THE CONTRIBUTION OF ACCOUNTING INFORMATION TO INVESTOR DECISIONS IN THE SAUDI STOCK MARKET

being a Thesis submitted for the
Degree of
Doctor of Philosophy
in
The University of Hull

by

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To my parents, my wife and my daughter.
ACKNOWLEDGEMENTS

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# TABLE OF CONTENTS

<table>
<thead>
<tr>
<th>Section</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABSTRACT</td>
<td>i</td>
</tr>
<tr>
<td>ACKNOWLEDGEMENTS</td>
<td>iii</td>
</tr>
<tr>
<td>LIST OF TABLES</td>
<td>xi</td>
</tr>
<tr>
<td>LIST OF FIGURES</td>
<td>xiv</td>
</tr>
<tr>
<td>LIST OF ABBREVIATIONS</td>
<td>xv</td>
</tr>
</tbody>
</table>

## CHAPTER ONE: INTRODUCTION

1.1. Background  
2  
1.2. Aims of the Research  
5  
1.3. Statement of the Problem  
6  
1.4. Justification  
7  
1.5. Limitations of the Study  
7  
1.6. Research Methodology  
8  
1.7. Organization of the Study  
9

## CHAPTER TWO: THEORETICAL BACKGROUND AND REVIEW OF RELEVANT LITERATURE

2.1. Introduction  
14  
2.2. Financial Markets  
15  
   2.2.1 Money and Capital Markets  
   15  
   2.2.2 The Role of the Capital Markets in Economic Development  
   16  
   2.2.3 Purposes of Capital Market Development  
   18  
   2.2.4 Structure of Capital Markets  
   21  
   2.2.5 Financial Intermediaries  
   22  
2.3. Securities Markets  
23  
   2.3.1 The Role of Securities Markets in Promoting Economic Development  
   25
2.3.2 The Risks Involved in Establishing Securities Markets in Less Developed Countries 27

2.4. The Stock Exchange 29

2.4.1 The Over-the-Counter Market 29

2.5. Factors Behind the Efficiency of the London Stock Exchange 30

2.5.1 Mechanism of the Primary Market 31

2.5.2 Mechanism of the Secondary Market 34

2.5.3 Types of Orders 36

2.6. The Contribution of the Stock Market within the Financial System 38

2.7. Investment Theory and Modern Portfolio 40

2.8. The Efficient Market Hypothesis 43

2.9. Sources of Investment Information 44

2.10. Investment Community Equity-Valuation Models 49

2.11. Financial Accounting 50

2.11.1 Objectives of Financial Accounting 51

2.12. Accounting Information 53

2.12.1 The Value of Accounting Information 54

2.13. Definition of the Accounting Information System 55

2.13.1 Information 55

2.13.2 Accounting 56

2.13.3 The Relationship of the Accounting Information System to other Information Systems 57
<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.2.1</td>
<td>The First Development Plan (1970 - 1975)</td>
<td>126</td>
</tr>
<tr>
<td>5.2.2</td>
<td>The Second Development Plan (1975 - 1980)</td>
<td>127</td>
</tr>
<tr>
<td>5.2.3</td>
<td>The Third Development Plan (1980 - 1985)</td>
<td>129</td>
</tr>
<tr>
<td>5.2.4</td>
<td>The Fourth Development Plan (1985 - 1990)</td>
<td>130</td>
</tr>
<tr>
<td>5.2.5</td>
<td>The Fifth Development Plan (1990 - 1995)</td>
<td>137</td>
</tr>
<tr>
<td>5.3.</td>
<td>Summary</td>
<td>147</td>
</tr>
</tbody>
</table>

**CHAPTER SIX: THE FINANCIAL INFRASTRUCTURE IN SAUDI ARABIA**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>6.1.</td>
<td>Introduction</td>
<td>151</td>
</tr>
<tr>
<td>6.2.</td>
<td>The Saudi Money Market Intermediaries</td>
<td>151</td>
</tr>
<tr>
<td>6.2.1</td>
<td>The Saudi Arabian Monetary Agency (SAMA)</td>
<td>152</td>
</tr>
<tr>
<td>6.2.2</td>
<td>Commercial Banks</td>
<td>154</td>
</tr>
<tr>
<td>6.2.3</td>
<td>Money Exchangers</td>
<td>163</td>
</tr>
<tr>
<td>6.2.4</td>
<td>Islamic Financial Institutions</td>
<td>165</td>
</tr>
<tr>
<td>6.3.</td>
<td>The Saudi Capital Market Intermediaries</td>
<td>167</td>
</tr>
<tr>
<td>6.3.1</td>
<td>Government Specialized Credit Institutions (SCIs)</td>
<td>167</td>
</tr>
<tr>
<td>6.3.2</td>
<td>Government Secondary Investment Sources</td>
<td>176</td>
</tr>
<tr>
<td>6.3.3</td>
<td>Private Credit Institutions</td>
<td>176</td>
</tr>
<tr>
<td>6.4.</td>
<td>Summary</td>
<td>178</td>
</tr>
</tbody>
</table>

**CHAPTER SEVEN: THE ROLE OF THE PRIVATE SECTOR IN THE ECONOMIC DEVELOPMENT OF SAUDI ARABIA**

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1.</td>
<td>Introduction</td>
<td>182</td>
</tr>
<tr>
<td>7.2.</td>
<td>The Role of the Private Sector</td>
<td>183</td>
</tr>
<tr>
<td>7.2.1</td>
<td>The Policy of Privatization</td>
<td>192</td>
</tr>
<tr>
<td>Section</td>
<td>Title</td>
<td>Page</td>
</tr>
<tr>
<td>---------</td>
<td>----------------------------------------------------------------------</td>
<td>------</td>
</tr>
<tr>
<td>7.3</td>
<td>The Development of the Joint Stock Companies</td>
<td>196</td>
</tr>
<tr>
<td>7.3.1</td>
<td>The Classification of Joint Stock Companies</td>
<td>201</td>
</tr>
<tr>
<td>7.4</td>
<td>Summary</td>
<td>204</td>
</tr>
</tbody>
</table>

**CHAPTER EIGHT: THE STOCK MARKET IN SAUDI ARABIA**  

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>8.1</td>
<td>Introduction</td>
<td>207</td>
</tr>
<tr>
<td>8.2</td>
<td>The Primary Market</td>
<td>208</td>
</tr>
<tr>
<td>8.3</td>
<td>The Secondary Market</td>
<td>214</td>
</tr>
<tr>
<td>8.3.1</td>
<td>Share Negotiation System through Commercial Banks</td>
<td>220</td>
</tr>
<tr>
<td>8.3.1.1</td>
<td>Types of Orders</td>
<td>222</td>
</tr>
<tr>
<td>8.3.1.2</td>
<td>Mechanism of the Secondary Market</td>
<td>222</td>
</tr>
<tr>
<td>8.4</td>
<td>The Official and Unofficial Brokers</td>
<td>230</td>
</tr>
<tr>
<td>8.5</td>
<td>Information Sources</td>
<td>233</td>
</tr>
<tr>
<td>8.6</td>
<td>The Market Indices</td>
<td>238</td>
</tr>
<tr>
<td>8.7</td>
<td>Summary</td>
<td>241</td>
</tr>
</tbody>
</table>

**CHAPTER NINE: THE RESEARCH SURVEY IN SAUDI ARABIA**  

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>9.1</td>
<td>Introduction</td>
<td>248</td>
</tr>
<tr>
<td>9.2</td>
<td>Review of Previous Studies</td>
<td>249</td>
</tr>
<tr>
<td>9.3</td>
<td>The Questionnaire Survey</td>
<td>272</td>
</tr>
<tr>
<td>9.4</td>
<td>The Interview Survey</td>
<td>280</td>
</tr>
<tr>
<td>9.5</td>
<td>The Sample Selection</td>
<td>281</td>
</tr>
<tr>
<td>9.6</td>
<td>Summary</td>
<td>283</td>
</tr>
</tbody>
</table>

**CHAPTER TEN: THE SURVEY RESPONSES**  

<table>
<thead>
<tr>
<th>Section</th>
<th>Title</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>10.1</td>
<td>Introduction</td>
<td>286</td>
</tr>
</tbody>
</table>
10.2. The Responses to the Questionnaire Survey 287

10.3. The Interview Survey 317

10.4. Results and Comparison with Earlier Studies 321

CHAPTER ELEVEN: CONCLUSIONS AND RECOMMENDATIONS 333

11.1. Conclusions 334

11.2. Recommendations 338

11.3. Limitations of the Study and Recommendations for Further Research 345

APPENDICES

Appendix 1 347
Appendix 2 377

BIBLIOGRAPHY 384
## LIST OF TABLES

<table>
<thead>
<tr>
<th>Table</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>5.1 Actual Revenue and Expenditure</td>
<td>133</td>
</tr>
<tr>
<td>5.2 Growth in Oil and Major Non-Oil Sectors</td>
<td>134</td>
</tr>
<tr>
<td>5.3 Structure of the Economy</td>
<td>140</td>
</tr>
<tr>
<td>5.4 Indicators and Economic Trends</td>
<td>148</td>
</tr>
<tr>
<td>6.1 Percent Shares of Various Categories of Deposits</td>
<td>159</td>
</tr>
<tr>
<td>6.2 Consolidated Balance Sheet of Commercial Banks</td>
<td>161</td>
</tr>
<tr>
<td>6.3 Regional Distribution of Bank Branches</td>
<td>162</td>
</tr>
<tr>
<td>6.4 Specialized Credit Institutions' Disbursements and Repayments</td>
<td>170</td>
</tr>
<tr>
<td>6.5 Consolidated Balance Sheet of Specialized Credit Institutions</td>
<td>171</td>
</tr>
<tr>
<td>6.6 Specialized Credit Institutions Loans</td>
<td>174</td>
</tr>
<tr>
<td>7.1 Estimated GDP Contribution by the Private Sector</td>
<td>186</td>
</tr>
<tr>
<td>7.2 Estimated Private Sector Share in Value Added</td>
<td>187</td>
</tr>
<tr>
<td>7.3 Number of Companies Operating in Saudi Arabia</td>
<td>191</td>
</tr>
<tr>
<td>7.4 Individual Proprietorships and Firms in Saudi Arabia</td>
<td>193</td>
</tr>
<tr>
<td>8.1 Shares Traded through Commercial Banks and Joint Stock Companies Listed</td>
<td>228</td>
</tr>
<tr>
<td>8.3 Stock Market Price Index</td>
<td>239</td>
</tr>
<tr>
<td>10.1 Number of Questionnaires Distributed and Responses</td>
<td>287</td>
</tr>
</tbody>
</table>
10.2 Educational Level, Sex, Occupations and Annual Income of Survey Respondents
10.3 Summary of Respondents' Investment Behaviour
10.4 Preferred Type of Investment
10.5 Reason for Buying Shares
10.6 Information Considered Important by the Sample of Saudi Investors
10.7 The Sample Base of Selection
10.8 Preferred Market for Share Purchase
10.9 Purposes of the Financial Statements Contained in the Company's Annual Financial Report
10.10 Respondents' Views on the Degree of Influence of Sources of Information on their Investment Decisions
10.11 Actual Understanding of Financial Terms
10.12 Criteria Considered by Respondents when Evaluating Companies for Investment
10.13 Relative Importance of Sources of Information
10.14 Survey Respondents' Interest in Looking at the Company's Annual Financial Reports
10.15 Respondents' Understanding of the Contents of Company's Annual Reports
10.16 Problems Experienced when Reading the Company's Annual Reports
10.17 Survey Respondents' Views on the Accuracy of the Company's Annual Reports
10.18 Respondents' Understanding of Investment Risk
10.19 Aspects of the Annual Report which Survey Respondents Considered they did not Fully Understand

XII
10.20 Respondents' Views on Additional Information which should be Shown in Annual Financial Reports 317

10.21 Comparison of Saudi Investors' Sources of Accounting and Financial Information With Other Studies 328

10.22 Comparison of Saudi Investors' Views on the Important Sections in the Financial Reports with Other Studies 332
## LIST OF FIGURES

<table>
<thead>
<tr>
<th>Figure</th>
<th>Description</th>
<th>Page</th>
</tr>
</thead>
<tbody>
<tr>
<td>7.1</td>
<td>Classification of Joint Stock Companies</td>
<td>202</td>
</tr>
<tr>
<td>8.1</td>
<td>The Regular Structure of the Saudi Stock Market (SSM)</td>
<td>221</td>
</tr>
<tr>
<td>8.2</td>
<td>Share Negotiation System (SNS)</td>
<td>226</td>
</tr>
<tr>
<td>8.3</td>
<td>The CCFI Index of Saudi Share Prices from November 1981 to December 1992</td>
<td>242</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Full Form</td>
<td></td>
</tr>
<tr>
<td>--------------</td>
<td>-----------</td>
<td></td>
</tr>
<tr>
<td>AAC</td>
<td>Arabian Automobile Company</td>
<td></td>
</tr>
<tr>
<td>AFM</td>
<td>Amman Financial Market</td>
<td></td>
</tr>
<tr>
<td>AIS</td>
<td>Accounting Information System</td>
<td></td>
</tr>
<tr>
<td>ANB</td>
<td>Arab National Bank</td>
<td></td>
</tr>
<tr>
<td>BNU</td>
<td>Branch Negotiation Unit</td>
<td></td>
</tr>
<tr>
<td>CAPM</td>
<td>Capital Asset Pricing Model</td>
<td></td>
</tr>
<tr>
<td>CCFI</td>
<td>Consulting Centre for Finance and Investment</td>
<td></td>
</tr>
<tr>
<td>CNU</td>
<td>Central Negotiation Unit</td>
<td></td>
</tr>
<tr>
<td>CTH</td>
<td>Central Trading Hall</td>
<td></td>
</tr>
<tr>
<td>ESIS</td>
<td>Electronic Securities Information System</td>
<td></td>
</tr>
<tr>
<td>FCF</td>
<td>Fixed Capital Formation</td>
<td></td>
</tr>
<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
<td></td>
</tr>
<tr>
<td>GIB</td>
<td>Gulf International Bank</td>
<td></td>
</tr>
<tr>
<td>GNP</td>
<td>Gross National Product</td>
<td></td>
</tr>
<tr>
<td>GOSI</td>
<td>General Organization for Social Insurance</td>
<td></td>
</tr>
<tr>
<td>IDB</td>
<td>Islamic Development Bank</td>
<td></td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
<td></td>
</tr>
<tr>
<td>IIC</td>
<td>Islamic Investment Company</td>
<td></td>
</tr>
<tr>
<td>JD</td>
<td>Jordanian Dinar</td>
<td></td>
</tr>
<tr>
<td>KD</td>
<td>Kuwaiti Dinar</td>
<td></td>
</tr>
<tr>
<td>KLSE</td>
<td>Kuala Lumpur Stock Exchange</td>
<td></td>
</tr>
<tr>
<td>KSE</td>
<td>Kuwait Stock Exchange</td>
<td></td>
</tr>
<tr>
<td>LSE</td>
<td>Lagos Stock Exchange</td>
<td></td>
</tr>
</tbody>
</table>
MIS  : Management Information System
MPT  : Modern Portfolio Theory
NADEC : National Agricultural Development Company
NASDAQ : National Association of Securities Dealers Automated Quotation System
NCB  : National Commercial Bank
NCFEI : National Centre of Financial and Economic Information
NIC  : National Industrialization Company
NSE  : Nigerian Stock Exchange
OBU  : Offshore Banking Unit
OTC  : Over-the-Counter
PIF  : Public Investment Fund
RPA  : Retirement Pensions Agency
REDF : Real Estate Development Fund
SAAB : Saudi Arabian Agricultural Bank
SABIC : Saudi Basic Industries Corporation
SAFCO : Saudi Arabian Fertilizer Company
SAEF : Stock Automatic Execution Facility
SAIB : Saudi Investment Bank
SAIC : Saudi Advanced Industries Company
SAMA : Saudi Arabian Monetary Agency
SAMBA : Saudi American Bank
SAP  : Structural Adjustment Programme
SAPTCO : Saudi Public Transport Company
SAUDIA : Saudi Arabian Airlines
SBB  : Saudi British Bank

XVI
SCAD : Share Control Administration Department
SCB : Saudi Cairo Bank
SCB : Saudi Credit Bank
SCECO : Saudi Consolidated Electric Company
SCI : Specialized Credit Institution
SFB : Saudi French Bank
SFP : Specialist Funding Programme
SHARACO : Saudi Hotels and Resort Areas Company
SHB : Saudi Holland Bank
SIBC : Saudi Investment Banking Company
SIC : Saudi Investment Company
SIDC : Saudi Industrial Development Company
SIDF : Saudi Industrial Development Fund
SISE : Singapore Stock Exchange
SNS : Share Negotiation System
SR : Saudi Riyal
SSM : Saudi Stock Market
SSRC : Saudi Share Registration Company
SUCB : Saudi United Commercial Bank
SVCG : Saudi Venture Capital Group
UAE : United Arab Emirates
US$ : United States Dollar
CHAPTER ONE

Introduction
1.1. Background

Accounting information meets the legitimate needs of external users, communicates among parties transacting business with one another, and provides a basis for informed management decision making. The external financial statements are prepared for investors, creditors, and other outside parties. Most accounting data are expressed in monetary terms, but some, although financially relevant, can best be expressed in units of product, ratios, percentage, or other terms (Nash and Heagy, 1993:5). Accounting information systems are the delivery systems that provide accounting information to users within an organization and to shareholders, creditors, government agencies and others outside the organization. They process transactions, provide routine and nonroutine reports, and support an accounting data base from which information can be retrieved when needed for decision-making purposes.

The need for complete and truthful information about the history, financial position and prospects of private issues of securities has been stressed as the only effective means by which members of the investing public can be protected against making irrational investment decisions.

The need for current information about the issuer's
financial position and prospects is equally great after investors have acquired its securities, so that they can decide whether to keep them or to sell, or whether to press for higher dividends or a change in the management.

An issue which deserves some attention is the degree of influence, direct and indirect, which these private shareholders may exert. A great deal of information is available to shareholders, even if it is not received as promptly as many would wish. The most important, and usually the most up-to-date, source is that provided by the company itself, that is the annual report and accounts and also the interim statement.

In developing countries, social and economic factors combine to place severe constraints on economic progress. Among the economic constraints, one stands out above all: the lack of capital. However, in Saudi Arabia capital has been available in adequate amounts, at least since 1960, to support brisk economic activity and a high growth rate.

A viable economy must have a well-developed, efficient financial system. This means that it must develop a money market, a capital market and a banking system that facilitates the operation of these markets. Saudi Arabia has a fairly well-developed money market and an adequate capital market and commercial-banking system.
Saudi Arabia has the largest oil reserves in the world, and is considered to be the biggest oil exporter in the world, with a contribution of 13.4% of the total world oil production. However, the Saudi government is making persistent efforts to reduce total dependence on oil as a source of national income, by diversifying the economy through investments in industry and agriculture, with participation from the private sector. In addition, the government has used the vast income derived from the period of high oil production and oil price boom, in a productive way in order to achieve the diversification of economic resources. All these efforts result in the availability to Saudi nationals of numerous investment opportunities.

