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AUDIT COMMITTEE CHARACTERISTICS AND PERFORMANCE OF BANKS IN THE KINGDOM OF SAUDI ARABIA: THE MODERATING EFFECT OF ENVIRONMENTAL DISCLOSURE

Emran Ali Mustafa Alshorman[1]
Char-Lee Lok[2*]

[1]School of Management, Universiti Sains Malaysia (USM), Malaysia, (E-mail: Emranshorman@student.usm.my)
[2]School of Management, Universiti Sains Malaysia (USM), Malaysia, (E-mail: lokcl@usm.my)
[*]Corresponding Author

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Abstract: *This study examines the effect of audit committee financial expertise and its independence on the performance of Saudi Arabian banks. In addition, the paper assesses the moderating effect of Environmental Disclosure (ED) on the association between audit committee characteristics and bank performance. The study's sample was drawn from banks listed on the Saudi Stock Exchange (SSE) between 2016 and 2020. Descriptive statistics and correlation analysis were applied to the collected data. The results suggested that audit committee independence and financial knowledge of audit committees positively affect bank performance in KSA. Moreover, ED moderated the relationship between audit committee independence and bank performance in KSA, as well as the relationship between financial knowledge of audit committees and bank performance in KSA. In future studies, the researchers propose using alternative accounting metrics and market measurements to provide a more complete picture of a firm's performance than conventional accounting measures.*

Keywords: *Audit Committee's Financial Expertise (COMBBSK), Audit Committee's Independence (COMIND), Environmental disclosure (ED).*

Introduction

Currently, Saudi Arabia faces challenges in governance mechanisms due to diverse cultural mechanisms, and the concept of corporate governance is misunderstood (Sharma & Senan, 2019). The financial crisis in many banks has caused the Saudi stock market's price index to plunge by approximately 13,000 points in one month (65% of its maximum level) (Al-Twaijry, 2007). As a result of the banks' failing auditing practices, minor stakeholders suffered significant financial losses. During the 21st century, modern corporations have experienced several challenges for survival. Thus, the critical success factors include sufficient education and financial expertise in human resources, especially in top-level management (Niazi et al., 2021). Earlier researchers have suggested that content knowledge alone is insufficient for

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ensuring hierarchical success; instead, an eccentric integration of various capabilities and personality factors is also essential (Laud et al., 2016).

Besides financial performance, climate change directly affects the economy owing to several environmental alterations, such as rising temperature and sea levels, extreme and frequent storms, droughts, and floods (Rudebusch, 2019). These climate change-induced consequences directly influence the state's financial and monetary policies. There are growing concerns in the KSA about environmental disclosure (ED) due to increased consumption of fossil fuels such as natural gas, oil, and coal, which are burnt by electric power plants, factories, households, and motor vehicles. Carbon dioxide emissions are the most significant source of greenhouse gases and pose a risk of global warming. Different companies mainly publish the ED in their regular annual reports, and investors can easily distinguish the companies doing green business from those who are not practicing based on this information (Alessi et al., 2021). Studies on the relationships between corporate governance, environmental disclosure, and firm performance in the KSA context aid in recognizing certain economic operations' negative impacts. Banks play a crucial role in mitigating the effects of climate change by allocating funds to the most vulnerable areas. Although good corporate governance is emphasized for banks in the KSA, only a few papers address this issue (Ahmad & Omar, 2016; Alhammadi et al., 2020; Aslam & Haron, 2020; Huu Nguyen et al., 2020; Malik, S. A. (2015).

This study examines the effect of the audit committee's independence and financial expertise on the performance of Saudi Arabian banks. In addition, the paper assesses the moderating effect of Environmental Disclosure (ED) on the association between audit committee characteristics and bank performance in the Kingdom of Saudi Arabia (KSA). There is a need to co-explain the role of an independent audit committee in improving the efficiency and performance of the banking sector amid the disastrous phenomenon of climate change. In addition, how potential financial experts can help banks optimize their performance under these crises by ensuring efficient allocation of resources. This research makes an essential contribution to the accounting and auditing fields of the banking industry in the Kingdom of Saudi Arabia. Furthermore, it would be helpful for corporate organizations to promote and strengthen their environmental efforts.

