater clarity and more transparent as to their own roles and responsibilities in order to promote accountability, ethical behavior, transparency, and stewardship of investors' capital (Hasani & Algoere, 2019). The current Saudi Regulations on Corporate Governance (SRCG) 2017 outlines the recent evolution of corporate governance in Saudi Arabia for attaining good financial management and enhance the Saudi Arabian economy and capital market (Vision, 2030).

With respect to board independence, Article 1 of the SRCG 2017 identifies independent director as a non-executive member of the board who enjoys complete independence in his/her position and decisions with no bias to help the board make correct decisions that contribute to achieving the interests of the company. The SRCG provides instances under Article 20 where the independence of the board will be in questions. So the board should annually evaluate the extent of the member's independence and ensure that there are no relationships or circumstances that affect or may affect his/her independence. To further ensure the independence of the board, Article 16 of the SRCG 2017 provides that the majority of the board members should be non-executive directors and the number of independent directors should not be less than two members or one-third of the board members, whichever is greater?

Empirically, board independence has been highly debated in the literature especially according to the relationship with firm performance and the link between the different mechanisms of corporate governance. Habib & Azim (2008) argue that the strength of corporate governance is a direct function of board independence. Song, et al., (2010) find that the value relevance of fair value assets is positively associated with board independence in financial firms. Yasser, et al., (2011) find a significant positive relationship between board composition and two firm performance measures, return on equity, and profit margin. Likewise, Khan and Awan (2012) conclude that firms with greater independent directors showed a greater return on equity and return on assets. However, Bhagat & Bolton (2008) argue a negative correlation between board independence and firm performance, the ratio of outside board members appears to be positive for the firm and its stakeholders. Finally, Cornett, et al., (2008) demonstrate that if outside board members enhance the monitoring of managers, board independence should also be associated with higher accounting quality.

Board efficiency involves the issue of increases in coalition costs between members and the fact that boards with more members have greater difficulty finding time to discuss and reach consensus on issues pertaining to the company’s organizational structure (Shen et al., 2016). Based on the agency theory, larger companies need larger boards to control and monitor the management actions. Under the SRCG 2017, the number of board members should be suitable for the size and nature of the company's activities without prejudice to paragraph (a) of Article 17 of these regulations which indicate that the company’s bylaws should specify the number of the Board members, provided that such number shall not be less than three and not more than eleven.

According to Ahmed & Duellman (2007), larger boards can face the problem of "free-riding" in the sense that the members of the board depend on each other to monitor management. In other words when the number of directors increases, the board’s efficiency decreases, and internal conflicts can arise. Cornett, et al., (2008) discuss that the size of the board is expected to be negatively associated with monitoring quality, as they argue that larger boards are less effective and more easily influenced by the CEO. However, Dimitropoulos & Asteriou (2010) find no relation between board size and in formativeness of accounting earnings. Moreover, Siekkinen (2017) shows that board size is not significantly associated with market value.

The audit committee is commonly viewed as a monitoring mechanism that can make a significant contribution within a good corporate governance framework and reduces agency problems in organizations (Balagobei, 2017). Furthermore, several authors examine the impact

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of the audit committee on the value relevance of accounting information (Moses, 2016; Al-Matari et al., 2014; Sharma & Iselin, 2012). The results reveal that audit committee attributes, especially meetings and size have a significant impact on book value per share.

Audit committee activity is commonly used as a proxy for audit committee diligence (Balagobei, 2017; Sharma & Iselin, 2012; Hermawan, 2011). Actually, the audit committee that conducts frequent meetings is more probable to function more effectively and it is expected to perform its duties based on the audit committee charter effectively. Sharma & Iselin (2012) show that the frequency of audit committee meetings has a positive and significant impact on the quality of financial reporting. They find that an audit committee that meets at least four times a year has a negative impact on the restatement of financial statements. Hermawan (2011) finds that the cost of corporate debt decreases with an increasing number of audit committee meetings. This indicates that the activity of the audit committee in the form of regular meetings will improve the quality of financial statements and the relevance of fair value.