In 1985, the government introduced a new share trade negotiation system (SNS) through the commercial banks, which seemed the initial step in the capital market revolution. In August 1990, the Electronic Securities Information System (ESIS) was introduced by the Saudi Arabian Monetary Agency (SAMA) to run parallel to the SNS. The full implementation of the ESIS was completed in March 1991. Currently, the stock market in Saudi Arabia is becoming more active.

In Saudi Arabia, apart from the government agencies, the institutional investors are too few for heavy participation in the market. Therefore, individual
investors play an important role in the market activities. Although the big individual investors such as company founders and directors dominate the market in terms of share ownership, the small investors are the majority in numbers.

In fact, some small investors are very active in share trade, despite the fact that they own a relatively small number of shares. Due to the fact that the government is continuing to implement a policy of broadening the base of small investors, their role seems to be one of increasing significance.

In this climate, a need is felt to examine the information needs and ascertain the investment behaviour and motivation of such groups of investors and to assess the market information readily available to them, as well as to other investors.

1.2. Aims of the Research

The aims of this research are to examine and investigate the contribution and effectiveness of accounting information systems in promoting the trade in shares and securities in Saudi Arabia, with regard to the efficient provision of investment information; to identify and analyse the limitations associated with the provision of market information; and to see how this function can be
improved in order to ensure better information, increase trading activity, and promote greater economic growth.

1.3. Statement of the Problem

The principal problem investigated by this research is whether the accounting information systems currently available contribute to the enhancement of the trading activity in shares and stocks in Saudi Arabia. Since any such contribution is dependent upon a number of relevant factors, the following subsidiary questions must be asked:

1) Do investors use and understand the accounting information contained in the corporate financial statements?

2) Which part of the corporate financial reports do investors consider to be most important when making investment decisions related to buying or selling stocks?

3) Is there a market information system freely available to all investors?

A positive answer is an indicator of the contribution of the AIS. If the result of the investigation leads to a conclusion that there is no contribution, then the next question should be how to improve the AIS to render information understandable and helpful to the lay investor and shareholder.
1.4. Justification

This study is significant because it relates to the role that accounting information systems play on investor decisions in the Saudi stock market. The importance of the AIS in this research lies in the fact that it plays, or can play, a significant role in the increase of the trade activity of the stock market, and, in turn, assist in the efficient allocation of resources in Saudi Arabia, which will affect economic development.

1.5. Limitations of the Study

The research covers only one part of the security market, namely, the equity security market, due to the Islamic principles which control financial activities in Saudi Arabia.

One of the limitations facing studies in developing countries is the scarcity of reliable and consistent data. In most cases, aggregate figures were available through governments' resources and Central Bank publications (SAMA in the case of Saudi Arabia). However, more detailed data were very hard to get and what was available was rarely up-to-date. Other data for this research were obtained from secondary sources such as books, articles and other published and unpublished materials.
This research is confined to published data and to data released by its sources. Although a number of books and articles have been published about share price movements in stock markets all over the world, no study has been published covering all major aspects of the trading activities of the stock market. The limited writings, both in English and Arabic languages, are incomplete, lacking in detail and provide little assistance for the investigation of the AIS in the Saudi stock market.

1.6. Research Methodology

The methods used in this research were library research, field survey, interviews and observations and the analysis of these data. The researcher visited Saudi Arabia and interviewed small investors, commercial bank officials and official and unofficial brokers, as well as government officials.

The primary method of research used to present the theoretical background and review of the concerned literature was library research.

The description of the economic structure and stock market in Saudi Arabia was based on interviews and correspondence with government officials, listed companies, bankers, unofficial brokers, and library research.
A field study was conducted in Saudi Arabia from January to May, 1993, to examine the investors' level of use and understanding of the accounting information contained in the corporate reports. This included a questionnaire survey of small and medium investors, (holding shares totalling less than SR 500,000 in value) as well as interviews with brokers.

1.7. Organization of the Study

The study is divided into eleven chapters. The first chapter is an introduction in which the research problem and the objective of the study are discussed and the contents of the thesis are outlined. This chapter also states the limitations of the study and discusses the methodological procedures and techniques of investigation used in the study.

The role of the accounting information systems in the capital market can not be fully understood without looking into the relevant literature on the money and capital market. In Chapter Two, literature on the role of the securities markets in promoting capital accumulation and economic development in developing countries and sources of investment information is examined and the information needs of private investors which might have some impact on the accounting information systems are outlined. In this
chapter, the emphasis is on equities securities rather than on debt securities, due to the Islamic rules which are applied to any development affecting the capital market in Saudi Arabia.

The third chapter discusses the impact of the stock market on the economic development of developing countries, with special reference to the Kuwaiti stock market, Amman financial market, the Nigerian stock market, and the Indonesian stock market. This chapter describes the historical development of these stock markets and their impact on the economic development of these countries.

Since any further development of the Saudi stock market has to take into account Islamic principles, Chapter Four explains the Islamic view of financial debt and securities investments in terms of mechanism and instruments. It also discusses Islamic jurists' opinions regarding the formation of joint stock companies and the investment in their shares and outlines the Islamic perspective on the framework of an Islamic securities market.

The discussion in Chapters Five to Eight is based on information obtained during the fieldwork. Chapter Five provides a profile of the economic structure for the development of Saudi Arabia. This chapter outlines the
development which has occurred in Saudi Arabia through the five year development plans implemented in the country.

Chapter Six examines the financial infrastructure in Saudi Arabia, with particular focus on the money and capital market intermediaries and their impact on the economic development of Saudi Arabia.

The role of the private sector in the process of the economic development of Saudi Arabia is examined in some detail in Chapter Seven. This chapter focuses on the role of the joint stock companies formed by the private sector in the development process of Saudi Arabia.

The eighth chapter describes the historical development of the Saudi stock market. It includes discussions of both primary and secondary markets in Saudi Arabia and the trading system. This chapter examines the role of both the official and unofficial brokers in the process of the trading transactions in the Saudi stock market. It also provides details of the sources of market information available to Saudi investors and the market indices.

Chapter Nine describes and discusses previous studies which have been undertaken to investigate the importance and usefulness of the accounting and other information disclosed in corporate annual reports to individual
investors, in the United States, the United Kingdom, Australia, and Saudi Arabia. After presenting the findings from these prior studies, it explains the method of conducting the questionnaire and interview surveys in the present study.

The field survey is described and discussed in detail in Chapter Ten. This chapter presents the findings from the questionnaire survey, and from interviews conducted with small investors, official brokers in the commercial banks, and unofficial brokers. Comparison of the results of the Saudi investors study with the results of prior studies is presented in this chapter.

Finally, Chapter Eleven summarizes and discusses the major findings of the study and draws some conclusions from these findings. It also offers some suggestions for further research.
CHAPTER TWO

Theoretical Background and Review of Relevant Literature
2.1. Introduction

The aim of this chapter is to outline the basic concepts necessary to a study of the contribution of accounting information systems to the growth of the trade in Stock and Share markets when studying the case of Saudi Arabia. It is made up of three elements:

First, we consider concepts which are fundamental to the review of the role of the securities markets in promoting capital accumulation and economic development. The main focus will be on the capital market rather than the money market, because financial activities in Saudi Arabia are controlled by Islamic rules. As a result, the focus will be more on equities securities than on debt securities, due to the Islamic view of debt securities investment.

Second, theories will be presented relating to the field of study, including basic concepts to evaluate a stock market and theories of investment and market efficiency.

Finally, we discuss the sources of investment information required by private investors for making their own decision about investment in stocks and shares and there is a brief review of financial accounting and its objectives, the definition of the accounting information
system (AIS), and the information needs of private investors—with special reference to accounting information.

2.2. Financial Markets

Financial markets arise from the needs of human society. In mercantilistic and capitalistic societies, financial markets have become inevitable for various reasons. Merchants need money to finance their trade, and manufacturers must have short-term and long-term capital to facilitate their production and distribution activities.

Blake defines the financial market as:

...a place where, or a system through which, securities are created and transferred (1990:16).

2.2.1. Money and Capital Markets

The financial markets in a given country may include a number of subsectors. These, generally, are divided into the money, capital, and other financial market sectors, which can be differentiated in terms of the maturity of their financial assets.

The money market is an impartial market for short-term credits and permits participants to arrange their liquidity positions in a relatively manageable way. The instruments or types of credit that are appropriate to be exchanged in a country's money market include short-term government
securities (frequently in the form of treasury bills), commercial papers, banker's acceptance, interbank loans, overnight loans by banks to securities firms, negotiable certificates of deposit, and off-shore accounts (Lees and Eng, 1975).

The money market can be further divided into the retail market, for dealing in modest amounts of money, and the wholesale market for larger sums. Influential participants in the money market usually include large commercial banks, industrial corporations with liquid funds, financial institutions, the central bank, and government agencies (Cox, 1986:59).

The performance of the money and capital markets in a country during a given period of time depends on economic conditions, availability of funds, and investors' attitudes. The amount of savings that can flow through the money and capital markets at any time depends on the level of economic activity and the ability of income recipients and wealth holders to save from current income receipts.

2.2.2. The Role of the Capital Markets in Economic Development

Capital markets play an important role in economic development because they directly affect two of the major development goals of the developing countries, namely, the
mobilization of savings and the channelling of investment into productive enterprises. So the main reasons for developing capital markets are to attract an increased volume of medium and long-term savings into the financial system by offering investors a variety of financial institutions and investment opportunities and to improve efficiency in allocation of financial resources by allowing a broad spectrum of entrepreneurs an opportunity to obtain financing for their projects.

Therefore, capital markets are mechanisms for mobilizing and channelling funds which are received from surplus units and are allocated among deficit units. Consequently, these markets must satisfy savers and borrowers by providing a range of financial instruments and services at a reasonable cost. However, the primary purpose of capital market development is to strengthen the economy and thereby improve the standard of living of the people. Thus, efficient capital markets complement and support the productive activities of the economy.

Capital markets perform a number of important functions. First, as mentioned earlier, they are mechanisms which facilitate the transfer of investible funds from economic agents in financial surplus to those in financial deficit. This is achieved by selling securities—shares or bonds—to those with surplus funds. As a result companies,
governments, local authorities and so on have access to a larger pool of capital than would be available if they had to depend exclusively on generating their own resources. This is the so-called primary market where new issues of equity or debt are arranged in the form of an entirely new flotation or in the form of an offer to existing investors.

The second function, which is the focus of more attention is that of acting as a secondary market for securities which may have been issued at some time in the past. The secondary market, in other words, provides a facility for the continuous reallocation of financial assets among various investors, allowing some to divest themselves of such assets, while others can use their surplus funds to acquire them (Foley, 1991).

2.2.3. Purpose of Capital Market Development

A necessary, if not sufficient condition for the rapid economic growth of a nation, is the development of an efficient financial capital market where savings by individuals flow efficiently into investment by suppliers of real productive capital. Economists emphasise the importance of the link between financial and capital market development and the economic growth of a nation.

Theoretically, investment could be financed by any mix of domestic and foreign savings. In the past, most
developed countries raised most of their investment funds from domestic savings which were routed through financial institutions such as commercial banks and savings banks. These funds were supplemented by foreign savings in the form of concessional loans from multilateral institutions and bilateral agencies and commercial loans from foreign banks.

Developing countries, in their early stage of development history, relied heavily on foreign capital because of insufficient volume of domestic savings available for rapid economic growth. The governments of these countries have generally played a dominant role in the capital market. During the early stages of economic development, most investment funds were government-guaranteed subsidized loans from government agencies, government-controlled development finance institutions or domestic commercial banks, to government-sanctioned infrastructure projects and large scale public enterprises. For this reason, most developing countries' companies have an excessive dependence on debt financing and have minimized equity financing.

The over-reliance of developing countries' governments and companies on debt finance which was available on easy terms both domestically and from abroad has become evident. Excessive reliance by governments on debt finance to fund
capital-intensive projects with low returns caused debt servicing problems and over-reliance by companies on debt led to unbalanced capital structures, high debt equity ratios, and financial vulnerability to the recent downturns in the world and domestic economies.

However, in the sixties, foreign aid grew less rapidly and a certain disillusionment set in as to its effectiveness. The solution was seen to lie in government fiscal policy, that is, taxation to raise the rate of gross domestic savings and government investment expenditure and development loans to allocate that saving.

More recently, government planners realised that it was becoming difficult to fund public capital expenditures, especially for public enterprises, through government allocations based on expectation of an increased flow of foreign commercial loans, because of the current debt crisis experienced by them and they began to rely on an increasing supply of external funds from multilateral institutions and bilateral agencies in the developed countries. Again, disappointment soon set in as government allocation of its investible resources was not always efficient.

In the light of these structural and financial changes, governments of developing countries decided to
develop their domestic capital markets to mobilize increased domestic resources to bridge their projected investment savings gaps and to allocate their limited capital resources efficiently to the most productive investment projects. Efficient capital markets can make important contributions in both of these areas and can provide a range of allocative investment opportunities to both individual and institutional investors.

2.2.4. Structure of Capital Markets

Capital markets can be defined as the portion of the financial system that deals in medium and long-term credits which may take the form of loans or cover the issue of stocks and bonds.

Capital markets consist of two segments, the non-securities markets and the securities markets. The non-securities markets provide non-negotiable medium and long-term debt funds through financial institutions such as commercial banks, development banks and contractual savings institutions which mobilize savings and then lend those mobilized funds directly to business, industry and other users of funds.

The capital market is composed of organized securities exchanges and financial intermediaries such as commercial banks, savings and loan associations, mutual savings banks,
life insurance companies, pension funds, investment companies and credit unions.

2.2.5. Financial Intermediaries

Financial institutions such as commercial banks, savings banks, savings and loan associations, life insurance companies, credit unions, mutual funds, pension funds and investment companies, are a set of institutions which act as channels of indirect investment and financing. These intermediaries purchase primary securities and, in turn, issue their own securities. Thus, they come between ultimate borrowers and ultimate lenders. In essence, they transform direct claims—primary securities—into indirect claims—called indirect securities—which differ in form from direct claims (Van Horne, 1978:6). They, like brokers and dealers, are important for the functioning of an equity market.

There are a number of specialists involved with new issues. Issuing houses, many of whom are merchant banks and stock-brokers, organize and administer much of the issue. They will ensure that Stock Exchange and legal requirements are fulfilled and will advise on the type of security to be issued, the method of issue and the security's initial selling price.
2.3. Securities Markets

Securities markets are groups of financial markets where government treasury bills, notes, bonds and corporation bonds are traded, as well as shares of all types. One way in which securities markets may be classified is by the types of securities bought and sold there. The broadest classification is based upon whether the securities are new issues or are already outstanding and owned by investors. Securities available for the first time are offered through the primary securities markets. The issuer may be a brand-new company or one that has been in business for many years. The securities offered may be a new type, issued as flotations, or additional amounts of an existing security. The latter were in the past frequently described as secondary issues.

The key difference is that primary securities absorb new funds for the coffers of the issuer, whereas in the secondary markets, existing securities are simply being transferred between parties, and the issuer is not receiving new funds. After their purchase in the primary market, securities are traded subsequently in the secondary markets through the organized stock exchange or a junior market such as an over-the-counter or an unlisted securities market (Fischer and Jordan, 1991:18).
Securities is the Stock Exchange term for stocks and shares in general. They fall into two basic categories: those that give the holder part-ownership of the company he has invested in, and those that do not. Other types of shares include deferred shares, non-voting shares, partly-paid shares, preference shares and redeemable preference shares (Valentine, 1985:180).

In number, the largest group of securities is equities, or ordinary shares. These are issued only by companies, and represent the money that has gone into financing the company. The ordinary shareholders between them own the company, have a vote in how its affairs are run, and are entitled to a share of any profit made by the company. On the other hand, nothing is fixed. The dividend which shareholders receive is decided afresh each year, depending on the size of the profit, and the amount that the directors feel that it is prudent to plough back into the company's reserves for future expansion.

Shares of all types represent the risk capital of a business, the shareholders sharing the success and the failure of the business which is usually reflected in the dividend and the share price quoted in the market. It is the ordinary shareholder who bears the total risk taken in any business. The preference shareholder has a right to dividends at a specified rate—when declared by the Board of
Directors—before the ordinary share dividends. There is priority too for the preference shareholder in the event of the liquidation of a business. Other classifications of shares are based on company size and performance as well as share price and yield. As securities markets are being widely developed, an options market and futures market have been introduced and expanded.

2.3.1. The Role of Securities Markets in Promoting Economic Development

For a long time, governments and international institutions held the belief that the creation of a securities market in developing countries would be difficult and expensive, its maintenance and development would be costly and its economic benefits would be few. Thus it was concluded that it was not worth setting up a market. In recent years, greater attention has been given to the capital market and particularly to the securities markets and stock exchanges, stressing the value of creating and strengthening these markets.

This shift of interest was encouraged by two important factors. The first is the failure of foreign aid policies in the 1950s to solve financial difficulties associated with capital formation and economic growth and of government fiscal policies in the 1960s, which manipulated
taxation to raise the rate of gross domestic savings and public spending on capital projects and allocation of investments by granting development loans. These and the governments' inefficient methods of pursuing development goals led to disappointment. These failures led some governments in the 1970s to raise the rate of private domestic savings and to encourage the allocation of these savings more efficiently by developing capital markets.

The second factor is the success of securities markets organized in some less developed countries. Economists started to believe that a securities market brings with it a number of benefits sufficient to justify its establishment in less developed countries, provided government policies accompany it.

In addition to the contribution of securities markets towards economic development, there are other functions attributed to such a market, such as the raising of capital by business enterprises, liquidity of monetary wealth, the identification and publication of economic indicators and the selection of more profitable investments for savers. As a result there are some other functions such as:

1) The effects of securities markets in terms of concentrating economic power, income and wealth. The development of a securities market and the widespread
placement of equities with investors is essential to avoid an extreme concentration of wealth in the public sector or in the hands of restricted groups of private capitalists.

2) The effects of a securities market as an incentive to entrepreneurial potential. When a company goes public it will be stimulated to earn higher profits and to employ skilled professional management. In addition, this would also lead to improved accounting practices, greater profit orientation, and more disclosure of information which yields social benefits.

3) The contribution of a securities market to privatization of productive activities. Another role securities markets may play in less developed countries involves the process of privatization of business activity.

4) The effect of a securities market on the control of monetary policy. The existence of an organized securities market, particularly a bond market, may enable the range of financial instruments and intervention procedures available to the policy makers to be expanded.

2.3.2. The Risks Involved in Establishing Securities Market in Less Developed Countries

There are two kinds of risk that can be incurred when establishing securities markets in less developed
countries. The first type of risk occurs when steps are taken to create a market in an economic and financial environment that is not yet ready for it, which may result in severely jeopardising the development and stability of the country's financial structure, as well as delaying the growth of the market. In addition to that, in such an environment, the risk also arises of the government and monetary authorities attempting to support the market by taking defensive action in a counter-productive and very costly way, which includes constraints on short-term interest rates and intervention to stabilize market prices to the detriment of money supply (Shaw, 1973).

