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# BOARD OF DIRECTORS' CHARACTERISTICS AND BOARD COMPENSATION MODERATED BY FAMILY CONTROL

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***Abstract***

*This study used a dataset of 219 listed firm years on the Tadawul Stock Exchange in 2018-2020, to examine how family ownership concentration, proxied by the family board shareholding, board composition and firm attributes, impact board compensation in Saudi Arabia. The research proves that the family board does not demand excessive director compensation, from minority shareholders, by expropriating them. However, it was interesting to note that this current work offers are in line with entrenchment effect theory, as it documents*

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*that family control (family with higher share proportion) calls for a high director compensation. The finding of the research implies that ownership concentration in the family board entrenches the level of the board compensation.*

***Keywords:*** *Board of Directors Characteristics, Board Compensation and Family Control*

***JEL Code:*** *J13 and J33*

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## 1. Introduction

Executive and board compensation worldwide have received much attention from the media and the public, thus calling for a closer assessment of the design of the pay structure **Ilhan-Nas et al., (2018)**. From a policy perspective, numerous legislators and regulators worldwide, including those in the United States, the United Kingdom, Asian countries and Saudi Arabia, have taken action to guarantee the independence of boards and the elimination of the conflicts of interest of boards and compensation committees in public companies **Bamahros, (2021)**. For instance, Fortune magazine reported an approximately 20% increase in the compensation rates of the largest public companies since 2012. Notably, this rise is twice as much as the increase in the wages of average Americans. As such, the 21st Century has been marked by the sharp increase of the average pay of directors in boards **Ilhan-Nas et al. (2018)**. Given this situation, opposing sides have raised the question of whether directors are actually more skilled and productive than the average employees and whether the higher salaries of the former are reasonable. The excessive pay that directors receive despite their lower performance, negatively affects other shareholders **Voordeckers et al. (2007)**. A director typically works a few hours every week while simultaneously working full time in a different organisation. In the United States, this issue has been aggravated by the ineffective enforcement of capital market regulators, thus constraining the protection of investors and faulty financial markets and putting the wealth of shareholders at risk **Sarhan, et al. (2019)**. As a country that also experiences the above mentioned issue, Saudi Arabia amended its corporate governance code in 2017. This revision aims to reinforce this regulation. Moreover, it seeks more transparent financial reports and the enhanced protection of the value of shareholders. Further, Article 93 of the Corporate Governance Regulations (2019), which discusses the compensation of directors, states that all capital market players in Saudi Arabia must submit an audited annual report, including the disclosure of the compensation costs of their directors. Meanwhile, the revised Companies Law, through Royal Decree No. M/6 of 1385H, indicates that joint-stock companies must provide articles of association that indicate the methods through which directors will be given compensation. In addition, after certain specified deductions and reserves, as well as the dividend distribution above 5% of the company's capital, this payment must be less than 10% of the company's net profits.

Consequently, the present work assesses family board ownership concentration through the family members' shares. Secondly, it determines the composition of the board, using the board's size, independence, gender proportion, ownership and international ownership. Thirdly, the study also considers other characteristics of the firm, such as approved capital, costs of workers and number of subsidiaries.

## 2. Review of Literature

### *2.1 Board family and board compensation*

Since the late 1990s, studies on equity ownership concentration have expanded to discuss emerging market countries. These works have indicated the prevalence of concentrated ownership structures worldwide, compared to relatively diffused structures in large, publicly traded firms in the United States and the United Kingdom **Vieira (2018)**. However, this generalisation overlooks significant variations across countries, in terms of the degree of ownership concentration and the identities of block holders. For instance, concentrated family ownership is predominant in Saudi Arabia. **Bertrand and Schoar (2006)** claimed that the interests of the controlling family drive the decisions in such firms, particularly, when these interests may differ from those of minority shareholders. Previous research has also demonstrated the negative consequences of family ownership on firm performance **(Ilhan-Nas et al., (2018).**

Families are large shareholders in businesses, and they give importance to control and often participate in managing the company (in Korea, for instance, such members are often called chaebol). But their participation may cause the firm to perform poorly **Perez-Gonzalez, (2006); Bennedsen et al., (2007).** There is substantial number of recent studies on family ownership in the Saudi Arabian setting (i.e. royal family members **Nasser, (2019),** ownership structure **Al Bassam et al., (2018); Alsahlawi and Ammer, (2017); Al-Ghamdi and Rhodes, (2015); Buallay et al., (2017); Hamdan et al., (2017)** and family business **Hamdan et al., (2017).**