Literature Review and Hypotheses Development

Audit Committee Independence

Andesto (2022) proposed that the number of independent commissioners significantly influences the company's value and performance. This effect is amplified when most members are drawn from the business's external environment. Kallamu and Saat (2015) also contend that including independent directors on the audit committee improves the company's performance. Similarly, Al-qatamin et al. (2020) discovered a positive relationship between the independence of audit committee members and the company's profitability. According to agency theory, independent directors from the company's external environment are expected to contribute to corporate profitability positively. As a result, the following hypothesis is proposed in this study:

*H*1: The independence of an audit committee improves a bank's performance.

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Audit Committee Financial Expertise

The audit committee offers an important role in monitoring and supervising organizational management in executing internal regulation of accounts and preparation of the financial statements (Arun et al., 2015; Zalata et al., 2018). According to Khudhair et al. (2019), good audit quality attracts more investors. Similarly, Sellami and Fendri (2017) asserted that the higher the percentage of experienced members in an audit committee, the better its performance. As a result, financial expertise positively impacts a company's market profitability. Therefore, this study proposes the following hypothesis:

*H*2: The audit committee's financial expertise improves the performance of a bank.

Moderating Effect of Environmental Disclosure

According to Janani et al. (2022), corporate social performance has become a significant performance indicator for firms. Environmental disclosure is considered significant for two primary reasons. First and foremost, it is directly related to human health. Second, it can help stakeholders make the best decision (Habbash, 2015). Environmental disclosure (ED) aids the investors in assessing the corporate's idiosyncratic menaces (Li et al., 2022). Global environmental concerns are growing, and corporations are under increasing pressure to disclose how their economic activities impact the environment (Habbash, 2015) (Peiyuan, 2005). Consequently, corporate social responsibility must be adopted to control environmental threats resulting from economic operations (Giannarakis, Konteos, & Sariannidis, 2014). However, no global regulations require firms to disclose accurate reporting, making environmental disclosure a voluntary action.

In general, environmental disclosure (ED) exerts a strong positive impact on the marketing as well as financial performances of banks (Komarnicka & Komarnicki, 2022). It was suggested that the attainment of ecological sustainability and environmental transparency had become the most important factors for corporations (Li et al., 2017). Banks need to perform energy saving as well as emission declining reforms and, in this way, the development of the green finance sector should be ensured, which has allowed the banks to improve their financial performance on a sustainable basis (Kpphgn et al., 2020; Zheng et al., 2021). Xi et al. (2022) reported that the improved quality of environmental disclosure augments the financial performance of the banks, and green finance development moderates the relation between bank financial performance and environmental information disclosure. The company can reduce information asymmetry by providing high-quality environmental information as a strategic tool. Therefore, the following hypotheses are proposed in this research:

*H*3: The relationship between the audit committee's independence and bank performance is moderated by environmental disclosure.

*H*4: The relationship between the audit committee's financial expertise and bank performance is moderated by environmental disclosure.

METHODOLOGY

Data

The data on the financial expertise and title of the directors, environmental disclosure, and financial information of all banks in KSA are collected from published annual reports covering 2016 to 2020. The banking industry in Saudi Arabia is a critical and crucial sector because it

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accounts for more than 53% of the trading value on the Saudi Stock Exchange. As a result of the country's extensive economic liberalization, the banking sector is critical to the country's transition to free-market trade. The listed banks are made up of 12 local commercial banks. The local banks are Alinma Bank, Al Rajhi Bank, Arab National Bank, Bank Al Bilad, Bank Al Jazira, Banque, Saudi Fransi, National Commercial Bank, Riyad Bank, Samba Financial Group, Saudi British Bank, Saudi Hollandi Bank, and Saudi Investment Bank,

Models And Estimation Methods

This study analyses fixed effects regressions to assess the effect of audit committee's characteristics on firm performance on an individual level. This study then investigates the moderating effect of environmental disclosure on the connection between audit committee's features and bank performance. On the basis of the existing literature and the rationale for the necessity to control for banking industry-specific issues, each model incorporates pertinent control variables. The following models are offered for analysis (excluding firm dummies and time dummies for the fixed effects technique).