The second type of risk is the instability of securities markets and the effects of this instability on business activity and fluctuation in economic trends. This in turn encourages speculation and may produce instability and emphasize fluctuations in manufacturing activity.

However, although there are risks involved in developing securities markets in less developed countries, this does not mean that a country should give up the idea of enriching its financial structure with an organized stock market, which may significantly facilitate the process of investment.
2.4. The Stock Exchange

The main function of any stock exchange is to provide the mechanism for the exchange of shares which already exist. This is the so-called secondary market (Midgley and Burns, 1977:109). The other function is to provide the capital for government and industrial purposes (Briston, 1970:34). Thus, the stock exchange plays a significant role in the economic development of a capitalist society.

The exchange provides a trading place where members of the exchange, or market makers, act on behalf of their clients or for themselves. The stock exchange is financed by private capital and administered by an elected Council of members.

2.4.1. The Over-the-Counter Market

The over-the-counter market (OTC) is not a physical market in the sense that there is a large central market place. It is a collection of brokers-dealers scattered across the country to buy and sell unlisted stocks through negotiated bidding, over a massive network of telephone and other means of communication, that link thousands of securities firms inside the country and abroad (Fischer and Jordan, 1991:25).

The phrase, over-the-counter, came originally from the
private bank counters in the United States during 1870s, where securities could be bought through recognised private banks as well as through stockbrokers. Thus, the phrase "over-the-counter" used to indicate whether the securities were bought from the recognised stock exchange or from dealers (Valentine, 1985). In the UK, in addition to the OTC market, there is the Unlisted Securities market, comprised of shares of young or small companies which are not required to comply with the stock exchange requirements for a traditional full listing.

2.5. Factors Behind the Efficiency of the London Stock Exchange

In the number and range of national and international securities handled and in size of membership the London Stock Exchange is the largest in the world and ranks second only to Wall Street in the total value of transactions. The market is considered among the most efficient markets in the world. The government privatization programme in the UK has affected the public involvement.

Although the London Stock Exchange is the main and largest stock exchange in the UK, there are seven regional exchanges to serve the other parts of Great Britain and Ireland under the control of the Council of the Associated Stock Exchanges.
In recent years, the growth of the institutional investors, the developments in information techniques, the international competition, and the agreement between the Secretary of State for Trade and Industry and the Chairman of the Stock Exchange following the cancelation of the Office of Fair Trading's Investigation of the Market's rule book (Hall, 1987) have led to a major revolution in the London Stock Exchange. In the Big Bang of 27th of October 1986, the Council of the London Stock Exchange made the commission rate negotiable, abolished the single capacity system and replaced it by a completely different system based on competing market makers. This new system, which is obviously based on the U.S. National Association of Securities Dealers Automated Quotation System (NASDAQ), will affect the future of the London Stock Exchange and will improve its functions (Stapley, 1986).

2.5.1. Mechanism of the Primary Market

Flotation describes the first time issue of a company's shares and secondary issue, describes the issue of additional shares of a company which already has a stake in the stock market through a previous share issue.

There are four mechanisms for the sale of new issues to the public:

a) Offer for sale; where all shares offered for sale
are bought by an issuing house, which then re-sells them to the public at a fixed price. This method is used to achieve the widest participation.

b) Offer for sale by Tender; where a realistic market value is set for the shares and investors are invited to tender for shares at a price they decide, which is usually over the bidding price. This method is used when the company expects a high demand.

c) Placing; where all the shares are bought by the stockbroker sponsoring the issue, who then offers them for sale to his clients at a slightly higher price. A quarter of the issue is reserved for offer to the jobbers. This method is used when companies expect a low demand or the issues are too small to attract public interest. It is commonly used when selling new shares of unlisted companies.

d) Introduction; where privately owned shares are made available to the public and traded in the stock market, provided the introduction of the shares concerned has been approved by the stock exchange.

In the UK, the existence of the system of underwriting the new issues ensures the sale of all shares by the underwriters and the capital required by the company which floats its new issues is guaranteed to be raised. The
public has access to information about the company and those who eventually buy shares are well informed by the publication of a comprehensive prospectus. A very little information is required from the buyer in the application for shares and the minimum time to complete the procedure for buying shares is kept to about four weeks.

Although the mechanisms for floating new issues described earlier require the payment of subscription money, there are four cases of new issues that do not require any payment.

Firstly, when a company decides to replace its existing shares with split shares. This free distribution will cause more shares to be issued in terms of quantity without any change in stockholders' equity or in the total amount of company capital. Secondly, when a company decides to increase its capital by issuing new shares equivalent in value to its legal reserves, without any change in stockholders' equity. Thirdly, the free distribution of some new issues, in the form of bonus shares, as an incentive mechanism to hold the allocated new shares for a specified period of time, usually three years, in order to protect the share price from short time speculation. Finally, when a company decides to issue new shares equivalent to and instead of any cash dividend, to be paid to shareholders.
2.5.2. Mechanism of the Secondary Market

Trading of listed shares is conducted by member firms in the organized physical two-way auction market, i.e., the stock exchange, the most efficient and important secondary market. Unlisted shares are traded in the unlisted securities market, which is run under a special rule and supervision of the stock exchange, or through the over-the-counter market (OTC).

Dealings in shares in the secondary market are always through a certain channel, called the brokerage system, which has one type of member firm, a broker/dealer, since October 1986. According to this system, for a competitive negotiable commission, the broker acts as agent for his clients, and the dealer acts as a principal on his own account. The broker/dealer must tell the investor, in which capacity he is acting. He is not allowed to act in both capacities simultaneously, in one transaction, for the sake of investor protection. In this system, under a strict code of practice, some firms will undertake to make markets in which they are authorized to buy and sell shares continuously, and all are allowed to deal with the public.

Under the old Stock exchange dealing procedure, when an investor wishes to deal in shares, he must do so through the stockbrokers' agent, who in turn approaches the share
dealer on the exchange floor and asks for quotations from the dealers handling the concerned shares. If only one price is given, which is very common in the London Stock Exchange, this price is regarded as being the middle price. Once the best price has been reached by the broker he can execute the order, or leave it with the dealer to be executed later (Stapley, 1986:22).

Currently, the Stock Exchange uses the Automatic Execution Facility (SAEF) which is of particular benefit and interest to investors since it is hoped it will help reduce member firms' dealing costs and hence the cost to their clients. Starting with a limited selection of shares, SAEF will route electronically small share transactions from a broker-dealer to whichever market maker is quoting the best price in a particular share. Where, as will normally be the case, more than one market maker is quoting the best price, the orders will be routed to each in rotation (Stapley, 1986:25).

After the completion of the transaction, the broker notifies his client. The execution of the order is to be cleared through a central clearing system where a clearing house undertakes to clear the account between the two brokerage firms, to transfer ownership of the shares to the buyer's name and to deliver the certificate to the buyer's broker. This normally takes about three to four weeks.
Account settlement is usually on the Monday ten days after the close of the trading period, according to the stock exchanges' calendar (Stapley, 1986:27).

2.5.3. Types of Order

In the London Stock Exchange there are two common types of order classified in terms of price determination for a transaction. These are known as "Market Order" and "Limit Order".

The market order is easier and faster to execute. It can be defined as an investor's instruction to buy or to sell shares at the best possible market price, the same as or close to the quotation obtained before placing the order. The market price at which the order is executed is not necessarily to be the best price for the day.

The limit order involves the placing of an order at a specific maximum (purchases) or minimum (sales) price at which the investor wishes to deal in a particular security. A buying limit will be below, while selling limits must be above, the prevailing market price. It is normal for a broker to retain an impracticable limit order for a period of one month or so, after which it is reviewed. Most brokers will accept only realistic limit orders - typically within a 10% margin of the share price - while normally the capital sum involved should also be of a reasonable size.
Monitoring limit orders does involve a fair amount of administration and an absence of regulations of the foregoing nature could easily lead to a broker being inundated with totally unrealistic limit orders (Stapley, 1986:73).

The automation of the share trading business is another factor behind the efficiency of the London Stock Exchange, as the Inter-Market Trading System allows immediate communication nationally and internationally and has speeded up the trading process, as well as making the market information system more efficient. In addition, the existence of share price indices helps investors, individual and institutional, to evaluate the portfolio they hold and their position in the market on which their trading activity depends.

Another factor of efficiency is the market information system, the wide publicity thereby generated, and the publication and wide availability of educational material concerning share investment. These help to improve the investment talent of ordinary investors, which in turn encourages rational investment. The primary concern of the stock exchange is the protection of the investors' interests through the introduction of new regulations, methods and techniques.
The price of a share, like the price of anything else, depends on supply and demand. Both of these depend on a large number of factors, such as the past history of the company, the rate of dividend paid, the proportion of earnings usually distributed as dividend, the prospects of the industry in which the company is engaged, in general, and the prospects of the company in particular. The marketability of the share is also a factor which affects the price.

2.6. The Contribution of the Stock Market within the Financial System:

The markets for shares and stocks carry out many important functions in the economy. One of the most significant is the effect which these markets, along with other financial and non-financial institutions, exert in allocating the nation's capital resources among frequent competing uses for these resources, through a number of properties. First, they permit long-term investments to be financed by funds provided by individuals, many of whom wish to make them available for only a very limited period, or who wish to be able to withdraw them at will. Thus, the markets impart a measure of liquidity to long-term investments that permits their instruments to be sold at a price that yields a lower rate of return than would otherwise be required.
Second, the markets offer a simple mechanism for the transfer of funds that imposes only a minimum of administrative effort upon the lender. Third, the stock markets offer the advantage of accessibility to a vast number of capitalists, many of whom possess only small amounts of money and yet who in their aggregate have command over vast quantities of wealth. Finally, they offer guidance to business management—information on the current cost of capital which is so important in determining the level of investment which it is appropriate for the firm to undertake. The capability with which this allocative service is achieved determines in large part the overall growth and productivity of the economy itself. Consequently, governments have from time to time passed legislation directed toward improving the achievement and productivity of the stock market (Baumol, 1965).

The stock market plays a significant part in the financial system, raising funds for investment on a long-term basis. However, this is not its only contribution, Agtmael (1984) argues that there are other contributions:

a) The ability, competitiveness and solvency of the financial sector.

b) The solvency of the corporate sector.

c) The deconcentration of ownership and distribution of wealth.
d) The mobilization of financial savings.
e) The allocative productivity of investment.
f) The development of accounting and auditing standards.
g) The access of new and emerging companies to equity.

It is generally understood that as a nation strives to move from the status of a less developed country to that of a developed country, a well-established system of organized securities exchanges is a necessary condition, for it provides investors with 1) market places for securities already outstanding, 2) availability of market liquidity, and 3) orderly market price fluctuations.

2.7. Investment Theory and Modern Portfolio

Return and Risk are the key factors of the investment theory. The term return can be defined as the reward for delaying consumption. In share investment, the return means the amount of capital gain (or capital loss) plus the dividends received for share holding.

Risk refers to uncertainty, which means the probability of loss. The risk, in portfolio investment, comprises specific risk and market risk. Specific risk is sometimes referred to as diversifiable, avoidable, or non-systematic risk, which can be measured by the standard deviation of returns and it is concerned with individual
companies. Market risk is more specific to the whole economic movements which affect all companies' performance or share prices and it is sometimes referred to as non-diversifiable, unavoidable, or systematic risk. It can be measured by (Beta), which is known as the market sensitivity index.

The investment theory evolved through several stages until Markowitz in 1952 introduced the portfolio theory based on the consideration of risk versus return. This theory, at a later stage, was called the Modern Portfolio Theory (MPT). According to this theory, the investor, being averse to risk, chooses to hold an efficient portfolio which maximizes his utility by maximizing expected return for a given degree of risk. As a result, the expected return is directly related to risk. The Modern Portfolio Theory holds that as specific risk is avoidable by diversification, the investor should not expect to be rewarded for taking risk. The reward that he expects would be for the market risk, which is unavoidable.

Sharp, in the mid-1960s, made another contribution to Modern Portfolio Theory by developing the Capital Asset Pricing Model (CAPM), to a theory of market equilibrium under conditions of risk, where he determined the efficient combination of risky securities (such as equities, sometimes called borrowing portfolios) and riskless
securities (such as treasury bills, which are lending portfolios). The above model demonstrates the link between returns of individual portfolio and the returns of market portfolio. It quantifies and prices the risk, assuming that every security will show a linear relationship between risk and expected return and they must lie in the same security market line (Elton and Gruber, 1972:543).

The model should be perceived under the assumption that securities are traded in a hypothetical capital market in which (Levy and Sarnat, 1986:327):

a) Investors are risk averse and reach their decisions using the mean variance rule;

b) All investors can borrow and lend any amount in the relevant range without affecting the interest rate and there is no risk of bankruptcy;

c) There is a given uniform investment period for all investors;

d) There are no transaction costs or taxes;

e) All investors have available access to all relevant information regarding securities.

Another contribution has been made to the portfolio theory through the Random Walk Theory of share price movement. In this theory, future price movements are independent of past changes and the most likely estimates
of tomorrow's prices are the levels they are today; in other words, the movement of the share prices will occur in a random way. Later on, this theory was developed to another stage known as the Efficient Market Hypothesis (Valentine, 1985:167).

2.8. The Efficient Market Hypothesis

The market is considered to be efficient when share prices fully reflect all available information. There are three forms of market efficiency hypothesis: weak, semi-strong, and strong (Kean, 1985).

The weak form of the efficient market hypothesis affirms that current share prices fully reflect all past share price behaviour, whereas the semi-strong form affirms that current share prices fully reflect all publicly available information, and the strong form affirms that current share prices fully reflect all information, whether publicly available or not.

The efficient capital market hypotheses have two main deficiencies as means of evaluating accounting methods. First, they are concerned with efficiency at the aggregate level, as it would not be possible to assess whether new publicly available information was useful to all investors' groups or to society in general. Second, the efficient capital market approaches are concerned primarily with the
efficiency of the market in processing available information; in other words, they are not concerned with alternative information which could be provided but is not available at present.

2.9. Sources of Investment Information

Since information affects the values of investments, the serious investor must be well informed, so he can make a good investment decision. The provision of information to investors and shareholders has been a legal responsibility of large companies. However, doubts have been expressed about whether the information provided is as useful as it should be. The problem of selecting the optimal financial information to be reported to investors is complicated by the variety of users. Information which is useful to one user, or group of users, may not be useful to others.

There is a staggering array of such investment information, some of it published directly by the company in its annual report, and some of it analysed and prepared in the form of statistical data. Although a company's annual report provides useful information, financial information published in the daily press, financial press, bulletins of share departments in commercial banks, and share indices, are also considered to be essential sources of investment information.
Private investors are particularly concerned with information relating to future expectations and they are also interested in historical information. Historical information such as growth and profitability trends may assist the private investor in making his own forecasts or in validating the forecasts of others, as past and present information serve as guides to the future because of forecasting uncertainties.

Private investors need more meaningful information in their analyses of dealings in shares and stocks than that provided by profit forecasts and current financial statements. This information varies from the future economic outlook of the company and the industry of which the company is a part, to the quality of the firm's management. Private investors need such information because the performance of individual firms may differ significantly from that of their industries and they are concerned with the selection of an individual company of a given industry.

Although share prices are influenced by many factors, most investors consider that earnings and sales growth, price trend and riskiness of the stock, and the company's characteristics such as its financial strength, reputation, profitability and involvement in research and development activities, are the primary factors underlying the market
behaviour of stocks and shares. However, the main information required by most private investors is the expected future growth rate in earnings per share.

There are two types of approach adopted to the problem of selecting an optimal accounting method to report financial information for different users.

The first are the efficient capital market approaches, which involve an examination of the efficiency of the capital market in incorporating account information and other information in share prices. This approach has been discussed in some detail in section 2.8.

The second type is the user decision oriented approaches which involve the identification of the main groups of users of financial information and accounting reports and an assessment of the ability of alternative accounting methods to satisfy the requirements of each group.

The following steps are involved in applying a user decision oriented approach:

a) the identification of the groups of users and their information requirements;

b) the specification of alternative accounting methods
which could be used for reporting information to the users and satisfying the information requirements of each group;

c) the selection of the optimal reporting method for each group, bearing in mind the cost of each alternative;

d) the assessment of the combination of the different groups' optimal reporting methods in a general purpose report.

Neither the efficient capital market approach nor the user decision oriented approach has provided a conclusive solution to the problem of choosing an optimal accounting method to report financial information for different users (Arnold, 1977:107).

For the investment in shares and stocks the sources of information available in Britain can be divided into three groups:

1) Company Reports; one of the most direct source of information is company reports. Often in response to abuses of the reporting system, each successive Companies Act in Britain has introduced additional requirements of information disclosure. The 1948 Act which consolidated the previous Acts is still the main one, although it has been supplemented by the 1967, 1976, 1980 and 1981 Acts.

2) Stock Exchange Publications; the London Stock
Exchange in its various publications provides some useful information about the listed companies. These publications include:

a) Stock Exchange Official Year Book; which is published annually and provides important facts about all the listed companies;

b) Quarterly Fact Book; which includes classified information on securities issued and lists all largest companies according to market valuation;

c) Stock Exchange Daily Official List;

d) Statistics Relating to Securities Quotation;

e) Interest and Dividends upon Securities Quoted.

The booklets referred to in (d & e) are published annually and include figures such as nominal and market values of quoted securities, classification of overseas and U.K. companies, combined total of interest and dividends, figures of nominal company interest and dividends.

3) General Publications; there is a wide range of financial publications, journals and newspapers which cover further information and related interest to investors. The predominant source among these is the information published by Extel Statistic Services Limited, London.

The most voluminous source of information about companies is the press: financial newspapers, investors'
reviews, trade periodicals and local newspapers. The Financial Times is considered to be the most important source of information, as it provides articles on company reports, industrial innovations and surveys, as well as listing quoted securities. In addition, there are other categories of publications like the Economist newspaper and the Investor's Chronicle.

2.10. Investment Community Equity-Valuation Models

The investment community has developed many different valuation models to use in security selection decisions. A common feature of most of these models is the use of financial statement data. An assumption underlying the use of these models is that the capital market misprices securities and that these models can be used to detect such mispricing (Foster, 1986:427).

The following two models are examples of the fundamental approach to active investment analysis:

a) The Wells Fargo Model, combines traditional valuation theory with developments in asset pricing theory, in an attempt to detect mispriced securities. There are two steps in implementing the model: 1) Estimate the expected internal rate of return of each security; and 2) Estimate the equilibrium rate of return of each security.
b) The Value Line Model, is one of considerable interest due to some evidence of its success in detecting under or overvalued securities. Each share is placed in one of five categories based on its estimated price performance in the next twelve months. The basic approach is to measure each share's price and earnings characteristics against the comparable characteristics of the other Value Line shares. Each share is ranked on its expected relative price performance in the next twelve months based on a combination of three criteria: The Nonparametric Value Position; Earnings Momentum; and Earnings Surprise Factor.