### *2.2 Board family shareholding and director compensation*

Following the interest alignment effect, a family board does not significantly impact the increase of director compensation. Family boards are more inclined towards maximising the value of shareholders **(Jensen and Meckling, 1976).** In addition, they focus more on long-term interests, such as developing a sustainable business and achieving long-term growth. However, families that own major shares, can have several avenues to expropriate wealth from minority shareholders, such as creating excessive compensation **Ilhan-Nas et al., (2018); Brunninge, & Nordqvist, (2004).** When a family member holds a large proportion of shares, families can take advantage of this situation by setting their compensation at high levels as a way to enhance the well-being of the family board and expropriate wealth from other shareholders. This argument supports managerial power theory, which suggests that family boards with power, can set their own compensation arrangements **Croci**. **et al., (2012).**

## 3. Statement of the Problem

Among the most prominent traits of the economy of Saudi Arabia is the intense conflict in management amidst the prevalence of family ownership in firms. Five of the top 10 companies, with the highest turnover and sales, are family owned. Among these firms is Prince Al-Waleed bin Talal's Kingdom Holding Company **(Al-Ajlan, 2004).** In addition, majority of companies, listed in Arab countries, are operated by families. Thus, this proportion reflects the power that family members typically hold in firm management as chairpersons or members of the board as well as members of senior management **(OECD, 2003).** Consequently, conflicts between the interest of higher management and minority stakeholders emerge from such involvement, thus calling for the understanding of how corporations are governed in Arab countries **Bamahros, (2021).** A handful of works have examined the influence of corporate governance in developed markets, by considering several factors, such as liquidity, costs of transaction, mechanisms in trade and size of trade. However, similar studies have scarcely been conducted for the Saudi stock market.

## 4. Need of the Study

The limited literature on the directors' compensation in Saudi Arabia, has also become one of the motivations for this study. By providing new evidence, this work can add new and interesting observations pertaining to this issue.

## 5. Objectives of the Study

The main objective of this study was to provide novel insights into the concentration of family board ownership and its impact on board compensation. The study also seeks to add to the existing literature on Saudi Arabia's governance structure, by examining the extent of the implementation of contemporary economic, financial and social reforms.

## 6. Hypotheses of the Study

**H1:** There is a negative relationship between the family board and director compensation.

**H2:** The negative relationship between family board and director compensation is moderated by high ownership concentration.

## 7. Research Methodology

### 7.1 Sample Selection

This study was based on secondary data, which were collected from the Saudi Stock Exchange database (TADAWUL). The study analysed 219 firm years in the study sample due to unavailable annual reports, as of the end of 2018 to 2020. As shown in **Table-1**, approximately 219 usable sampled firm years, from the total population, were analysed in this study.

### 7.2 Sources of Data

Data were obtained from the Saudi Stock Exchange database, based on publicly available information in the annual report and the Tadawul website (https://www.tadawul.com.sa/). The data, for all the variables in the study, were collected from the annual reports, available on the Tadawul website.

### 7.3 Period of the Study

The study used panel data for the years 2018, 2019 and 2020, to examine the relationship between board of directors′ characteristics and board compensation. This time period was sufficiently updated to provide the post-effects of Saudi Arabia's newly amended CG Code in 2017.

### 7.4 Tools used in the Study

This study used secondary data and the ordinary least square (OLS) regression model was used to study the relationship between family boards and ownership, and board compensation. In order to control for potential serial correlation and heteroskedasticity problems, OLS regression, with Huber-White robust standard errors, was selected. Further, the study included year fixed effects to control for systematic variation. The data were analysed by using STATA software. The empirical models are shown below:

$BC = \beta_0 + \beta_1 famboard + \beta_2 bsize + \beta_3 bindp + \beta_4 boardwomen + \beta_5 bshare + \beta_6 bforeign + \beta_7 lncap + \beta_8 foreignown + \beta_9 subsidiaries + \beta_{10} employeecost + \beta_{11} Yeardummies + error\ term$ (1) – **Equation$_1$**

The basic hypothesis of this research considered family board ownership as a moderator variable, in the relation between family board and board compensation. The moderator was considered a second independent variable, that affected the direction and strength of the relation between the dependent and independent variables. Hence, the operational measures of all variables in this study are as follows:

$BC = \beta_0 + \beta_1 famboard + \beta_2 famboard{*}share + \beta_3 bsize + \beta_4 bindp + \beta_5 board women + \beta_6 bshare + \beta_7 bforeign + \beta_8 lncap + \beta_9 foreignown + \beta_{10} subsidiaries + \beta_{11} employeecost + \beta_{12}\ Yeardummies + error\ term$ *(1)* – **Equation$_2$**.