$$ROA_{it}=\alpha + \beta_1 \text{COMIND}_{it} + \beta_2 \text{COMFIN}_{it}+\beta_3 \text{LEVER}_{it}+\beta_4 \text{LIQ}_{it} + {}_5 \text{TANG}_{it}+\beta_6 \text{FS}_{it} + \mu \quad (1)$$

$$ROA_{it}=\alpha+ \beta_1 \text{COMIND}_{it} + \beta_2 \text{COMIND} * \text{ED}_{it} + \beta_3 \text{COMFIN}_{it} + \beta_4 \text{COMFIN} * \text{ED}_{it} + +\beta_5 \text{ED}_{it}+\beta_6 \text{LEVER}_{it}+\beta_7 \text{LIQ}_{it} + \beta_8 \text{TANG}_{it}+\beta_9 \text{FS}_i + \mu \quad (2)$$

where ROA is calculated by dividing net profit by total assets for bank i over time t. This study's dependent variable is the firm's profitability as measured by an accounting-based metric. Return on assets (ROA) is a prerequisite for a company's long-term viability. ROA describes a company's financial situation in financial literature and analysts (Munawir, 2007).

COMIND denotes the proportion of independent board members serving on the audit committee. COMFIN is the fraction of audit committee members with financial expertise. ED is a dummy variable whose value is 1 if the information is disclosed in the annual or corporate social responsibility report and 0 otherwise. This study employs the unweighted dichotomous index as a proxy for environment disclosure (ED) to prevent the subjective perception that different items may have different weights. Previous research (Williams, 2001; Ragini, 2012; Chaklala & Gulati, 2015) utilized the same measurement to reduce subjectivity. The study also examines several firm-level and board-level control variables and their influence on bank performance. The firm-level variables included are firm leverage (LEVER), Liquidity (LIQ), Tangibility (TANG), and firm size (FS) (Vafaei, Ahmed, & Mather, 2015). LEVER is the ratio of total liabilities to total equity. LIQ is the ratio of total current assets to total current liabilities. TANG is the ratio of fixed assets to total assets. FS is the natural log of the total assets of the firm.

Results

Descriptive Statistics

Table 1 shows a detailed summary of all variables' descriptive statistics. ROA, which measures bank performance, has a mean value of 0.015 and a standard deviation of 0.013. The audit committee independence (COMIND) index has a mean value of 0.394, indicating moderate progress in audit committee independence in banks in the Kingdom of Saudi Arabia. The audit

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committee financial expertise (COMFIN) mean value of 0.449 indicates that many audit committee members have financial expertise.

Table 1: Descriptive statistics

Variable	Observations	Mean	Std. Dev.	Min	Max
Return on Assets	105	0.015	0.013	-0.016	0.089
Audit Com Independence	105	0.394	0.279	0.000	0.80
Audit Com Financial Expertise	105	0.449	0.125	0.200	0.600
Leverage	105	5.138	2.662	0.001	12.712
Liquidity	105	2.931	13.69	0.093	132.133
Tangibility	105	0.729	0.245	0.034	0.992
Firm Size (million USD)	105	929,429	1,760,675	63,207	11,419,615
Environmental Disclosure	105	0.619	0.487	0.000	1.000

Declaration of Panel Data

The data must be declared as panel data to enable the software to deal with the data effectively when using software such as STATA, version 16.0. Thus, the duration of this study is T=5 years, and the number of banks is N=21. As a result, the total number of observations was 105 (N=21*T=5). According to Hair, Hult, Ringle, and Sarstedt (2017), if the missing values of observations are less than 15%, researchers can replace them with the mean value. However, if more than 15% of the observations were missing, the observation should be removed from the dataset. This study had no missing values, and the data were strongly balanced. In other words, all bank observations from the previous five years were available and recorded.

Normality Test

The residual of the dependent variables can be used to test for normality. To test for normal distribution, the dependent variable's residuals are generated. Figure 4.1 depicts the residuals of ROA. The figure represents a bell-shaped curve, indicating a normal distribution.