When examining models of investment it is important to recognize that continual change in either the structure of the model, or its inputs, is the rule rather than the exception. Among the sources of these changes are new disclosures by companies; companies are continually changing the information they disclose, whether voluntarily or due to regulatory instructions. Investment institutions can use these new disclosures when changing their existing procedures.

2.11. Financial Accounting

Accounting is a service function and an information system. The accounting function has an important role in the successful operation of today's businesses.
2.11.1. Objectives of Financial Accounting

The objective of financial accounting is to supply useful information for making economic decisions. The processes of recording, aggregating, and summarizing the effects of historical transactions in financial statements under a specified set of rules constitute the bulk of financial accounting. Financial accounting serves its users through well-defined and closely controlled processes.

Financial accounting reports primarily serve both internal users who work for the company and have some managerial or supervisory responsibilities, such as firms' management and employees, and external users such as government agencies, who have the authority to prescribe their information needs, in order to provide information on the situation of and changes in the enterprise's resources and liabilities, to support investment and credit decisions and to supply cash flow information.

There are other groups of external users, such as investors, including shareholders, banks, trade unions, and creditors, who do not have such authority, and use the accounting information available in general purpose reports. When making investment and loan decisions, they assess the following aspects of the business:

a) Growth: the potential for growth is demonstrated by
sales growth, new product development, and introduction of new technology.

b) Stability: the enterprise should have control over its debts and the sales revenue must assure market need for its products.

c) Solvency: the enterprise should have adequate resources to pay off its liability.

d) Liquidity: it is essential for the firm to be able to pay its current liabilities from its current assets.

e) Profitability: will the firm make a profit in the future? (Rahman and Halladay, 1988).

Financial accounting operates from an historical perspective; it focuses on the immediate past activities of an organization in order to record and report to outsiders what has happened to that organization since the last financial information was presented to them. Any prediction of the future is left to the users of the information (Page and Hooper, 1992:5).

Few studies have been undertaken to see how important the investors find the financial reports and specifically what information in those reports the investors value. Those studies that have been performed in the form of
investor surveys yield mixed results in the United Kingdom and other countries.

Two decades ago some questions arose about who needs financial reports, what information they need, and whether corporate financial reports were useful to investors. To answer these questions an investor survey was conducted in the United Kingdom by Lee and Tweedie in 1976. The study revealed that the financial reports are considered an important source of information for investment decisions by the sample of individual shareholders in the United Kingdom (Lee and Tweedie, 1976).

2.12. Accounting Information

Accounting information is essential to the efficient management of economic affairs. The attributes of accounting information refer to the qualities necessary to satisfy users' needs. Two essential qualities for general purpose accounting reports supplied to external users are 1) relevance and 2) reliability.

Relevance of accounting information is judged in relation to the user's situation. Annual accounting reports provide relevant information for liquidity evaluation. Historical accounting information supplied by general purpose accounting reports is relevant for assessing past performance only; to predict future profitability or
liquidity, one has to use forecasts that are not usually included in accounting reports.

Accounting information must also be reliable. Reliability in accounting information signifies faithfulness, consistency, and trustworthiness. One way of ensuring reliability in accounting information is to ensure adherence to accounting principles (Rahman and Halladay, 1988:8).

2.12.1. The Value of Accounting Information

The value of any information depends on the following two factors:

a) Its accuracy, which is defined as the degree of mapping from the events to the data. When accounting data closely represent the measured events, the data are said to have high accuracy and the value of information based on the data increases. On the other hand, data that do not represent the measured events closely can not be used to develop valuable information.

b) Its ability to reduce uncertainty. One major objective of information is to reduce uncertainty. Thus, initial uncertainty in a decision situation increases the value of information. Accounting data are useful and of value when they have the potential to reduce uncertainty in
a decision situation. The costs of collecting additional information must always be balanced against the value expected.

2.13. Definition of the Accounting Information System

There is no single, universally accepted definition for the accounting information system (AIS).

Wilkinson defines it as:

...an integrated framework within a firm that employs physical resources to transform economic data into financial information for (1) operating and managing the firm's activities, and (2) reporting the firm's achievements to interested parties (1989:4).

According to Wilkinson's definition, this system will contain information data and accounting data.

2.13.1. Information

Information serves as the core for making decisions and taking action. Generally consisting of treated data, information is the collection of outputs from an accounting information system or any information system. A financial statement, such as an income statement, is an example of an information output. Data, on the other hand, are the raw facts, figures and regular symbols that jointly form the inputs to the information system. Data may occur from a
variety of sources. Substantial data are produced by the incidence of likely events. Further data reflect relevant conditions, such as interest rates and competitors' prices.

2.13.2. Accounting

Accounting has various levels of meaning. First, it is the activity of (1) recording economic data (2) calculating and analysing these data (3) presenting the subsequent information in financial terms. Second, accounting is the language of business. It provides the means by which the key affairs of a business enterprise are expressed and summarised. Finally, it can be observed as the information a business enterprise (i.e., a firm) uses to realise adequate operation and effective management.

Moscove and Simkin argue that the accounting information system can be defined as:

...an association component which accumulates, classifies, processes, analyses, and communicates appropriate financial-oriented, decision-making information to a company's outside parties [such as current and potential investors, and creditors] and inside parties [particularly management] (1984:9).

The accounting information system is the most influential and often the largest of the information subsystems in a business organization. Its influence lies
in the fact that all members of the firm participate in some way in the generation of transaction data.

Therefore, the accounting information system is the set of human and capital resources within an organization that is responsible for the preparation of financial information and also of the information obtained from the collection and processing of transaction data.

2.13.3. The Relationship of the Accounting Information System to Other Information Systems

Although the accounting information system (AIS) is an extremely important information system within a firm, it is not the only formal framework for providing information. Another important formal information system is the management information system (MIS).

The accounting information system serves both the managers and non-managerial users such as owners and creditors, with financial information. The management information system serves only the managers of the firm, and provides non-financial as well as financial information. By providing a more complete range of information the management information system assists finance, production, marketing, and other managers in their controlling and decision making responsibilities. The informal information system adds information drawn from
informal sources, such as trade publications, to the bulk of information provided by the formal systems (Wilkinson, 1989).

2.14. The Market Reaction to Accounting Method Changes

A frequent criticism of corporate financial reporting is the diversity in accounting methods used by companies. Diversity in accounting method choice, it is claimed, implies noncomparability of the figures derived from the financial statements of different firms. The choice of accounting method can influence the market value of the corporation's equity or debt securities in at least five ways (Foster, 1986:138):

1) Taxation expense influence. Where there is a link between the accounting methods used for financial reporting and those used for tax reporting, companies can affect their corporate tax exposure via accounting method choice. In the United States, under several laws a firm that uses the LIFO inventory method for tax reporting also has to use LIFO for financial reporting. This law gives firms the option of reducing taxation payments by accounting method changes and firms that expect inventory levels to increase/decrease and the purchase prices of inventory to increase/decrease can reduce expected taxation payments (in present value terms) by switching from FIFO to LIFO, or
from LIFO to FIFO. Management statements in annual reports at the time of inventory accounting changes frequently quote the cash flow benefits of the change.

2) Data collection and operating cost influence. Accounting alternatives can differ in their data collection and operating costs. For example, reporting land and buildings at historical cost is less costly than is reporting them at current market values, which are updated annually and certified by an external valuer. Similarly, using group depreciation rates for broad categories of plant and equipment is less costly than is using a separate depreciation rate for each individual item of plant and equipment. Operating cost issues also are an important factor in inventory decisions.

3) Financing cost influence. Financing cost can be influenced by accounting method choice, as in the case of a company which borrows from a bank and, as part of the lending agreement, a contract is written on the times interest earned ratio. If the contract does not specify the accounting methods under which the contract is to be interpreted, management may make an accounting change to avoid technical violation of the contract.

4) Political and regulatory cost influences. Governments and regulatory agencies have the power to
transfer wealth from companies to other parties. Companies may attempt to affect such wealth redistribution through their accounting method choice.

5) Wealth redistribution among claimants. Financial statement figures are often the basis by which wealth is distributed among various parties. In the case of profit sharing agreements with workers and in "earn-out" provisions associated with acquisitions, accounting method choice may affect the amounts individual parties receive.

2.15. Summary

There is an important link between financial and capital market development and the economic growth of a developing country, where these markets mobilize savings and allocate investment into productive enterprises. The stock exchange, as a mechanism for the exchange of shares, plays a significant role in the economic development of a nation.

The early theoretical and empirical work on securities and prices has evolved through several stages through the contributions of many economists in order to develop new market equilibrium models which can be widely accepted. The Efficient Market Hypothesis still attracts a large number of studies which test the efficiency of financial markets.
It has to be said that due to difficulties involved in applying the efficient capital market approach and the user decision-oriented approach as a method for reporting financial information to different users, no method can be demonstrated to be superior to the others at present and all approaches seem to offer opportunities for advancing the debate on the choice of accounting method.

We saw that financial accounting has both internal and external uses. It is used internally to track progress at the micro level, and externally for a wide variety of purposes. These vary from government use to ensure compliance with regulations, to investor use to determine the desirability of the company's stock. Managerial accounting is used exclusively for internal planning and control purposes.

Although there are several definitions of the accounting information system, it is the most influential information subsystem in a business organization as it provides information useful to both internal and external users for various purposes. It cooperates with other information systems within the firm to provide the required information.

The investment community is continually searching for new ways of detecting mispriced securities. Change in the
models can occur for a variety of reasons: new analytical or empirical insights; new data bases, new disclosures by firms; new statistical tools; and new developments in computer technology.

Increasing recognition is being given to the choice of accounting method as a factor affecting the market value of the firm's equity. At present, security analysts are better able to list factors such as taxation benefits and political costs than to develop models that reliably predict how the foregoing, and possibly other factors interact to produce the set of accounting methods chosen by individual companies.
CHAPTER THREE

Review of Literature on Stock Markets in Developing Countries and their Impact on Economic Development
3.1. Introduction

When the developing countries set out to modernize their economies in the 1950s and 1960s, their financial systems comprised mainly foreign-owned commercial banks which provided short-term commercial and trade credit. Governments of these developing countries decided to remodel their financial systems to ensure that resources were allocated in accordance with their development strategies.

Thus, they created new financial institutions to provide funding at low interest rates to the sectors that were to be at the forefront of industrial development, or they directed existing institutions to do so. The governments themselves borrowed heavily from both the domestic financial system and abroad, to finance budget deficits and the needs of state-owned enterprises. During the 1960s this development strategy seemed to be working, as many developing countries grew rapidly. But economic performance during the 1970s was more mixed. Despite favourable terms of trade and an ample supply of cheap foreign finance, growth in some countries began to slow. Except in Asia, only a few developing countries grew rapidly in the 1980s.

Although in recent years there have been numerous
analytical and descriptive studies on share price behaviour of stock markets in developing countries, due to the availability of the data required for such studies, there has been a noticeable scarcity of studies concerning the trading activities of stock markets in developing countries. The informational efficiency of the Kuala Lumpur Stock Exchange (KLSE) and of the Singapore Stock Exchange (SISE) was investigated by Dawson (1981), Barnes (1986), and Laurence (1986). The efficiency of stock markets in Hong Kong were investigated by Dawson (1984).

In this chapter we will review some studies concerning the stock markets of Kuwait, Nigeria, Jordan, and Indonesia respectively.

3.2. Trends in Stock Markets of the Developing Countries

Countries with stable economies and fairly well-developed and competitive financial markets would benefit from giving market forces more influence over interest rates. Where these conditions are not satisfied, governments may choose to control interest rates, but unless that control is flexible enough to take account of inflation and market pressures, it will hinder financial development. Proper adjustment of interest rates is particularly important for economies that have open capital markets.
In the past, governments have allocated credit extensively. In a world of rapidly changing relative prices, complex economic structures, and increasingly sophisticated financial markets, the risk of mismanaging such control has increased. Many countries could allocate resources better by reducing the number of directed credit programmes, the proportion of total credit affected, and the degree to which interest rates are subsidized. Governments can increase the supply of long-term loans and other types of financing by reducing the risks to lenders by requiring fuller disclosure of financial information and defining and enforcing lenders' rights. To ensure the stability of the financial system and discourage lenders from fraud, it is equally important for governments to supervise financial markets and institutions.

Many developing countries have benefited from the creation of money and capital markets. Capital markets can be a source of long-term finance, both debt and equity, and can help to foster sounder corporate capital structures.

Several developing countries have made great steps in recent years in establishing and stimulating equity markets. Such markets now exist in more than forty countries. In many countries, however, equity markets remain small and only a few countries have active corporate bond markets. In the past, demand for securities has been
inhibited by the lack of investor confidence but in the future, much of the demand is likely to come from institutional investors.

A primary reason for the underdeveloped state of capital markets in many developing countries is the absence of an appropriate legal, regulatory, and tax framework. In some countries new shares have to be issued at par value which makes them unattractive to companies if the market value of their shares has appreciated significantly. In other countries the tax-free status of time deposits or government and public enterprise bonds decreases the appeal of private corporate instruments.

A common problem in securities markets, especially early in their development, is the danger of a speculative boom followed by a sharp decline. Such crises have affected markets in both developing and high-income countries, but they can be much more pronounced in young markets.

In the last decade, stock markets in the developing countries experienced a remarkable growth in size and sophistication. The extraordinary growth of these stock markets can be seen in the context of a wider change—a general change away from government control and direction, toward policies that encourage the private sector to be the driving force of economic growth.
Stock markets play an essential role in the process as a source of equity finance, as well as a pricing mechanism for new issues. Economic growth requires that new and growing companies expand their capital bases. The recent significance of stock markets for developing economies can be seen by looking at the decade of the 1980s, when the total capitalization of the 20 largest markets increased up to seven times and the number of listed companies doubled. Moreover, the value traded on these markets by 1991 had increased to about 39 times the level of 1980.

However, in late 1991, the stock markets slowed down due to a host of changed circumstances: rising inflation, a tight monetary policy, the Gulf crisis, an uncertain international investment environment, and the continued global recession. The slowdown should be looked at as a blessing in disguise, however, for it allows policy-makers, entrepreneurs and investors to take stock and to prepare themselves for the next stage of institutional change and growth.

3.3. Kuwait Stock Market

The capital market of Kuwait is one of the most active markets in the Gulf area, if not in the Arab world. Shares in Gulf companies (particularly those of Bahrain and UAE)
are traded only in the Kuwait stock market, which has facilitated and diversified share trade.

However, only a few studies have paid some attention to the Kuwait stock market. One of these studies was carried out by Darwiche (1986), who studied the Kuwait Stock Market since its establishment on 12th April 1977. She described the origin of the Kuwait Stock Exchange (KSE), the magnitude of the secondary market, brokers' activities, issuing departments, listing requirements, commission rates, members of the stock exchange, the stock price index, and the market activities.

Despite the crash of the Kuwait stock market, due to over-speculation, together with the use of post-dated cheques as a method of payment in share-dealing, the study argued that the Kuwaiti stock market could achieve a number of important economic objectives, such as providing liquidity and averting the risk of inflation. Private investors played an important role by sharpening their economic and investment awareness and increasing their interest in dealing with companies and businesses which promoted economic recovery up to record level during the seventies.

The government tried to broaden the industrial base of the domestic economy and channel the oil surplus into the
domestic economy by encouraging investment in domestic companies, which was considered the most suitable way of directing more financial resources towards investment and employment to help in the creation of a solid economic base and to divert investors from the risk inherent in overseas investment.

Darwiche pointed out that, due to the lack of legislation and regulation by the authority, the absence of the important awareness in this business to raise the standard of individual investment, the Iraq-Iran war ventures and the recession of oil prices, quick profit-making and unsound criteria diverted many companies from the purposes for which they had been incorporated and created a lack of confidence throughout the market which affected the economy of the country in a serious way.

In another study of the Kuwait stock market, Al-Mudhaf (1983) assessed the efficiency of the stock market, considering all requirements of efficiency. The study was based on forty Kuwaiti stocks, using the daily closing prices for a five year period.

He applied the weak form of efficiency hypothesis to the market, according to the data which he was able to obtain from the market during the period of study. The lack of data about profits and dividends made him unable to
apply the semi-strong form of efficiency hypothesis. He found the market to be inefficient, despite the possibility of achieving the weak form of efficiency. He concluded that more publicly available information and improvement of trading conditions were required for the market to become efficient.

In Kuwait, a new securities exchange opened in September 1984, known as the "Financial Papers Market" to trade bonds and bank deposits as well as equities. The market listed Kuwaiti companies, although in 1986, an official parallel market was created on the main floor, which listed Gulf-based companies. The trading system is based on a written auction procedure and the market is regulated by an eleven man committee under the control of the Ministry of Commerce and Industry. In 1983, the government introduced an extensive set of laws to regulate the market's operations, which are similar to those of developed stock markets, including regulations covering information disclosure, securities registration, brokerage requirements and registration (Maliakah, 1990:13).

Since 1986, the stock exchange authority has the right to examine the financial position of the listed corporations and licences are issued for brokerage firms provided that they fulfil the capital and credential requirements. Those brokers instruct their floor brokers to
conduct the trades. This separation of functions is intended to protect the integrity of the market by ensuring that traders do not know the identity of their clients. Brokers are responsible for settlement of the deals in order to prevent another Al-manakh crisis. Two forms of market makers supply a measure of liquidity to the market (Maliakah, 1990:14).

Financial information is made available on the stock exchange floor by ticker tape or by a circular, as soon as it is reported to the stock exchange committee, and later through local media. Corporations have, since 1988, been required to report semi-annual financial statements. The Kuwaiti Stock Market performs financial analysis on all listed stocks and produces semi-annual and annual statistical summary reports which include world, regional, and local economic outlooks. Historical performance is prepared and reported to investors through the annual publications and directories. Daily, weekly, monthly, quarterly and annual stock price and trading summaries are produced and reported to the local news media. Although adherence to information disclosure requirements by corporations has improved, quarterly financial disclosures are not common among the corporations and insider trading regulations have not been developed.

The International Finance Corporation (IFC) Factbook
(1990), mentioned in its survey that the market started to decline from 1988, as the number of listed companies decreased from 65 companies in 1988 to 52 companies in 1989, the market capitalization decreased from KD 3,345 million in 1988 to KD 2,900 million in 1989, and the trading value dropped from KD 710 million in 1988 to KD 502 million in 1989. This decline was a result of the lack of confidence in the market due to the crash of the market in 1982 and the severe recession that hit most of the developing countries.

3.4. Nigerian Stock Market

In Nigeria, the capital market was designed to:

1) provide local opportunities for borrowing and lending for long-term purposes;

2) enable the authorities to mobilize long-term capital for the economic development of the country;

3) provide foreign businesses with the facility to offer their shares and the Nigerian public an opportunity to invest and participate in the shares and ownership of foreign businesses;

4) provide facilities for the quotation and ready marketability of shares and stocks and opportunities and facilities to raise fresh capital in the market;
5) introduce a code of conduct, check abuses and regulate the activities of the operators in the market;

6) through participation and ownership, provide a healthy and mutually acceptable environment for participation and cooperation of indigenous and expatriate capital in the joint effort to develop the Nigerian economy to the mutual advantage of both parties.