## 8. Data Analysis

**Table-2** represents the descriptive statistics of all variables for this study. The average total Board Compensation (BC) was SAR14.5 million. The minimum BC received by the boards, in the sampled study, was SAR33,000, and the maximum BC was SAR133.250 million. The average family members, seated in the board, was one. Meanwhile, some firms had no family members on the board (0). In other cases, the maximum number of family members on the board was five. The average share ownership among family boards was 2.05%, and the maximum share of family members was 39.88%. In some firms, none of the members in their family boards held any shares in the firm (0%). Furthermore, this study had nine control variables. On an average, eight (8) directors served on the management board, with a minimum number of five (5) boards and a maximum number of eleven (13). In addition, sampled firms had approximately 45.88% board independence, with the minimum being 33% and the maximum being 87.88%. On observation, all firms in the sample followed the capital market requirement, regarding the need to maintain at least one-third of board independence to protect minority shareholders. Of the 219 firm years, approximately 13% of women directors were seated in the board of director, with the maximum number of women directors being three. The study also included board shareholding and found that the average share percentage that the board of directors held was 11.95%. In addition, some boards of directors did not hold any percentage of shares (0%). The maximum shares held by the director in the firm were 96.67%. The maximum number of foreign directors serving the board of director was four (5). Notably, not all firms had foreign directors in their board. The analysis indicated that some of the firms did not have foreign directors on the management board. The low number of these directors could be attributed to the local regulations towards the Vision 2030 agenda, which aimed at maintaining the Saudisation status.

The average authorised capital was SR5.04 billion, the minimum was SR110 million, and the maximum was SR39.047 billion. The Saudi capital market also allowed for foreign investment to boost the growth of the foreign economy. On an average, 7.04% of foreign ownership was observed in the firms in the sample study. The minimum share investment of foreign ownership was 14%, and the maximum was 49.44%. Moreover, the study included a number of subsidiaries in the sample as control variables. The maximum number of subsidiaries by the sampled firms was 28. Notably, some firms had zero (0) subsidiaries. To be consistent with the benefit of BC, the research included employee cost as a control variable. On an average, the employee cost was SAR650 million. The maximum employee cost was SR 25.8 billion, while the minimum was SAR1.03 million.

To understand the varying impacts of the variables on BC, two different models were structured. **Table-3** provides the regression result for both structured models, which has been tabulated in Panel A and Panel B. Panel A presents the regression analysis for Equation 1 on the association between Family Board and BC. The association between Family Board and BC was negative for BC. This outcome demonstrated that the presence of more family members on the board had no effect on the director compensation. This trend was consistent with the interest alignment effect, which indicated that managerial opportunism was absent among family boards because they were focused on long-term benefits rather than short-term benefits. The negative association between Family Board and BC was consistent with **Voordeckers et al (2007).** The first hypothesis (H1) was supported.

Panel B, in **Table-3,** illustrates the regression analysis for the second hypothesis of this study. The outcome indicated a positive and significant relationship between family board ownership and director compensation. Moreover, the finding explained that a greater proportion of shares, held by family boards, signified a greater influence on firm control. Thus, they could demand a higher director compensation. This result was consistent with the findings of **Nyambia and Hamdan (2018), and Raheja (2005)**, who had concluded that directors, who were majority shareholders, were paid more than other management staff. Hence, this observation hinted that family boards prioritised long-term interests over short-term interests. Hence the second hypothesis (H2) was rejected. Panel A presents the 10 control variables, included in the study. In particular, Foreign Board, Authorized Capital, Subsidiaries and Employee Cost had reported significant association with BC. The association was consistent with the results of previous studies **Masulis et al., (2012); Pathan and Skully, (2010).**

**9. Findings of the Study**

The study found strong negative association with foreign directorship, influencing the board compensation. This finding was consistent with **Masulis, et al., (2012).** The presence of foreign directors on the board might control the board's biased decision, thus bringing numerous benefits to the firm and mitigating the managerial opportunism or expropriation of insiders **Ilhan-Nas et al., (2018); Choi, et al., (2007).** The findings also revealed that the other control variables (Authorized Capital, Number of Subsidiaries and Employee Cost), were positively associated with BC. Thus, this outcome indicated that firms, with more resources, were able to pay a higher compensation, to the board of directors and executives. These findings are in line with the majority of previous research **Ilhan-Nas et al., (2018); Brunninge & Nordqvist, (2004).**

## 10. Suggestions

The findings suggest that boards, demanding higher compensation, may exchange their dual role as directors and owners. The family board of directors, which owns more shares in the company, may take more power and make use of the company's resources for its own purpose.

## 11. Conclusion

The purpose of this work was to determine the factors, that influence board compensation, in listed firms in Saudi Arabia. The major finding of this research was the concentration of ownership in the family board and its effect on the entrenchment of the level of board compensation. The study discovered a negative relationship between family boards and board compensation, thus implying that family boards were not concerned with short-term gains. In the second association, the study found a significantly positive relationship between family boards that hold significant shares and the level of director compensation. The findings implied that such boards demanded higher compensation in exchange for their dual position as directors and owners. The family board, that holds more shares in the company, assumes more control and uses the firm's resources for their own benefit **(Nyambia & Hamdan, 2018),** as reflected by their excessive director compensation.