Additionally, firms with larger audit committees have higher quality information about firm-generated fair value estimates. Moses (2016) remarked that the ability of the audit committee oversight function rises when the figure of its memberships increases. These inputs suggest that the audit committee size constitutes a significant factor for the effective performance of the firm and specifically the relevance of fair value. Al-Matari, et al., (2014) argue that the presence of an important audit committee plays an important monitoring and controlling role of management activities that result in increased performance of the firm. According to Mohammed–Nor, et al., (2010) the size of the audit committee enhances the quality of financial reports. In the same line Persons (2009) argues that the audit committee size affects corporate disclosures. A bigger size of the audit committee can alleviate material differences throughout the tested equity submissions.

The latest Saudi Arabia recommendations to set up an audit committee came in Articles 54 to 59 of the SRCG 2017. On our part, Article 54 provides that the number of members of the audit committee shall not be less than three or more than five, provided that one of its members is specialized in finance and accounting. Moreover, Article 57 states that the audit committee shall convene periodically, provided that at least four meetings are held during the company's financial year, and at any time as may be necessary. Another remarkable development brought by SRCG 2017 was that, under Article 56 of the SRCG 2017 where "a conflict arises between the recommendations of the audit committee and the Board resolutions, or if the Board refuses to put the committee's recommendations into action as to appointing or dismissal the company's external auditor or determining its remuneration, assessing its performance or appointing the internal auditor, the Board’s report shall include the committee's recommendations and justifications, and the reasons for not following such recommendations".

The increased presence of women on the board of directors is expected to improve its effectiveness in carrying out its oversight functions and making the right decisions in favor of greater transparency through a better quality of financial and accounting information. Indeed, when women are represented in the board of directors, they actively seek to show other directors and stakeholders that they are also as competent in the fulfillment of their duties, making the board more effective in terms of guaranteeing reliable information and exerting efficient control over the accounting and financial reporting process (Gouiaa & Zéghal, 2014).

According to Adams & Ferreira (2009) in addition to their competence women bring new knowledge and new contacts to the board of directors for which relationships are very important. Nielsen & Huse (2010) added that these conclusions are recognized mainly to leadership styles more projecting in female leaders. Further, they reveal that the representation of women as board members increases board development activities and reduced the level of conflict. Campbell & Minguez-Vera (2010; 2008) argue that the gender composition of the board affects the quality of the monitoring role performed by the board of directors in a European setting. They show that the percentage of women on the board is positively associated with firm value and that the stock prices react positively to the appointment of female board

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members generating economic gains. In a related study, Gul, et al., (2011) find a positive association between gender diversity and stock price in formativeness. Furthermore, Branson (2012); Lu¨ckerath-Rovers (2013) find that firms with female board members perform better than those without female board members and state numerous benefits to corporations for having women among their board of directors. As cited in Hasani & Algoere (2019), these benefits include constructive role models for women in the intermediate and lower rank of companies, and diversity aids in avoidance of "groupthink". In the same idea, Hill, et al., (2015) opine that among the benefits of having female representation in the boardroom are greater innovation through diversity of thought, and development through a keen focus on performance results.

In Saudi Arabia, the SRCG 2017 does not prescribe certain quota to women regarding board and senior management positions. Despite this, some companies have achieved adequate gender diversity levels and many others continue to struggle. Continued efforts to improve boardroom gender diversity are issued, reflecting gender diversity as a key priority for Saudi Arabia.

Taking the findings together, gender diversity in the board leads to the better monitoring of managers, which decreases the risk for opportunistic behavior, and enhance the quality of financial statements.

From the above, and in the absence of previous studies in Saudi Arabia's context we must examine whether the value relevance of fair values depends on the firm's board characteristics, in a post-IFRS 13 era. As the risk related to discretion allowed to fair value estimates (Level 3) is harsh and cannot be controlled by investors, it is critical to investigate whether one of the most important determinants of corporate governance, *i.e.*, board characteristics, can mitigate the problems of fair value accounting. Behaving in this way, we are interested, first, in testing the value relevance of fair value measures for Level 1 versus Level 3. As Song, et al., (2010) we consider that the relevance with Level 2 fair values potentially falls between those of Level 1 and Level 3 fair values. Second, we will allow time to analyze whether board characteristics should play a larger role in the value relevance of Level 3 fair values where management's opportunistic behavior is likely to be highest. We estimate that Level 1 fair values are much less likely to suffer from information asymmetry, and one might expect that the effect of corporate governance mechanisms on the relevance of fair values is undermost.

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