The capital market activities in Nigeria recorded a significant growth during 1980s, as transactions increased noticeably. The establishment of the second-tier securities market during the year of 1985 was a major innovation designed to enhance the role of the capital market in capital mobilization in the country. In 1986 the market was active as the number of transactions rose by 17.7% and the value increased by 55.6%. The Nigerian secondary market is relatively poor, because the amount of new issues is very small, and investors tend to buy and hold securities.

The development of the Nigerian capital market has been fostered by the various governments, directly and indirectly. The objective of public policies was to extend the market through the introduction of more instruments and the provision of institutional support. In Nigeria there are statutory requirements on certain financial institutions, namely, insurance companies and officially
sponsored funds to invest in domestic securities. In addition, the introduction of exchange control on capital movements has had the effect of increasing activity in the local capital market. Furthermore, the increasing issues of government stocks have helped the local capital market to expand.

Okafor described and analysed the organized capital market in Nigeria as it operated on 5th June 1961. He described the origin of the Lagos Stock Exchange (LSE) and market activities (Onoh, 1980:145).

The study concluded that a reasonably workable stock exchange in a developing country, such as Lagos Stock Exchange, could become a useful vehicle in the wide distribution of ownership of large corporations. The study also pointed out the negative impact on the exchange activity resulting from short-sighted and heavy-handed government controls.

In another study, Abdul-Hadi (1989) analysed the economic and historical background and the development of the Nigerian Capital Market, its institutions, the securities market, and the development of Lagos Stock Exchange (LSE). He showed that the early operations of the Nigerian capital market had been encouraging and the prospects for continued progress were favourable.
The study concluded that the network of commercial banks in Nigeria contributed to the development of the capital market by indirect participation in capital market operations through their role as agents receiving in application moneys in new issues.

The Nigerian stock market continued to climb in 1990, placing the performance of the market among the top ten world equity markets. While there are currently no country funds to serve as an equity investment vehicle in Nigeria and foreigners can not invest directly, the stock exchange is said to be considering ways to improve international opportunities, including the establishment of such a fund.

According to the International Finance Corporation (IFC) Factbook (1992), the Nigerian stock market continued its upward trend during 1991. The local general index gained almost 53% in Naira terms and the liquidity increased in Naira terms as well. However, the total value of shares traded decreased from US$ 10.9 million in 1990 to a little over US$ 9 million and the average daily value traded for 1991 also decreased to US$ 36,975 from US$ 43,426 in 1990. The total market capitalization grew more than 34% in 1991, rising from US$ 1.4 billion at the end of 1990 to US$ 1.9 billion, with 11 new listings.

Capital market reform and a privatization programme
revived market activity and broadened the market during the year. Primary market activities were also brisk. The policy of mass participation is reported to have resulted in 620,000 shareholders all over the country, a 55% increase from 400,000 shareholders at the beginning of the year, in an effort to provide an incentive to greater corporate accountability.

The market was also boosted by the government's decision in July to cut the withholding tax on dividends from 15% to 5% and to reduce tax expenses associated with companies seeking quotation on the second-tier securities market.

Recently, Soyode (1993), studied the sensitivity and responsiveness of securities on the Nigerian stock exchange (NSE) to changes within the Nigerian economy. He investigated the impact of a particular fundamental economic policy, the structural adjustment programme (SAP), on the stock market and on its performance. The individual Nigerian companies report, through the required profit and loss account, balance sheet, and statement of sources and application of funds, the data by which investors gauge the earnings performance and the financial position.

This study revealed that the Nigerian stock market is a faithful barometer of economic conditions, which are
rapidly reflected in earnings, dividends and price changes on the stock market. A constant monitor of the stock market performance is likely to reveal, most often, the direction of the economy or at least the perception of the general investing public about the state and direction of the economy. These perceptions determine the rate of change of capital information and of capacity utilization, both direct determinants of the prospects of the economy.

3.5. Jordan Stock Market

The role of financial markets, together with the recent developments in the Jordanian economy, especially the huge investments, both domestic and foreign, which created the need to establish an instrument capable of mobilizing these investments, supported the call for establishing the Amman Financial Market (AFM).

The Amman Financial Market was formally opened on the first of January 1987, to provide an organized market for trading in securities of public share-holding companies, government and private corporation bonds, and other securities and debt instruments that are introduced into the Jordanian financial sector. The objectives of the market according to its Act include the following (Al-Hmoud, 1987:9):

1) To promote savings by activating and encouraging
investment in financial papers and to direct such savings to serve the development of national economy.

2) To organize and control issues of, and dealings in financial papers to ensure the soundness, ease and speed of such dealings and to guarantee the financial interest of the country and the protection of small savers.

3) To gather and publish the statistics and information necessary to realize the above objectives. The market Act required that information about the economic activities and transactions within the market should be available to the public free of charge, in order for the capital market to play its role efficiently.

The size of the Jordanian economy could be considered as an environmental constraint. However, the strategic location of the country near the oil countries, and its relative political stability (although the stability in the region as a whole is in question) improve its chances of being the financial centre of the Middle East (Al-Hmoud, 1987).

The performance of the primary market could be measured by the extent to which the establishment of the exchange has helped to raise more capital. During the period 1978-1984 more than 62 new companies offered shares to the public, while 46 existing companies offered
additional shares to the public during the same period. The number of listed companies increased from 57 companies in 1978 to 103 companies in 1984. The percentage of capital raised through the AFM to total fixed capital formation (FCF) ranged from 8.1% in 1984 to 22.2% in 1982 with an average of 14.5% for the period of 1978-1984. The proportion of total issues of securities to GNP (Gross National Product) ranged from 2.1% in 1984 to 7.9% in 1982 with an average of 4.7% (Al-Hmoud, 1987:12).

The average equity raised in the AFM to the FCF and GNP was 9.2% and 3.1% respectively by 1984. The shareholders' base has become broader since the establishment of the stock exchange, as it increased by 240% from 1978-1984 to over six hundred thousand shareholders. Share ownership is much wider than in the past, as the average number of shareholders of each company ranges from 4094 to 1096 over all sectors except the insurance sector, which has an average of less than 1000 shareholders per company. This large number of investors is important since it is one of the sufficient conditions for an efficient market. Thus, the primary market performance was important in raising capital through the AFM.

The activity of the the secondary market recorded an impressive growth during the period 1987-1984. The volume of trading in the organized market increased from JD
5,615,891 million in 1978 to JD 119,607,842 million in 1983, though it declined to JD 53,092,334 million in 1984 as a result of the recession.

In order to reduce the pressure on the organized market, to limit stock price increases, and to reduce short run speculations, the supply of securities was increased by allowing the shares of newly established companies that did not meet all the listing requirements to be traded over the counter. Thus the management of Amman Financial Market in 1982 established a parallel market, similar to the unlisted securities market in London, for those companies waiting for a full quotation and by the end of 1986 there were 11 registered companies with a combined nominal subscribed capital of JD 28,546,202 million.

The establishment of the OTC market helped to provide liquidity and set suitable prices for the shares of the new (unlisted) companies and encouraged these companies to provide the further necessary information to the AFM and so fulfil all the requirements in order to become listed in the organized market (Al-Hmoud, 1987:22).

The main difference in the treatment of the OTC stocks and stocks listed in the organized market is that the prices of the former do not appear in the daily and weekly reports. Therefore, the establishment of the OTC market is
a further indication of moves by the AFM to provide services needed by the financial market and thus improve efficiency and effectiveness.

The market has shown consistent growth and diversification during recent years in various aspects and the investors have responded positively to the formation of the market as far as their savings are concerned. The size of the AFM relative to the economy as a whole is larger than markets in less developed countries and somewhat similar to the markets in European countries in general. However, the Jordanian economy is still very small when compared to the economies of many developing and European countries.

The factors affecting the AFM's size include the newness of the market, the limited scope of financial instruments, the law, income and savings, and more recently the decline in oil revenues resulting in a reduction of the remittences of Jordanian expatriates working in the Gulf States and the decline in the oil countries' aid to Jordan.

The disclosure of information is important to encourage investors and to assure them that they are involved in a fair game, where timely information needs to be publicly available. The AFM Laws list many financial and legal requirements to be fulfilled by the companies
operating in the market. They must provide annual financial statements and a list of shareholders; a prospectus should be prepared in case of stock offerings; listed companies should make prompt disclosure to the market of any important information that influences its share price. These requirements aim to ensure that the relevant information is publicly available and investors are protected against insider trading (Al-Hmoud, 1987:28).

The publication of information about the stock prices, the volume of trading, and the analysis of financial statements is mainly carried out by the AFM, which prepares the following:

a) The daily price sheet;
b) The weekly price sheet;
c) The monthly report;
d) The quarterly report;
e) The semi-annual report;
f) The annual report.

Both the daily and weekly price sheets give a summary of the individual prices for the day or the week and are published in the local newspapers. The other reports provide summary statistics for different activities of the market during a given period. In addition, the AFM publishes a guide to the public shareholding companies
every two years, which includes a classification of the financial statements for all companies and provides some financial ratios for each company. It also provides some statistics about the shareholders, employees, number of companies, etc.

In Jordan, the main source of information about the performance of the companies is their financial statements, which should be prepared and audited annually. Due to the lack of facilities and specialization, interim financial statements are not prepared and published by companies and are not required by law. Thus, necessary information arrives very late. Therefore, it is believed that an improvement should be made to company law in this regard, as some measures have been adopted by the government to increase the efficiency of the AFM (Al-Hmoud, 1987:30).

In a recent study, Omet (1990) has investigated the Amman Financial Market, its formation, the impact of the market on the economic development of the country, and the efficiency of the market, since its establishment. The study revealed that relative to the size of the national economy, Amman Financial Market is unlikely to have a significant impact on the economy for some years to come.

Since then, due to the Gulf crisis and Jordan's proximity to both Kuwait and Iraq, the performance of the
Jordanian stock market has been severely affected, as the Amman Financial Market recorded great losses because the market activity was affected by the drastic decrease in foreign remittances from expatriate Jordanians employed in the Gulf States and the rise in unemployment due to the return of expatriates to the country. However, the market recovered and recorded a good level of trading activity, even though it was very slow after the crisis ended.

The International Finance Corporation (IFC) Factbook (1992), mentioned that even though the AFM remained steady throughout 1991, the market saw weak activity during the first two months of the year, with an average daily trading value of US$ 0.35 million in January and February. However, trading activity increased fourfold in March to US$ 1.4 million per day and remained even higher for most of the year and the market capitalization increased by 25% for the year, to US$ 2.5 billion in December.

3.6. Indonesian Stock Market

The Indonesian stock market is typical of a small, less developed stock market in a developing country. Commission rates are fixed by the Capital Market Executive Agency (BAPEPAM) and stamp duty is payable. Margin trading is permitted (although it rarely occurs); short selling is not permitted. Although the market has grown impressively
since the end of 1988, the thinness of the market was a particular feature. The number of stocks quoted on the market reached more than 60 at the end of 1989. The daily trading volume in the secondary market often reached more than US$ 1 million in the same year (Husnan and Theobald, 1993:353).

Several studies were carried out in the Indonesian stock market. When very few stocks are quoted in a particular market, results can be sensitive to the index selection. In the light of these two phenomena, a recent study investigated their impact upon price reactions to earnings announcements in Indonesia (Husnan and Theobald, 1993).

This study found that the problems of thin trading and index sensitivity were present in the Indonesian stock market and differing price reactions were observed when thin trading impacts in parameter estimates were reduced. As a result of this finding, the study concluded that the market seems not to be efficient in the semi-strong form and investors could obtain abnormal returns several weeks after the first potential release of the earnings figures. These inefficiencies are a potential reflection of the market conditions and institutional aspects of the Indonesian stock market.
3.7. Summary

Capital formation is one of the main factors responsible for economic growth and the availability of capital is, consequently, one of the central themes in discussions of growth possibilities in developing countries. Success in the mobilization of needed capital for development has varied among countries and has depended on the availability of domestic savings within the economy and the inflow of foreign capital.

Studies of the contribution of accounting information to investor decisions which may affect the trading activities and the performance of the stock markets in developing countries are few, as most studies focus on stock market behaviour in general and on share price behaviour in particular. Studies of the developing exchanges indicate that market efficiency is not conclusive.

Although the Kuwaiti stock market is an active market, in comparison with the stock markets of other countries in the same region, the Kuwait economy was seriously affected by the crash of the market, the recession, and the recent Gulf crisis which created a lack of confidence in the stock market. However, the trading system of Kuwait stock market produces relatively more competitive prices and bid/ask
spreads due to order consolidations and the presence of many market makers brought together in a single organized market.

A close look at Nigeria's stock market shows that it has not been able to satisfy the needs of individual investors for low risk, easily accessible investment instruments and the needs of institutional investors for long term rates of return. Thus, government action is needed to provide incentives and more orderly market conditions.

In the case of AFM, we saw that information which can affect the investment decision either does not exist or is not measured. Those data that are available, are published relatively infrequently. The collection and distribution of information is not the sole responsibility of the AFM, as it lies in the hands of various parties including the government, quoted companies, management consultancy firms, and stockbroking firms. Indeed, in the long run, this aspect of the market should be improved in order to enhance its impact on the economy of the country.

The Indonesian stock market is not efficient in the semi-strong form, since abnormal returns could be achieved several weeks after the first possible release of new information. The presence of such inefficiencies will
further obscure the measurement of price reactions to information disclosure.

Each of these markets has suffered interruptions in trading and investors have not been very enthusiastic towards company equities. Governments have been restrictive and at times discouraging in their policies towards securities markets.

A robust research programme, constantly updating stock market data, refining analysis and ensuring currency of findings, promises to yield a large positive net benefit to the economy.
CHAPTER FOUR

The Islamic View of Financial Debt and Securities Investments
4.1. Introduction

Islam is not just a religion, but a unique way of organizing society, which covers all aspects of human life. Hence, the Holy Qur'an and the Sunnah (the teaching of the Prophet Muhammad, peace be on him) contain the principles a Muslim society needs to know in order to deduce what constitutes a justified or unjustified and rightful or wrongful source of earning.

Islam is a balanced and coherent way of life, designed to cater for human welfare through the establishment of harmony between the moral and the material needs of human beings and the actualization of socio-economic justice and brotherhood in human society (Chapra, 1985:15).

The Islamic principles are relevant and applicable to all aspects of economic activity of man: they guide an individual's relationship with his Creator (Allah), respecting his wealth, his relationship with the society, his partners, his legal heirs, and his overall dealings with them. Islam has laid down general principles for every aspect of economic activity in such a way that they are applicable to all situations and periods of history.

Muslim society does not condone usury. Therefore, throughout the fourteen centuries of its history prior to domination by imperialist powers, it managed its economy
and carried on domestic and international trade without the institution of interest. Profit-sharing and various kinds of participation arrangements served as adequate bases for savings and investment and considerable capital was mobilized for textiles, ship-building, mining and other industries and for maritime trade also.

Despite the fact that circumstances now force many people to deal with interest-based financial institutions, the notion of the essential illegitimacy of interest has always remained. A sizeable section of the community still refuses to have any dealings with these institutions, despite the inconveniences involved (Siddiqi, 1983:9).

The objectives of this chapter are to discuss the receiving of any monetary advantage in a business transaction without giving a rightful countervalue, which is called Riba (Interest or Usury) in the Islamic value system. We will first define the meaning of Interest and Riba in Islam and investigate the implications of prohibition of Riba for the Islamic financial system. The Islamic alternatives to Riba will be briefly indicated, though not discussed in detail.

Finally, we will discuss the Islamic thought regarding securities investment and outline the Islamic jurists' sentiments regarding the formation of joint stock
companies, investment in their shares, and the Islamic perspective on the framework of an Islamic securities market.

4.2. The Meaning of Interest

Patinkin defined interest as:

...a payment for a loan (in money or in kind) over a period of time, measured by the difference between the amount repaid by the borrower and the principal received by him (1972:471).

4.2.1. The Meaning of Riba in Islam

The word Riba comes from Raybah which literally means doubt or suspicion and refers to any sort of income which has the semblance of Riba or which raises doubts in the mind about its rightfulness. It covers all income generated from injustice to, or exploitation of, others (Chapra, 1985:60).

Riba, in Arabic, literally means increase, growth, addition, rise, and hence excess of the fixed amount that should be paid by the borrower to the lender over the principal amount in a lending transaction, against time allowances. The word Riba was used in the pre-Islamic period to identify a class of business transactions, the main feature of which was that a fixed amount must be paid over the principal due.
Riba is prohibited in Islam and this prohibition appears in the Holy Qur'an several times. The verses that prohibit the use of Riba in Chapter Two of the Holy Qur'an are:

Those who swallow Riba can't rise up save as he ariseth whom the devil hath prostrated by [his] touch. That is because they say: trade is like Riba, whereas Allah hath permitted trade and forbidden Riba. He unto whom an admonition from his Lord cometh and [he] desists [in obedience], he shall keep that which is past, and his affair henceforth is with Allah. As for him who returneth [to Riba] such are the rightful owners of the fire. They will abide therein (11:275).


0, you who believe, keep your duty with Allah and relinquish what remains of Riba, if you are believers (11:278).

But if you do [it] not, then be apprised of war from Allah and his Messenger; and if you repent, then you shall have your capital. Wrong not, and you shall not be wronged (11:279).

0, you who believe, devour not Riba, doubling and redoubling, and keep your duty with Allah, that you may be successful (III:129).

In all these verses the word Riba means the premium that should be paid over the principal. One form of Riba is that a person sells a product to someone on the agreement that a specified price must be paid at some future date, then if at the maturity date the buyer cannot pay, the seller would increase the price and extend the payment period.
Another form of *Riba* is to lend money to someone on the agreement that the borrower will repay an excess amount over the principal sum due after a specified period of time (Khan, 1985:24). These types of *Riba* are classified as *Riba al Nasi`ah* or *Riba al Duyun* which means clear usury.

However, there is also a class of non-financial transactions classified as *Riba* and prohibited by Prophet Muhammad, peace be on him, which is encountered in hand-to-hand purchase and sale of commodities. This kind of *Riba* is known as *Riba al Fadl* or *Riba al Buyu*, meaning unclear usury. This type of *Riba* refers to six commodities mentioned in an authentic *hadith* (Prophet's tradition); these commodities, it is said, may only be exchanged like for like, of the same quality and quantity:

1. "From Abu Sa'id al Khudri: The Prophet, peace be on him, said: Do not sell gold for gold except when it is like for like, and do not increase one over the other; do not sell silver for silver except when it is like for like, and do not increase one over the other; and do not sell what is away [from among these] for what is ready."

2. "From Ubada ibn al-Samit: The Prophet, peace be on him, said: Gold for gold, silver for silver, wheat for wheat, barley for barley, dates for dates, and salt for salt - like for like, equal for equal, and hand to-hand; if the commodities differ, then you may sell as you wish, provided that the exchange is hand-to-hand."