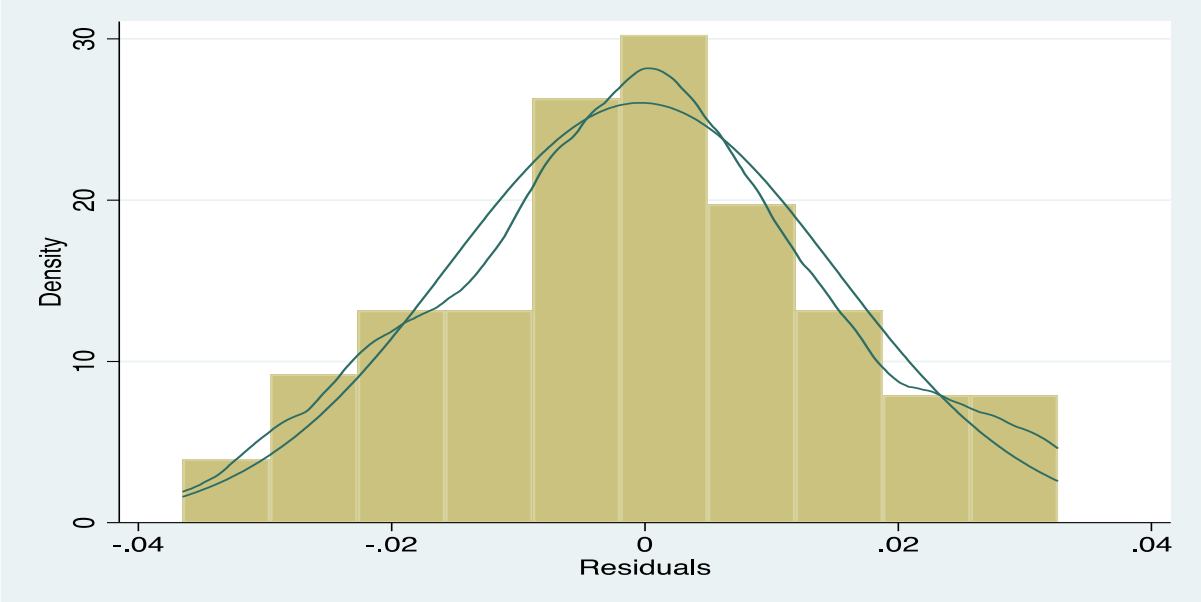

Figure 1: Residuals of normality of ROA

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Multicollinearity Test

To confirm that there is no multicollinearity issue, the Variance Inflation Factor (VIF) value must be less than 10 for all variables. Furthermore, 1/VIF or the tolerance must be greater than 0.10. In Table 3, the maximum VIF value is 2.39, indicating no multicollinearity problem in any of our model's variables and that all explanatory variables are independent of one another.

Table 3 Variance inflation factor of all independent variables

Variable	VIF<10	1/VIF>0.10
Tangibility	3.1	0.322
Liquidity	3.02	0.330
Firm Size	2.51	0.398
Leverage	2.01	0.496
Environmental Disclosure	1.91	0.523
Audit Committee Financial Expertise	1.72	0.582
Audit Committee Independence	1.68	0.595
Mean VIF	2.39	

Regression Analyses

Table 4 summarizes the findings of regression analyses on the effects of audit committee characteristics on bank performance. The Audit Committee Independence has a positive effect on ROA with a coefficient of 0.019 (p-value 0.013), indicating that having more independent directors on the audit committee can increase banks' ROA. According to the findings of several studies, Kallamu and Saat (2015) emphasized that the inclusion of independent directors on the audit committee enhances the company's performance, whereas Al-Qattamin (2018) found a positive relationship between the independence of audit committee members and the company's profitability. Furthermore, the effect of Audit Committee Financial Expertise on ROA is likewise positive, with a coefficient of 0.002 (p-value of 0.082), indicating that the financial expertise of audit committee members contributes to improved bank performance. Aldamen et al. (2012) and Sellami and Fendri (2017) concur that an audit committee's performance improves when the proportion of experienced executives increases.