## 12. Limitation of the Study

The study was limited to Saudi publicly traded companies and the findings may not be applicable to other nations or private companies. On the other hand, the results cannot be generalized in a broader analysis due to the small sample size and lack of information.

## 13. Scope for Further Research

In future, the study could look at all Gulf countries. Another possible direction for future research is to look at cross-sectional analysis, by comparing before and after the corporate governance regulations in 2017.

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**Table-1: List of Sample Firms**

| Description | Number |
|---|---|
| Total companies listed on the Tadawul Stock Exchange from2018 to 2020 | 579 |
| Companies with missing annual report | 9 |
| Companies with missing compensation data | 240 |
| Companies from REITS sector | 51 |
| Companies with missing information | 60 |
| Final sample | 219 |

**Source:** Required Data were extracted from Saudi Stock Exchange and computed using STATA Software

**Table-2: Result of Descriptive Statistics showing the Appropriateness of Variables**

| Variables | Mean | Std. Deviation | Minimum | Maximum |
|---|---|---|---|---|
| Board Compensation (BC) | 14,568,132 | 22.73 | 33,0000 | 133,250,000 |
| Family Board | 1 | 1.45 | 0 | 5 |
| Family Board Ownership | 2.05 | 5.93 | 0 | 39.88 |
| Board Size | 8.55 | 1.50 | 5 | 13 |
| Board Independence | 45.88% | 14.12 | 33.00% | 87.88% |
| Women on Board | 0.13 | 0.33 | 0 | 3 |
| Board Shareholding | 11.95 | 15.23 | 0 | 96.67% |
| Foreign Board | 0.66 | 0.66 | 0 | 5 |
| Authorized Capital | 5,041,040,776 | 8.21 | 110,614,060 | 39,047,964,000 |
| Foreign Ownership | 7.04 | 8.33 | 0.14 | 49.44 |
| Subsidiaries | 1.6 | 6.33 | 0 | 28 |
| Employee Cos | 650,133,231.9 | 22.959 | 1,034,885 | 25,800,612,000 |

**Source:** Required Data were extracted from Saudi Stock Exchange and computed using STATA Software

**Table 3: Result of Regression Analysis showing the Significance of Board of Directors´ Characteristics and Director Compensation**

| Variable | Panel A (Equation 1) | | Panel B (Equation 2) | |
|---|---|---|---|---|
| | Coefficient | p-value | Coefficient | p-value |
| Family Board | -2.658 | 0.005 | -2.856 | 0.005 |
| Family Board Ownership | - | - | 2.032 | 0.079 |
| Board Size | -0.115 | 0.845 | -0.286 | 0.654 |
| Board Independence | 0.958 | 0.365 | 1.264 | 0.195 |
| Women on Board | 1.777 | 0.081 | 1.715 | 0.089 |
| Board Shareholding | 1.251 | 0.216 | -1.451 | 0.311 |
| Foreign Board | -2.144 | 0.036 | -3.366 | 0.000 |
| Authorized Capital | 2.444 | 0.018 | 3.854 | 0.000 |
| Foreign Ownership | 1.787 | 0.165 | 1.887 | 0.077 |
| Subsidiaries | 2.564 | 0.036 | 1.971 | 0.046 |
| Employee Cost | 3.543 | 0.000 | 3.879 | 0.000 |
| Constant | 3.214 | 0.000 | 7.116 | 0.000 |
| Year Dummy | Yeas | | Yeas | |
| Number of Observations | 219 | | 219 | |
| Adjusted $R^2$ | 0.612 | | 0.797 | |
| F-stat | 8.922 | | 6.544 | |

**Source:** Required Data were extracted from Saudi Stock Exchange and computed using STATA Software

*Board compensation: The natural Logarithm of Total compensation (Salary, Bonuses, Allowances, Benefit in Kinds, etc); Family Board: The proportion of family members seat in the board to total board size; Family Board Ownership: The percentage of shares held by family members who are seated in the management board; Board Size: The total board size; Board Independence: The proportion of independent board to total board size; Women on Board: The proportion of women directors to total board size; Board Shareholding: The percentage of shares held by the board of directors; Foreign Board: The proportion of foreign directors to total board size: The proportion of foreign directors to total board size; Authorized Capital; The natural logarithm of the total authorized capital of the firm; Foreign Ownership: The total shares held by foreign shareholders; Subsidiaries: The number of subsidiaries; Employee Cost: The natural logarithm of employee cost (i.e, revenue employee cost, administrative employee cost and sales employee cost)*