Arguments have been raised among Islamic jurists as to whether the prohibition of *Riba* in loan is limited only to
those forms that existed in the pre-Islamic period. Another argument concerns whether or not Riba is applied to productive, commercial loans as well as to consumption loans. Finally, there is also debate as to whether the prohibition of Riba in trade is applied only to the six commodities mentioned in the above authentic hadith, or whether these should be treated as examples of a general principle.

In spite of those arguments, Islamic jurists, in general, hold that the prohibition of Riba extends to cover any form of fixed and pre-determined increase to be paid over the original amount of a loan, after a specified period, no matter what the rate of the increase or what the purpose of the loan. This general conclusion is according to the Holy Qur'an and Sunnah, whatever the differences on points of detail among some Islamic jurists. Since our concern is with investment in shares and stocks, attention will be focused on the first kind of Riba or usury.

4.2.2. The Prohibition of Riba

The prohibition of Riba was justified by many Islamic jurists for different reasons. At the individual level, Riba creates selfishness, miserliness, greed and malevolence. On the basis of Riba the money lender cares only for the principal and the Riba to be paid on it by the
borrower, who may need the money to meet an unexpected accident or emergency. Moreover, at the social level, Riba would tend to result in one class of people accumulating most of the society's wealth, leaving the rest of the society poor. This will lead to a highly unstable society.

The prohibition of Riba is intended to ensure justice and remove all forms of exploitation through unfair exchanges by requiring the absence of rigging, uncertainty or speculation, and monopoly or monopsomy. A fair knowledge of the prevailing prices should be possessed by both buyer and seller before they enter into a transaction.

Islam, by prohibiting Riba, intended to establish an economic framework where all forms of exploitation are eliminated, and particularly, the injustice perpetuated in situations where a financier is assured of a positive return without doing any work or sharing in the risk involved, while the enterpreneur, despite his management and hard work, is not assured of such a positive return.

4.2.3. The Islamic Alternatives to Riba

The Islamic view of investment in general is based on two fundamentals, according to the Holy Qur'an where it is stated as follows:

Allah hath permitted Trade and forbidden Usury. (II:275).
The first principle is that risk is involved in the process of investment, in other words, there is a possibility of loss or profit. The second is that the return on investment should not be in any way predetermined. Thus, investment in bond securities is considered to be contrary to Islamic principles, because the term bond in Arabic means a debt receipt of a certain amount of money, the user of which is obligated to pay a percentage in return for having the use of the money for a given period of time.

These days, due to economic constraints and in the interest of the whole society, some Islamic jurists ask for an exception for governments or business organizations to issue bonds.

There are two types of financial contract which are presented in Islamic jurisprudence to replace Riba-oriented transactions. These are (i) Musharakah [partnership], and (ii) Mudarabah [commenda]. There are differences among jurists about the conditions controlling these contracts (Khan, 1985:28).

*Musharakah* is a type of contract where two or more people contribute in varying amounts both the capital and management for running a business, with the provision that
they will share in the profit or loss in some pre-determined proportions.

The principle of partnership in business is stated in two verses in the Holy Qur'an and in an authentic hadith of prophet Muhammad, peace be on him, which is reported by Abu Daowd:

"From the teaching of Abu Horira: The Prophet, peace be on him, said: Almighty Allah said we are the third two partners as long as neither of them is disloyal to the other. However, once one is disloyal to the other, We withdraw our care."

Mudarabah, on the other hand, is a contract in which one party, the owner of the business [Rabbul-Mal] provides capital while the other party, [Mudarib] contributes his labour and effort, with the provision of profit sharing in some pre-determined proportions.

In addition to these there is another type of partnership business in Islam, called al Enan, which is considered as an Islamic form of corporation with no prohibition on the trading of its capital shares, provided that there is no restriction in the form of share trading nor on the company activity.

Islamic banks play a significant role in meeting the desire of Muslim savers to invest their savings in an investment vehicle that complies with their religious belief. The methods used in their investment operation are
those explained by Shari'ah to be the Islamic methods of financing and investment. Those methods are characterized by these terms:

a) Mudarabah Investment Financing; a formula by which there is a union of capital with expertise. The Islamic bank as a sleeping partner provides the capital and the client is entrusted with the technicalities of how to manage the project. Profit or losses are split according to some agreed upon ratios and not on the basis of capital contribution.

b) Musharakah Investment Financing; a system similar to that of Joint venture, whereby the Islamic bank enters into partnership for a limited period for a particular project. Both the bank and the client contribute to the capital, with the client maintaining the right to buy back gradually the bank's shares. Profits emanating from such ventures are normally shared by the bank and the client in some agreed upon ratios.

c) Murabahah Investment Financing; similar to that of consignment business where the Islamic bank purchases a commodity for the client or any third party and resells it at a fixed mark-up or rate of profit on the stated original cost. As the sale price is based on the original cost of the item to the seller, the client is provided a kind of
protection against unfair exploitation. As an additional protection to the client, the Islamic jurists insist that the seller avoid any misleading statements.

d) Bai'-al-Salam; through this agreement the Islamic bank may enter into a contract with a client for advance purchase of his products, specifying complete details of the commodity, its quality, its price and the place and time of delivery and make the payment of the agreed amount at the time of entering into the agreement. When the commodity is produced and supplied to the bank on the specified date, the bank has the right to sell the commodity. *Bai'-al-Salam* is a special type of trading arrangement which is subject to strict conditions as laid down in the Holy Qur'an and *Sunnah*.

e) Lease Purchase Financing; under this arrangement the Islamic bank acquires equipment or buildings and rents them to the user against a fixed charge. It is a contract whereby the bank purchases an asset and leases it to a client. The lease contract specifies the leasing period, the amount and timing of lease payments and the responsibilities of both parties during the life of the lease.

Islamic banking has grown as an integral part of the Islamic financial system based on the rules of the
Shari'ah. Even though theoretical discussion of the impact of Islamic banking is introductory and fragmentary, practical steps to change institutional structures along these lines gained momentum in the 1980s. The last decade has witnessed an enormous growth in the number and strength of Islamic banking and financial institutions (Mangla and Uppal, 1990:182).

A major contribution of these banks has been their development of an Islamic investment mechanism by modifying several investment schemes which exist in commercial banks' operations, such as investment units and portfolios as well as savings and deposit accounts, to make them acceptable under Islamic law. Efforts will continue to adapt and modify the mechanisms used in international stock markets.

4.3. Islamic Thought Regarding Securities Investment

Joint stock companies, along with financial institutions, should establish the most convenient form of investment available to a majority of savers, who have neither their own businesses to invest in nor the ability to evaluate running businesses or become sleeping partners.

Corporate shares are most attractive to such people, because of the relative ease with which they can acquire them when they wish to invest, or sell them when they need the liquidity. It will, however, be necessary to reform
joint stock companies in the light of Islamic teaching to safeguard the interest of shareholders and consumers, and also to reform stock exchanges to ensure that share prices reflect more or less the underlying economic conditions and do not fluctuate erratically in response to speculative forces (Chapra, 1985:73).

The trade in shares and securities of joint stock companies has been permitted in the Qur'an for the interest of the social and economic welfare of the society, provided that it is an honest business carried out by honest partners.

According to Islamic law, a company is not permitted to deal or to be involved in certain activities which might conflict with Islamic principles, such as:

1) Dealing in the production of alcohol;
2) Gambling;
3) Mortgages and commercial banks which facilitate interest loans;
4) Dealing in prohibited meats such as ham, bacon, pork, etc.;
5) Production of idols;
6) Production and trade of illegal drugs;
7) Management of licenced premises, such as night clubs, cabarets and public houses.
Moreover, Islamic law requires that certain conditions be met, for trading in shares and stocks to be acceptable. These conditions are:

a) The seller must first own the goods himself, before delivering them to the buyer, in order to safeguard the latter.

b) The trade values of the goods must be known to both buyers and sellers, as must their quality and quantity. The goods must be freely available to everybody so that a realistic price can be set according to supply and demand.

c) A debit loan contract cannot be paid by selling a credit loan contract. In other words loans may not be traded.

Though there are no significant studies regarding the development of the stock exchange mechanism to a level acceptable to Islam, Dr. Al-Khiat reports that Islamic scholars have discussed the issue of stocks and shares, joint companies and the prohibition of Riba. There are two main schools of thought regarding investment in the shares of joint stock companies. The first permits dealings in shares and stocks in general, without discussing the different types of shares of the companies. This school argues that Shari'ah permits partners to share in the capital of a company, provided the shares are equal, which
is the usual case. In that case, the partners share equally the profit and loss of the company.

The second group prohibits shares and their dealings. They consider the share to be like a bond, which reflects the company's assets, so it does not represent a share in the capital of the company. Moreover, as the values of shares fluctuate, they do not represent the capital of the company at the time of its formation, but at the time of the sale of the share. Thus, this group prohibits dealings in shares and their profits, as joint stock companies were forbidden originally. This opinion is not based on fair and reasonable study and investigation of the issue of the shares and stocks of joint companies.

Some Islamic jurists, however, compromise between those two views, permitting some kinds of shares but prohibiting others.

Despite the debate among Islamic jurists, the issue of shares, and dealings in them, are permitted in Islam, whatever the meaning of the share in the company's contracts, provided that the shares do not cause any harm to any partner of the company, and that the company is not involved in prohibited activities, such as *Riba*, alcohol or any other activity which conflicts with Islamic principles.

Mohsin (1983), assessed the basic form and character
of corporate securities from the point view of Islamic investment requirements, when he studied the stocks and bonds issued by modern corporations without involvement in issues like the form and nature of interest which is prohibited in Islam. His study was based on the existing ruling of Fuqaha which interprets interest as a predetermined positive rate of return on saving and loans, making no distinction between "Usury" and "Interest" which is prohibited in Islam.

Within this framework the study tested various alternatives and types of corporate securities that might be acceptable under Islamic principles. Since it is assumed that Islamic institutions and individuals have to carry out their investment operations in a mixed economy, they will constantly come into contact with institutions and organizations which are secular in character. Thus in a secular environment, in addition to the problem of pursuing a sound investment policy, there arises the problem of keeping intact the basic Islamic investment values.

The pertinent issues in Islam are the return attribute and nature of debt contracts. Islam does not prohibit debt transactions; rather it requires that the debt contracts should be without interest, for a specified fixed period and must be drawn in terms of equity. The nature and form
of financial transactions in Islam are determined in accordance with the following verse of the Holy Qur'an:

Allah hath permitted Trade and forbidden Usury (II:275).

The verse determines the scope and pattern of investment activities and also sets an outline for the flow of funds in an Islamic economy. The Fuqaha, guided by this verse, has allowed equity investment in real estate or in business from which the profit may be positive or negative and is not pre-determined.

In the field of business, the equity is the ownership, with all the risks and opportunities which this implies. Equity holdings in business by individuals can be direct or indirect through the financial institutions. In recent years Islamic Banks have been collaborating with business concerns in various forms of partnership allowed in Islam (we discussed these forms in section 4.2.3). Return on investment in ownership securities is based on current earnings and also on changes in the market value of the shares.

Ordinary shareholders have a right to whatever residual income is left over after the claims of creditors and preference shareholders are met, and this income will fluctuate in value. This nature of income accruing to the ordinary shareholders appears to be in line with Fuqaha;
however, it seems that preference shares in their present form do not conform to this general picture of ownership. The preference share is like a credit instrument in two most important respects: a) its claim to income is a fixed amount or rate, which is objectionable to the Fuqaha, rather than a variable residual such as the ordinary shareholders receive; b) in the event of dissolution of the company, the holders of these shares are usually repaid a stipulated sum, before the ordinary shareholders are paid. The other concessions given to the preference shares can be seen as in exchange for voting rights.

The study concluded that in the contemporary world of Islam, both a moral and practical need exist to facilitate the flow of funds in the economy without imposing managerial responsibilities on all types of suppliers of capital. Therefore to encourage the flow of capital in both individual and social interest, Islamic funds should take advantage of the investment offers emerging from the secular institutions. One of the most important institutions that ensures stability is the modern corporation which is perpetual in life and offers limited liability.

Islamic financial institutions should offer more investment opportunities by mobilizing savings and exerting their pressure on corporate management to introduce the
necessary changes in form of securities. There will be a continuous need to explore new possibilities for investment in the corporate sector and research needs to be oriented towards working out proper ways and means to establish equity among debtor and creditor in debt transactions. Once the requirement of equity is carefully interpreted and presented in the true spirit of the Holy Qur'an, possible avenues of investment can be found in the corporate and other sectors of the economy, even in a secular environment.

Recently, the Second Conference of Financial Markets organized by Bahrain Islamic Bank resolved that the formation of joint stock companies which have permissible purposes and activities is a permissible matter. If a company's basic purpose is impermissible, the holding of its shares is also impermissible, without question (1991:16).

Al-Barakah Group has been organizing and participating in conferences, conventions and academic circles to focus on economic issues in an Islamic perspectives, while at the same time enlisting the help and cooperation of some eminent Muslim scholars, jurists, and economists. For this purpose, in March 1990, Al-Barakah Group organized its sixth seminar on the Islamic Economics, where this legal
ruling regarding buying shares of joint stock companies was resolved:

a) Buying shares of companies operating in the Islamic countries with the intention of setting things right is desirable, because this may help Muslims to conform more and more to the laws of Shari'ah.

b) Buying shares of companies operating in non-Islamic countries is permissible for investors if they find no other alternative which is sound and free of flaw.

c) Buying the shares offered by Islamic financial organizations is permissible, if it is restricted to investing surplus cash or establishing investment funds specializing in helping individuals to enter this field (Sixth Al-Barakah Seminar, Fatwa no.5:10).

The Council of the Islamic Fiqh Academy, in its sixth session held in Jeddah, after having studied the papers and recommendations presented on the subject of the financial markets in the light of the rules in the Shari'ah, recommended that encouragement should be directed towards lawful earning and investment of savings through Islamic modes of investment based on the principle of sharing burdens and bearing the risks of liabilities.

It was recognized that financial markets play a vital role in mobilizing the economy and stimulating investment operations, and that giving due importance to these markets and studying their problems in the light of the Shari'ah can fulfill the need to apply the guidance of Islamic Fiqh to contemporary problems. This is in line with the efforts exerted by Muslim jurists to explain the rulings of the
Shari'ah about financial transactions, and particularly about the principles governing the market and the system of "Hisbah" introduced to supervise market operations. It was held that equal importance should be given to the secondary markets which facilitate investors' re-entry in initial markets, provide access to liquidity, and encourage investment by promoting confidence in the investors, since they can leave the markets whenever they need to do so.

After studying the papers presented to explain the working system of the existing financial markets, their procedure and the different instruments used therein, the Council resolved the following:

1) The financial markets should be given due importance in order to discharge the obligation of preserving capital and ensuring its growth, because it leads to fulfil the general human needs and discharge the spiritual and material duties relating to capital.

2) Although the original concept of financial markets is sound and its application is very much needed in the present day context, yet their existing structure does not present an example to carry out the object of investment and growth of capital within the Islamic framework. This situation requires serious academic efforts to be undertaken in collaboration between the Fuqaha (Islamic jurists) and the economists, so that it may be possible to review the existing system with its procedure and instruments and to amend what needs amendment in the light of the recognized principles of the Shari'ah.

3) The financial markets are established through certain procedural institutions and the adoption of these procedures can be attributed to the rule of general expediency (Al-Masalih Al-Mursalah) which is a recognized principle in the Shari'ah and does not contravene any of its injunctions or principles. It relates, therefore, to the regulation introduced by
the authorities of the State, in order to organize professions and public utility services. If such regulations are carried out in complete conformity with the Islamic principles and injunctions, no one has the right to violate them or to seek devices to circumvent them (1989:17).

In the case of the investment in bonds, the Council in its sixth session resolved the following:

a) Bonds which represent an undertaking to pay their amount, together with interest related to the face value or to a predetermined profit are prohibited in the Shari'ah. Their issue, their purchase and their negotiation, all are prohibited because they are interest-bearing loans, no matter whether their issue authority belongs to the private sector or is a public entity having relation to the State. A change in the nomenclature, such as calling the bonds certificates, or investment securities or saving certificates, or calling the interest profit or income or service charge or commission, has no effect on the aforesaid ruling.

b) Zero Coupon Bonds are also prohibited because they are loans sold at a price inferior to their face value, and the owners of such bonds benefit from the difference in their prices which is considered a discount on the bonds.

c) Similarly, Prize Bonds are also prohibited because they are loans in which a liability to pay a predetermined profit or an additional amount is undertaken in favour of their bearers as a whole, or in favour of an undetermined number of persons out of them. Moreover, these bonds have a resemblance with gambling.

d) Interest-bearing bonds can be substituted by bonds and certificates issued on the basis of the contract of "Mudharabah" (Profit and loss sharing) meant for a particular project or a particular enterprise, wherein no predetermined profit or interest shall be paid to the bearers, but they shall be entitled to get a proportionate share in the profit of the project in relation to the proportion of their respective investments. This profit can not be given to them unless it has actually accrued (1990:18).

In the following (seventh) session, also in Jeddah,
the Council of the Islamic Fiqh Academy resolved the following:

1. Holding Shares in Companies;

a) As long as the principle in transaction is permissible, it follows that the establishment of a joint stock company, which has permissible purposes and activities is a permissible matter.

b) There is no controversy whatsoever on the impermissibility of holding shares in companies whose basic purpose is impermissible, such as dealing by Usury or producing Muharamat (impermissible stuffs) or trading and dealing in them.

c) In principle it is impermissible to hold shares in companies which sometimes deal in Muharamat, Usury and the like, even if their basic activities are permissible.

d) As for the question of holding shares in companies which sometimes deal in Muharamat, the Council suggests that discussion of this matter be postponed until a future session, so that more studies and researches can be conducted.

2. Paying the Value of Stocks by Installment;

There is no Shari'ah objection to paying part of the value of the underwritten stocks, and delaying the payment of the other part, to be paid by installments. This is considered participation through what is prepaid and the expectation of increasing the capital. There is no restriction on that, as it includes all the stocks. The liability of the company remains as it is concerning the other parties, and in accordance with the stated capital as it is the amount agreed upon by the participants in the company.

3. A Stock for its Holder;

As long as the principle of the sale "the stock is for its holder" implies a common share in the properties of the company, and that the certificate of the stock is a document affirming that right in the share, then
there is no Shari'ah objection to issuing stocks in the company by such a method and circulating them.

4. Subject of Contract in the Sale of Stocks;

The subject contracted for in the sale of the stock is the common share in the assets of the company. The certificate of the stock is considered as a document for the right in that share.

5. Extraordinary Stocks;

It is not permissible to issue extraordinary stocks with financial advantages leading to the guarantee of the capital or the guarantee of part of the profit, or to present these stocks at the time of dissolving the company or at the time of distributing the profits. However, it is permissible to give some stocks advantages as regards procedural and administrative matters.

6. Dealing in Stocks Usuriously;

a) It is not permissible to buy stocks by a usurious loan offered to the buyers by a broker or otherwise in exchange of mortgaging the bought stocks. In such acts there is usury which is affirmed by mortgaging, and these acts are forbidden by the text stating the curse on the devourer of usury, its offerer, its writer and its witnesses.

b) It is neither permissible to sell a stock not owned by the seller, or to give a promise to the broker that the stock would be mortgaged to him at the time of delivery, because such kind of sale is the sale of what the seller does not own. The prohibition in this case is reinforced if it was stipulated that the price of the stock would be delivered to the broker so as to deposit it for a certain interest rate.