Leverage and firm size harm ROA. Leverage has a negative and substantial impact on ROA. It is argued that firms with a high leverage ratio are susceptible to liquidation if they cannot generate enough cash flow to cover their expenses (Razali et al., 2018). Interestingly, firm size has a negative and significant effect on ROA, indicating that large firms may also have coordination issues that negatively impact their performance (Williamson, 1967). As a whole, the characteristics of the audit committee and the control variables included in the model account for 52% of the variance in ROA.

Table 4: Audit committee characteristics and ROA

ROA	Coef.	Std. Err.	t	P>t
Audit Committee Independence	.019	.007	2.56	**.013**
Audit Committee Financial Expertise	.002	.001	1.87	**.082**
Leverage	-.001	.0005	-1.69	**0.096**
Liquidity	-.00001	.00001	-.84	0.404
Tangibility	-.005	.004	-1.34	0.185
Firm size	-.012	.004	-2.85	**0.006**

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_cons	.166	.050	3.32	0.001
R-square	0.52			
F (20, 79) =	16.22			
Prob > F =	0.0000			

Table 5 displays the results of the analysis of the moderating effect environmental disclosure has on the association between audit committee characteristics and ROA. The moderating effect is produced by multiplying audit committee independence by environmental disclosure. Similarly, environmental disclosure multiplies the audit committee's financial competence.

The term coefficient for investigating the moderating effect of environmental disclosure (i.e., Audit Com Independence * Environmental Disclosure) is positive and significant, suggesting that environmental disclosure has a positive and significant moderating effect on the relationship between audit committee independence and ROA. Correspondingly, the moderating effect of environmental disclosure (i.e., Audit Com Financial Expertise * Environmental Disclosure) is also positive and statistically significant, indicating that environmental disclosure positively moderates the association between audit committee financial expertise and performance. These findings imply that as environmental disclosure rises, the benefits of audit committee independence and audit committee financial knowledge on the performance of banks increase.

Table 5: Moderating effect of environmental disclosure on the relationship between audit committee characteristics and ROA

ROA	Coef.	Std. Err.	t	P>t
Audit Com Independence	.0211	.0051	4.137	**.0000**
Audit Com Independence * Environmental Disclosure	.0192	.0053	3.622	**.0004**
Audit Com Financial Expertise	.0029	.0014	1.873	**.0820**
Audit Com Financial Expertise * Environmental Disclosure	.0021	.0012	1.752	**.0950**
Leverage	-.0012	.0005	-2.41	**.0060**
Liquidity	-.0001	.0001	-.941	.4590
Tangibility	-.0049	.0052	-.980	.2310
Firm size	-.0119	.0042	-2.833	**.0020**
_cons	.175	.0586	2.986	.0010
R-square	0.542			
F (20, 79) =	17.03			
Prob > F =	0.0000			

Conclusion

In this study, we investigate whether audit committees' independence and financial knowledge are connected with banks' operational performance in the Kingdom of Saudi Arabia and whether this connection varies according to the disclosure context. The results show that the audit committee's effectiveness significantly impacts the firm's performance, measured by operational performance.

The findings indicate that the independence of audit committees promotes the performance of banks, and environmental disclosure strengthens this favorable association. In addition, the financial knowledge of audit committees boosts the performance of banks that report their

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environmental information with a greater impact. Therefore, the mandatory requirements for audit committee independence and the financial expertise of committee members are advantageous for Saudi Arabian banks.

This research provides a deeper understanding of the relationship between environmental disclosure, audit committees, and corporate performance. The audit committee members' independence and financial expertise will likely increase firm performance in emerging markets. As a result, regulators and policymakers must ensure the audit committee's effectiveness and environmental information disclosure.

Similar to other international empirical studies, our study possesses certain limitations. First, the sample size is limited because only 21 Saudi Arabian banks are publicly traded. Second, although this study includes several control variables in the regression models, the results may be susceptible to omitted variable bias. Future research may employ alternative accounting metrics and market data, providing a more comprehensive view of a company's performance than traditional accounting indicators.

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