7. The Sale or Mortgage of the Stock;

It is permissible to sell the stock or mortgage in accordance with the company policy. For example, if the policy permits the absolute sale or the conditional sale with priority given to the old shareholders, and also given to the statement of the
places of the mortgage as far as the shareholders are concerned, in respect of the mortgage of the common share.

8. The Specification of the Liability of the Limited Stock Company;

There is no Shari'ah objection to establishing a stock company with limited liability according to its capital, as this is known to its clients, and would cause no damage to those clients. Also there is no Shari'ah objection to the responsibility of some shareholders becoming unlimited, without imposing any charges for creditors in exchange for this obligation. This applies to companies with acting partners and partners with limited responsibility.

9. The Control of Stock Circulation among authorized Brokers and Imposing Charges forDealing in them;

The concerned official authorities have the right to organize the circulation of stocks. This should only take place through authorized brokers who are licensed to practice that kind of business, as that is an official transaction achieving legal interests. Also it is permissible for dealers to impose some charges for obtaining membership of money markets so as to cover expenses or to collect an indirect tax (1992, :1-3).

4.4. The Framework of Islamic Securities Market

The Islamic securities market exists to bring buyers and sellers together as without it, industries would not be able to raise the vast amount of capital they need to keep the economy going. Individuals and institutions would be reluctant to participate with their capitals if they were not certain of being able to liquidate their stocks in the market at any time they want to do so. Islamic securities,
like any other conventional securities, bridge the gap between governments, companies or other institutions, which need to raise long-term permanent capital, and investors who wish to invest their money for comparatively short-term periods, provided that the various financial instruments floated would have to conform to Shari'ah.

The establishment of an Islamic securities market can be very helpful for Islamic institutions and the Islamic banks, as the latter always face two problems with regard to investing their surplus funds. The first is the absence of an Islamic secondary securities market where they can invest their surplus liquidity; and the second is the weakness of the inter-bank depositing system among the Islamic banks. Thus, the Islamic securities market could play an important role in bridging these gaps.

Zaky (1992) argues that the organization of the Islamic securities market can be seen as an attempt to create a balance between individual freedom and social responsibility in the economic field. Its organization would provide an opportunity for individuals to mobilize financial resources for investment in accordance with the principles of the Shari'ah.

He believed that there are several different modes of investment opportunities within the Islamic framework.
Musharakah, Mudarabah, and Murabahah-financing are the principles underlying the Islamic securities market. The execution of such principles will lead to an important structural change in the existing operation of the secular financial markets.

He also emphasized the operational principles which control the financial markets, such as:

1) elimination of elements of Riba from all transactions of financial markets;

2) application of the doctrine of limited liability, in other words, the bearing of loss is to the extent of shareholders' contributions;

3) distribution of fair dividends among the shareholders, which clearly implies sharing of an agreed percentage of profit and loss to the extent of shareholders' contributions;

4) ensuring broad-based ownership of securities and investment certificates for greater distribution of income. Merger and take-over bids in the securities market should be controlled very closely under the Islamic system of operations (Hisbah) which shows a wide testimony to the fact that it is permissible in the Shari'ah to check the manipulation of prices of the securities or monopolistic collusions. This reflects Islamic concern for the
implementation of justice and fair play in the securities market, and in society as a whole.

The Islamic securities market has to perform the role of a regulating body for issuance of financial instruments in the Muslim countries. It has to ensure that all financial securities to be traded strictly conform to the principles of the Shari'ah and comply with the rules and regulations controlling the market. It should supervise, among others, the dissemination and flow of appropriate information on a timely basis, concerning the primary issues or flotation in the primary market. It also has to regulate the type, quantity and quality of the instruments issued, besides the information that is continuously published to the general public by the companies, to assure that a fair, just and orderly marketplace is maintained.

The organization of an Islamic securities market facilitates the change in ownership of Islamic securities. Without it, investors would have to claim their money back from the company, which in turn would affect the functioning of the company. If the markets were inefficient, many would be unwilling to acquire Islamic securities with longer maturities, because it would take a long time for them to sell these stocks if they wished to liquidate them and the risk of loss of capital-values would be high. The existence of a highly efficient market for
outstanding securities would markedly increase its liquidity and the safety of principal value.

The marketability of the securities based on the principles of the Shari'ah will promote the cause of cooperation and healthy competition, where all participants of the securities market are bound by the Islamic law of justice and expected to implement the Islamic law of investment without resorting to any unfair or manipulative means. This coorative competition may give rise to stability in the values of shares.

4.5. Summary

Any type of dealing is permissible unless a prohibitive statement is declared by either the Holy Qur'an or Sunna. Riba is prohibited in Islam. This prohibition appears several times in the Holy Qur'an and in the Sunna of Prophet Muhammad, peace be on him.

Despite the arguments among Islamic jurists regarding the prohibition of Riba, there is no controversy whatsoever on the prohibition of any form of fixed and pre-determined increase to be paid over the principal. There are different reasons for the prohibition of Riba, which have been justified and explained by many Islamic jurists according to the Holy Qur'an and Sunna, to ensure justice and remove all forms of exploitation.
Islam provides alternatives to Riba through the establishment of a wide range of contracts. The formation of joint stock companies is an example of contracts permitted by Islam for the interest of the whole society, provided certain conditions are fulfilled.

The Islamic economy is essentially equity-based rather than loan-based. It is permissible to borrow money without interest and without the lender participating in any profit or loss. The evolution of the Islamic securities market should be seen as an integral part of the establishment of an ideal Islamic society based on the principles of social justice and economic growth. Various types of financial instruments, both short-term and long-term, can be issued on the basis of the principles of Musharakah, Mudharabah, Murabahah, Bai’-al-Salam and others according to the Islamic law, through the Islamic banks or the other financial institutions.

Although there have been some studies regarding the Islamic viewpoint on dealing in shares and stocks, it seems that further research is required to cover this issue, since it has generated much interest in the financial markets of many Islamic countries.
CHAPTER FIVE

The Economic Structure for Development of Saudi Arabia
5.1. Introduction

Saudi Arabia, before oil, had a pastoral economy based on the raising of goats, sheep and camels. The majority of the population lived in small villages built of mudbrick and earned a living from subsistence agriculture.

In 1938, oil was discovered in Saudi Arabia and the Arabian-American Oil Company (Aramco) began production in the same year, with a total output of only 31 million barrels. Oil production was interrupted by World War II, but from 1944 to 1945, output rose almost threefold from 7.8 million barrels to 21.3 million barrels, and it reached 89.9 million barrels by 1947. The next significant increase in output took place in 1948, when crude oil output rose by nearly 60 percent over the previous year.

Today, Saudi Arabia is one of the fastest growing nations in the world. Its role as the possessor of the world's largest proven oil reserves (officially estimated at 169 billion barrels in early 1985, which would allow over 100 years of extraction at 1983 levels), the largest foreign exchange reserves, and possibly the most ambitious development plans ever undertaken, rank it as a significant world economic power (Abdeen and Shook, 1984).

In this chapter we will discuss the economic development in Saudi Arabian economy, with particular
reference to the five-year development plans which have been implemented by the government to boost economic development.

5.2. Review of Economic Development

A major part of Saudi Arabia's wealth or total capital stock, consists of oil reserves. Since the price of oil is subject to sudden and at times unpredictable fluctuation, the value of this wealth is itself uncertain and unpredictable. In order to reduce the dependence of the Saudi economy on this single source of wealth and thereby reduce the variability of its present value, the economy must be diversified. Accordingly, the major objective of Saudi Arabia's development strategy has been and still is, diversification of the economy so as to create new sources of income (Soufi, 1985:78).

Economic development in Saudi Arabia has been achieved under a series of five-year development plans. The first started in 1970 when the first small oil revenues provided the means for the government to improve economic and social conditions in the country. Although, before 1966, reliable statistical data were not available, the Gross Domestic Product (GDP) rose more than 100 percent from 1966/67 to 1972/73, at an annual rate of 12.9%. From 1966/67 to 1969/70, real GDP rose 28.3%, at an annual rate of 8.6% and
in 1970/71 it rose 40.4%, with an annual rate of growth of 18.6%. This growth rate is truly phenomenal, considering the many economic and social obstacles in the way of development.

Planning has played an important role in guiding the economic and social development of Saudi Arabia during the past two decades, and will become even more essential in the future, as conditions and needs become more complex and the country moves into a new phase of development.

The Five Year Plan documents reflect the long term vision and provide the conceptual framework for restructuring the country's productive resources, expanding its industrial sector, and introducing modern technologies throughout the economy. The preparation of a plan requires the specification of objectives for each dimension of development: economic, social and institutional, and designing the most effective measures to achieve them. The effectiveness of each plan's contribution to development depends partly on the consistency of its multiple objectives, partly on the priorities set for each successive plan period, and partly on the practical design and implementation of its policies and programmes.

Development activities accelerated significantly during the First and Second Development Plan periods, when
the first large increase in world oil prices generated substantial government revenues. The further expansion of the country's oil income during the Third Plan created opportunities for a rapid growth in government expenditure, which fostered very high rates of investment in infrastructure and rapid economic growth. Although the instability in the world oil market during the Third Plan period caused a decline in oil revenues, which adversely affected development programmes under the Fourth plan and resulted in some delays, the government has taken sound measures to restructure the country's economic base in order to enable the economy to sustain its long-term momentum.

During the period of 1970 to 1985, the steady and systematic progress in long term economic diversification into manufacturing, agriculture, and financial services, in education and manpower development, and in the expansion of health and social services, continued at a rapid rate.

During the past two decades, the institutional structures of both government and the private sector have been successfully evolved as the economic and social needs of Saudi Arabia have become more complex and sophisticated.

The long-term strategic goals of the Saudi Arabian development have been formulated since the First
Development Plan to provide a foundation for future development efforts and for the achievement of national objectives.

5.2.1. The First Development Plan (1970-1975)

A major objective of the First Development Plan was to increase the rate of growth of GDP and to develop human resources so that the several elements of society would be able to contribute more effectively to production and participate fully in the process of development. It was also aimed to diversify sources of national income and reduce dependence on oil, by increasing the share of other productive sectors such as agriculture and industry, with particular emphasis on petrochemicals, in which Saudi Arabia has a comparative advantage. Emphasis on the physical and social infrastructure, related to the nature of planning itself and to the needs of the nation, was also expressed in the First Development Plan.

Although there were financial constraints at the time of implementation of the First Development Plan, as GDP in the year before the First Plan was SR 17,152 million at current prices, the government was successful in achieving the objectives of its First Plan. The rate of growth of GDP rose from 13.1% in 1970 to 20.5% in 1973. The non-oil sector growth rate increased significantly, with its
contribution to GDP rising from SR 7,802 million in 1970 to SR 11,857 million in 1973 in current prices.

The financial scale of the First Development Plan was modest by subsequent standards. However, it established for the first time a comprehensive planning framework for the systematic construction of a modern infrastructure, the improvement of government services, and the development of human resources, thereby laying the foundations for achieving the long-term strategic goals.

The sharp increase in government revenues in the latter part of the First Plan period permitted much more ambitious objectives, interpreted in the Second Development Plan, which was implemented in 1975 (Ministry of Planning, 1990).

5.2.2. The Second Development Plan (1975-1980)

The Second Development Plan called for rapid growth in all sectors of the economy, benefiting from the large increase in world oil prices which generated substantial government revenues. These revenues were invested primarily in establishing the physical and social infrastructure systems essential to a stable, productive and just society.

The government provided the majority of capital investment in the economy, while private sector activity
was concentrated mainly in the construction and trade sectors. During the period of the Second Plan, some effective institutions were established by the government to guide and assist industrial development and to achieve the long term goal of economic diversification (Ministry of Planning, 1990).

By 1979, the end of the Second Plan period, the achievement was impressive and progress had been made in each major area of development. Saudi Arabia became the world's largest oil exporter and third largest oil producer. Standards of living had been achieved for most of the population which were in most ways comparable to those prevailing in the developed countries, and the majority of the physical infrastructure had been completed, providing an outstanding base for future economic and social development.

As a result of these achievements, the economy recorded a rate of growth which would be impressive by any standards. The average annual growth rate of GDP was 9.2% and that of the non-oil sector was 14.8%. Per capita GDP rose from SR 23,980 in 1975 to SR 43,400 in 1980, while it had been only SR 3,185 in 1970.

Within the broad context of the long term goals that guided the development process, each plan has had its own
particular focus. The First and Second Plans reflected both the stage of development and the resources available to the government.

5.2.3. The Third Development Plan (1980-1985)

In 1980 the Third Development Plan was implemented to accelerate the construction of physical infrastructure and to lay the foundations for a more diversified economy. Large-scale public sector investments were initiated in capital-intensive industries linked to the country's petroleum resources.

This plan set more specific goals, emphasizing growth in the production sectors, notably hydrocarbon and other manufacturing industries, and placing restraints upon the growth of the expatriate labour force. In manufacturing industries, the private sector became more prominent and agriculture emerged as a high growth sector in response to government incentives and funding (Ministry of Planning, 1990).

As a result of the high volume of capital formation during the first two Plans, the need to maintain and operate existing infrastructure meant a switch from capital to recurrent expenditure during the Third Plan.

The strong pace of economic progress during the Second
and Third Plan years was associated with a sharp increase in the number of foreign workers, which highlighted the importance of developing Saudi human resources and of gradually reducing the reliance on expatriate labour.

By the end of the Third Plan period, the majority of the country's infrastructure was being completed, as were the major basic and heavy industry projects.

5.2.4. The Fourth Development Plan (1985-1990)

The next stage of development of the economy of Saudi Arabia under the Fourth Development Plan, which was started on 22 March 1985, aimed at horizontal integration in production capabilities, as there were over 1,400 Saudi plants producing raw materials and finished products which had previously been imported.

The Plan projected that investment in the non-oil private sector would grow by an average of 10% a year, increasing the sector's share of gross fixed capital formation from 35% in 1985 to 50% by 1990. The development of human resources was given top priority, accounting for 27% of the development funds allocated, with emphasis on education and vocational training. Industrial diversification remained a major goal of the Fourth Plan which stressed the need for rationalization and efficiency. The Fourth Plan reinforced the diversification theme of the
Third Plan, with even greater emphasis on restructuring the economy and with the private sector playing a leading role.

The government aimed to reduce the economy's dependence on imports from the equivalent of 70% of non-oil GDP to under 50%, to reduce the dominance of the public sector within the economy and to place more reliance on the private sector and free enterprise. At the same time, producing sectors, particularly manufacturing and agriculture, were encouraged to grow more rapidly and government expenditures, in turn, were focused on health, education, training, and other social services essential to social and human resources development.

The Fourth Development Plan was implemented during a period of great change in the financial circumstances of the country. The increase in oil revenues at the end of the Second Plan and in the early years of the Third Plan was a short term phenomenon in the context of the overall historic process of development. It provided opportunities for accelerating certain aspects of development, but could not be regarded as a permanent feature of the economy. Therefore, it was apparent at the time of the Fourth Plan's preparation that revenues available to the government would be substantially less than during the Third Plan, and as a result, a more realistic approach had to be adopted in financing both recurrent and project expenditures.
The Fourth Plan was on a more modest scale than its predecessor, with planned government expenditure of SR 1,000 billion being 23% lower than during the Third Plan period. Over half of the allocations were for development expenditure and a high proportion of this was allocated to completing existing projects.

The volatility of oil revenues had a major impact on the economy throughout the first two decades of planning in Saudi Arabia. Oil income, which consistently held the dominant share of total government revenues, peaked in 1981/1982 and fell steadily in subsequent years of the Third Plan period. Further declines occurred during the first two years of the Fourth Plan, but this was followed by more stable oil revenues in the late 1980s. Due to this decline in government oil revenues, the budget for the fiscal year 1403/04 (1983/84) showed a deficit of SR 23,766 million between the total expenditure and total revenue, as shown in Table 5.1. The shortfall was covered by drawing from the general reserves (SAMA, 1990).

Non-oil revenues also declined during the Fourth Plan, although they increased as a share of total government revenues. Table 5.2 shows the comparative figures of GDP average within the four plan periods. As a result, a wide range of policies was implemented by the government to reduce the impact of the declining oil revenues in 1986/87,
TABLE 5.1

ACTUAL REVENUE AND EXPENDITURE

(Million Saudi Riyals)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue</th>
<th>Oil Revenue</th>
<th>Other Revenue</th>
<th>Total Expenditure</th>
</tr>
</thead>
<tbody>
<tr>
<td>1402/03 (1982/83)</td>
<td>246,182</td>
<td>186,006</td>
<td>60,176</td>
<td>244,912</td>
</tr>
<tr>
<td>1403/04 (1983/84)</td>
<td>206,419</td>
<td>145,123</td>
<td>61,296</td>
<td>230,185</td>
</tr>
<tr>
<td>1404/05 (1984/85)</td>
<td>171,509</td>
<td>121,348</td>
<td>50,161</td>
<td>216,363</td>
</tr>
<tr>
<td>1405/06 (1985/86)</td>
<td>133,565</td>
<td>88,425</td>
<td>45,140</td>
<td>184,004</td>
</tr>
<tr>
<td>1406/07 * (1986/87)</td>
<td>76,498</td>
<td>42,464</td>
<td>34,034</td>
<td>137,422</td>
</tr>
<tr>
<td>1407/08 (1987/88)</td>
<td>103,811</td>
<td>67,405</td>
<td>36,406</td>
<td>173,526</td>
</tr>
<tr>
<td>1408/09 (1988/89)</td>
<td>84,600</td>
<td>48,400</td>
<td>36,200</td>
<td>134,850</td>
</tr>
<tr>
<td>1409/10 (1989/90)</td>
<td>114,600</td>
<td>75,900</td>
<td>38,700</td>
<td>149,500</td>
</tr>
<tr>
<td>1410/11 (1990/91)</td>
<td>154,721</td>
<td>118,142</td>
<td>36,579</td>
<td>210,430</td>
</tr>
</tbody>
</table>

* Ten-month fiscal period from Rajab 1406 to Rabi'II 1407 (March-December 1986).

TABLE 5.2

GROWTH IN OIL AND MAJOR NON-OIL SECTORS

(Compound annual real rates of growth)

(Percent)

<table>
<thead>
<tr>
<th></th>
<th>I PLAN AVERAGE</th>
<th>II PLAN AVERAGE</th>
<th>III PLAN AVERAGE</th>
<th>IV PLAN AVERAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>TOTAL GDP</td>
<td>13.0</td>
<td>9.2</td>
<td>(1.6)</td>
<td>0.1</td>
</tr>
<tr>
<td>OIL SECTOR GDP</td>
<td>15.1</td>
<td>4.8</td>
<td>(14.5)</td>
<td>0.9</td>
</tr>
<tr>
<td>NON-OIL GDP</td>
<td>10.1</td>
<td>14.8</td>
<td>6.2</td>
<td>(1.6)</td>
</tr>
<tr>
<td>GOVERNMENT</td>
<td>20.1</td>
<td>14.6</td>
<td>2.8</td>
<td>1.5</td>
</tr>
<tr>
<td>PRIVATE</td>
<td>6.6</td>
<td>14.9</td>
<td>7.8</td>
<td>2.3</td>
</tr>
<tr>
<td>AGRICULTURE</td>
<td>3.6</td>
<td>6.9</td>
<td>9.5</td>
<td>13.8</td>
</tr>
<tr>
<td>CONSTRUCTION</td>
<td>21.4</td>
<td>15.8</td>
<td>(2.4)</td>
<td>(6.7)</td>
</tr>
<tr>
<td>PUBLIC UTILITIES</td>
<td>3.4</td>
<td>21.9</td>
<td>21.2</td>
<td>5.7</td>
</tr>
<tr>
<td>MANUFACTURING</td>
<td>3.9</td>
<td>9.8</td>
<td>7.3</td>
<td>3.9</td>
</tr>
<tr>
<td>REFINING</td>
<td>0.9</td>
<td>6.1</td>
<td>3.0</td>
<td>5.3</td>
</tr>
<tr>
<td>OTHER</td>
<td>10.8</td>
<td>15.4</td>
<td>11.7</td>
<td>(4.6)</td>
</tr>
<tr>
<td>TRANSPORT AND COMMUNICATIONS</td>
<td>0.7</td>
<td>19.3</td>
<td>7.1</td>
<td>(1.9)</td>
</tr>
<tr>
<td>TRADE</td>
<td>13.8</td>
<td>22.7</td>
<td>8.7</td>
<td>(1.5)</td>
</tr>
<tr>
<td>FINANCIAL AND BUSINESS SVCS</td>
<td>7.9</td>
<td>23.7</td>
<td>2.5</td>
<td>(11.3)</td>
</tr>
<tr>
<td>COMMUNITY AND PERSONAL SVCS</td>
<td>7.1</td>
<td>10.6</td>
<td>4.4</td>
<td>0.5</td>
</tr>
</tbody>
</table>

the second year of the Fourth Plan, when the budget deficit reached SR 69 billion. Foreign reserves were used in the early years of the Fourth Plan as a shield against declining oil revenues and a major budgetary initiative was introduced in the fourth year of the Plan with the issue of government development bonds.

In addition, capital spending was reduced and efficiency measures implemented to control recurrent expenditures. However, the level of direct and indirect subsidies needed for the welfare of citizens and to maintain their living standards, was preserved and expanded the number of public sector employees was to maintain the level of essential services and to compensate for the shortage of employment opportunities in the private sectors (Ministry of Planning, 1990).

In response to the government's planning initiatives and its firm commitment to free enterprise, by increasing the sale of shares in public companies and the privatization of public sector enterprises, the private sector steadily expanded its role in the economy. It demonstrated impressive resilience during times of overall economic stagnancy and has continued to expand and diversify. The volume of real output of the private sector has grown fivefold since 1970 and private investment has increased sevenfold in real terms.
The number of registered corporations rose from less than 1000 in 1971 to over 7000 in 1989 and the number of employees in these corporations increased by 3.9 million. The private sector considerably strengthened its institutional role in development during the Fourth Plan period, as an Export Promotion Council was formed and additional research activities were carried out within the Federated Council of Saudi Chambers of Commerce and Industry, in areas such as investment opportunities, trade patterns and development policies. This demonstrated the willingness and capacity of the private sector to undertake a wide range of economic activities and development responsibilities, compatible with commercial principles. It was envisaged that the private sector would be able to take over, on a commercial basis, many of the services provided by the government.

At the end of the Fourth Plan a new fiscal policy was implemented, as government revenues used to finance development projects were supplemented by domestic borrowing, instead of further draw-downs of the country's foreign reserves. This policy will be continued, as necessary, in the Fifth Development Plan and has several advantages:

1) It supports the continued funding of high priority
projects that are essential to the country's further development.

2) It mobilizes domestic financial resources that would otherwise be dormant or invested abroad.

3) It provides Saudi citizens with new savings opportunities. Furthermore, domestic borrowing through the issuance of development bonds provides a much needed monetary policy instrument. Although the costs of servicing such domestic debt will increase current expenditure, government foreign investment income will not be affected (Ministry of Planning, 1990).

5.2.5. The Fifth Development Plan (1990-1995)

By the beginning of the Fifth Development Plan on 2 August 1989, the physical infrastructure had been largely completed, and the processes of economic diversification and of restructuring were well under way. High living standards and a healthy quality of life had been largely secured, most of the institutional framework for development had been established and the private sector was ready to carry out more of the tasks which had previously been handled by the government agencies.

Although the economy experienced a difficult phase of constraints and contraction at the start of the Fifth Plan period, the government affirmed a new phase of development
in which the institutional dimension will be emphasized and where progress will be achieved as much through private sector initiative as through government expenditures. The objectives of the previous development plans are reaffirmed in the Fifth Plan and they are to be achieved with a substantially different set of development policy initiatives, in response to the special conditions that have emerged in recent years and the constraints that dominate the national economy.

The Fifth Plan emphasizes the development of human resources, by ensuring a constant supply of manpower, upgrading its quality and improving its efficiency to meet the requirements of the national economy. Dependence on the production and export of crude oil as the main source of national economy is to be reduced. Real structural changes in the country's economy are to be continued, so as to establish a diversified economic base with due emphasis on industry and agriculture. Mineral resources are to be developed, and their discovery and utilization encouraged. The infrastructural projects necessary to achieve overall development are to be completed, and private sector participation in socioeconomic development is to be encouraged.

Therefore, the targeted growth rates for the individual sectors will gradually affect the structure of
the economy as shown in Table 5.3. The government's share of non-oil GDP is expected to fall significantly during the course of the Fifth Plan. The share of the producing sectors within non-oil GDP is expected to increase from about 38% in 1409/10 (1989) to over 43% in 1414/15 (1994). The sectors mainly contributing to this growth include agriculture, petrochemicals, and other manufacturing. Overall, the share of service sectors in non-oil GDP is expected to change only modestly. The crude oil sector is expected to account for about one-fifth of the total economy during the Fifth plan, considerably lower than its share at the beginning of the Fourth Plan, when it exceeded one-third of total GDP (Ministry of Planning, 1990:89).

So far during the Fifth Plan period, the private sector has reached a stage which will allow for its more effective participation in the country's development. This is of great importance in view of the need to stimulate a net inflow of private capital from abroad, and from within the country, to participate in development projects and increase the level of foreign direct investment in the country.

The private sector's motivation to invest is closely linked to the overall economic and regulatory environment in general, and the availability of attractive new investment opportunities in particular. In this regard, a
### TABLE 5.3
STRUCTURE OF THE ECONOMY

(In current prices)

<table>
<thead>
<tr>
<th></th>
<th>VALUE ADDED (SR BILLION)</th>
<th>SHARES OF NON-OIL GDP (PERCENT)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>PRODUCING SECTORS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Agriculture</td>
<td>22.8</td>
<td>34.8</td>
</tr>
<tr>
<td>Other Mining</td>
<td>1.8</td>
<td>2.4</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>25.0</td>
<td>41.4</td>
</tr>
<tr>
<td>Refining</td>
<td>9.9</td>
<td>16.5</td>
</tr>
<tr>
<td>Petrochemicals</td>
<td>5.7</td>
<td>9.9</td>
</tr>
<tr>
<td>Other</td>
<td>9.4</td>
<td>15.0</td>
</tr>
<tr>
<td>Public Utilities</td>
<td>0.8</td>
<td>1.1</td>
</tr>
<tr>
<td>Construction</td>
<td>34.2</td>
<td>46.6</td>
</tr>
<tr>
<td>Service Sectors</td>
<td>78.6</td>
<td>102.9</td>
</tr>
<tr>
<td>Trade</td>
<td>27.4</td>
<td>33.4</td>
</tr>
<tr>
<td>Transport And</td>
<td>21.4</td>
<td>27.6</td>
</tr>
<tr>
<td>Communications</td>
<td>6.1</td>
<td>9.0</td>
</tr>
<tr>
<td>Real Estate</td>
<td>13.7</td>
<td>20.9</td>
</tr>
<tr>
<td>Financial Svcs.</td>
<td>10.0</td>
<td>12.0</td>
</tr>
<tr>
<td>Government Svcs.</td>
<td>56.8</td>
<td>62.6</td>
</tr>
<tr>
<td><strong>SUB-TOTAL: NON-OIL SECTORS</strong></td>
<td>220.0</td>
<td>291.8</td>
</tr>
<tr>
<td><strong>CRUDE OIL AND NATURAL GAS</strong></td>
<td>60.2</td>
<td>87.1</td>
</tr>
<tr>
<td><strong>CRUDE OIL AND NATURAL GAS AS SHARE OF GDP (PERCENT)</strong></td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td><strong>GROSS DOMESTIC PRODUCT</strong></td>
<td>280.2</td>
<td>378.9</td>
</tr>
</tbody>
</table>

number of key issues have arisen which will require new regulatory and administrative measures, and adjustments in the institutional relations between the government and private sector during this plan and for the future. These issues, which concern the creation of the economic environment required for an expansion in private sector investment, are as follows:

a) Private savings and capital mobilization. The development financing process depends on the mobilization of national savings into capital investment and on encouraging legal channels to absorb private savings. Future development will depend increasingly on the private sector. Thus, an effectively functioning capital market is necessary to help reduce and share risks and to avoid the negative consequences of speculation. The inadequacy of the existing capital market and the limited scope for long-term investment by private financial institutions now constitute constraints against wider private sector investment in the development process. The operations and scope of the financial sector, under SAMA's control, need to be redefined so that banking and other financial services can fulfil their potential to participate more directly in the medium and long-term capital transactions of the private sector in the country.

b) Public and private sector coordination. Since
private enterprise activities embrace almost all sectors of the economy and the private sector is making a wider and more effective contribution to the development process, a reconsideration is necessary of some of the government's financial and administrative regulations, in order to avoid the negative impact of the private sectors on the efficient functioning of private enterprises and market forces.

c) Information. The role of information in reducing uncertainty is important for investment decisions and for guiding the future direction of private sector activity. One of the essential functions of any government department or agency is to improve and develop the quality of information within its jurisdiction for use by other government agencies and the private sector.

The cornerstone of economic growth in the Fifth Plan is investment, which in earlier periods was initiated predominantly by the government sector, although with the completion of the majority of the infrastructure, investments will be increasingly needed for activities which are within the domain of the private sector. As the importance of the private sector in the economy grows in the Fifth Plan period and beyond, the government's function of guiding future development will increasingly have to be exercised indirectly, through a comprehensive policy framework which encourages investment in activities which
are in accordance with the country's long-term development objectives.

The policy-focused strategy of this plan will employ a much broader array of economic policy measures than in the previous plans. These policies will be directed toward the following objectives:

a) Stabilization of the economy, through stable government expenditure and avoiding sharp increases and decreases in the budget. Thus, government expenditure will continue to increase at a modest rate, thereby enabling the private sector to base its forecasts and set its policies accordingly. As a result, spending is targeted to increase by 9% to SR 196,950 million whereas the budget, announced in January 1993, forecasts a 12% rise in total revenue to SR 169,150 million, giving a deficit of SR 27,800 million which will be financed by borrowing, according to the Ministry of Finance and National Economy.

b) Broadening the revenue base of the government, by increasing non-oil revenue sources in order to reduce the budget deficit and to lessen the impact of volatile world oil markets on the government budget.

c) Expanding and diversifying the economy, through the continuous implementation of new initiatives to support private sector activities and increase its contribution to
the national economy, particularly in the producing sectors.

d) Increased investment; the plan predicts a steady recovery in government investment expenditure, while a high level of private sector investment will also be stimulated through a broad range of government initiatives.

e) Strengthening the competitiveness of Saudi industry, through measures that will enable Saudi producers to compete effectively with imported goods in the domestic market and to increase and broaden their penetration of export markets. Policies to increase productivity, such as improving the skill levels of the labour force and introducing more advanced technologies, are a high priority in the Fifth Plan.

f) Improving the balance of payment, by encouraging rapid growth in non-oil exports and through import substitution.

The Fifth Plan considers some measures to bring about the creation of a well-supervised market for equity and debt instruments, such as the development of a more extensive domestic capital market, which would expand the pool of available capital and provide more diverse opportunities and greater liquidity for Saudi investors. An executive mechanism, such as the establishment of a private
sector department at the Ministry of Planning, is needed to improve government decision making on complex topics affecting many aspects of private sector activity and to ensure improved coordination and cooperation between the public and private sectors.

Another measure being considered is the establishment of an information centre to undertake the collection and analysis of data concerning the national economy and other economies. This would be an important asset for the private sector in making its decisions. An expansion in the activities of the specialized commercial courts is a prerequisite for the targeted expansion in the size and scope of private investment, in order to ensure prompt settlement of commercial disputes.

In Saudi Arabia, the main strategy of future plans will be on measures to accelerate the process of economic diversification to achieve a more development economy. While oil will be a vital part of the country economy for a long time, the goal is to use petroleum as a resource for diversified industrial growth, rather than as a single export commodity.

A modern physical infrastructure has been the prerequisite for the industrialization process. The development of a capability successfully to absorb and
efficiently to utilize available technologies, and to become innovators of technologies tailored to the country's environment, is a necessary condition for the next stage of development. The methods and institutions necessary for developing this capability are significantly more complex than those needed for developing the physical infrastructure. The Fifth Development Plan includes a series of policies and new initiatives which will be built upon in subsequent plans (Ministry of Planning, 1990:12).

With one of the world's most modern economies, Saudi Arabia has recently witnessed strong economic growth fuelled partly by continued high revenues from oil exports and also by rapid expansion of non-oil manufacturing industries in the country. These represent the result of two decades of effort to diversify the country's industrial and economic base and to build an extensive, modern infrastructure to support it.

A recent study of the Saudi Arabian economy conducted by the Economics Department of the National Commercial Bank (NCB), published in January 1993, suggests that the growth of the economy will continue with the turnaround in activities that started in 1990 due to the surge in oil price and production levels following the Gulf crisis. The country's oil revenues jumped from SR 90 billion in 1989 to SR 150 billion in 1990, fueling growth in nominal GDP of
21.1% that year. Oil revenue and related activities have increased the growth in 1990 with GDP generated in the government sectors up 10.2% as shown in Table 5.4.

The economic growth continued in 1991 and 1992, as oil revenues prevailed at around SR 169 billion allowing the government to implement expansionary fiscal policy. GDP growth rates are estimated at 6.6% and 5.0% for 1991 and 1992 respectively. Non-oil GDP growth is estimated at 6% and 7% in 1991 and 1992 respectively.

The outlook for 1993 is quite positive with total GDP estimated to grow at 4% to 5%. Oil revenues in this year are likely to stay close to the 1992 level of SR 169 billion and the cash flow strain on government finances because of the Gulf crisis is now over. Growth in non-oil sectors' GDP is expected to continue at a rate of 6.3%.

5.3. Summary

The combination of high economic growth and social welfare in Saudi Arabian development has been achieved through planning. This has always been practical, as each plan in the series of five-year plans which commenced in 1970 has been designed in accordance with the capabilities of the government and of the private sector, and the evolving maturity of the economy. Furthermore, each plan has identified the medium-term strategy to achieve the long
### TABLE 5.4

**INDICATORS AND ECONOMIC TRENDS**

*(At current prices)*

<table>
<thead>
<tr>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>GDP (SR BILLION)</strong></td>
<td>376.5</td>
<td>401.3</td>
<td>421.4</td>
<td>440.4</td>
</tr>
<tr>
<td><strong>COMPOSITION OF GDP (%)</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Oil Sector</td>
<td>36.9</td>
<td>38.6</td>
<td>36.6</td>
<td>34.0</td>
</tr>
<tr>
<td>Non-Oil Sectors</td>
<td>61.3</td>
<td>61.4</td>
<td>63.4</td>
<td>66.0</td>
</tr>
<tr>
<td>Private Sector</td>
<td>36.9</td>
<td>36.9</td>
<td>38.3</td>
<td>40.8</td>
</tr>
<tr>
<td>Government</td>
<td>24.4</td>
<td>24.5</td>
<td>25.1</td>
<td>25.2</td>
</tr>
<tr>
<td><strong>NOMINAL GROWTH IN TOTAL GDP (%)</strong></td>
<td>21.1</td>
<td>6.6</td>
<td>5.0</td>
<td>4.5</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>NOMINAL GROWTH IN OIL SECTOR GDP (%)</strong></td>
<td>53.1</td>
<td>7.5</td>
<td>1.5</td>
<td>1.0</td>
</tr>
<tr>
<td>Non-Oil GDP (%)</td>
<td>8.2</td>
<td>6.0</td>
<td>7.0</td>
<td>6.3</td>
</tr>
<tr>
<td>Private Sectors (%)</td>
<td>6.9</td>
<td>4.7</td>
<td>6.7</td>
<td>6.0</td>
</tr>
<tr>
<td>Government (%)</td>
<td>10.2</td>
<td>8.0</td>
<td>7.5</td>
<td>6.8</td>
</tr>
</tbody>
</table>

-term goals of national development and has allocated the various tasks of implementing the strategy to the government or to the private sector.

The objectives, policies and programmes of the development plans have been directed to making optimum use of all available resources, together with the development and evolution of the production sectors and manpower potential. This has been undertaken with a view to diversifying the country's economic base, as well as encouraging the private sector to play its important role in the development process by active participation in specified areas of development.

The financial system in Saudi Arabia has developed significantly to meet the needs of economic development. The role of the financial system and the financial infrastructure in Saudi Arabia will be discussed in the next chapter.
CHAPTER SIX

The Financial Infrastructure in Saudi Arabia
6.1. Introduction

Any financial system has three basic economic functions: first, to mobilize resources by offering investment opportunities to savers and holders of financial assets; second, to disburse funds to productive uses in the economy, primarily through loans or equity investments; and third, to ensure efficient intermediation between sources and users of funds.

The fulfillment of economic and social development plans in Saudi Arabia is made possible through a financial system which channels government revenues through public and private financial institutions. Although the financial system in Saudi Arabia has developed significantly during the last two decades, it needs further strengthening to meet the investment requirements of the development plans more effectively.

The aim of this chapter is to discuss the development of the financial infrastructure in Saudi Arabia, with particular focus on the money and capital market intermediaries and their impact on the economic development of the country.

6.2. The Saudi Money Market Intermediaries

Prior to 1948 Saudi Arabia did not have a financial
system. Only one commercial bank operated in the economy. During the 1950s the government realized that the increasing oil revenues provided a unique opportunity to accelerate the country's economic development, and to achieve that goal it was decided to establish a financial system (Knauerhase, 1977:238). In fact the structure and efficiency of the financial markets in any economy are largely dependent on the banking system, and the Saudi Arabian financial market is no exception. The dominating force is the Saudi Arabian Monetary Agency (SAMA), with policy direction coming from the Ministry of Finance and National Economy which controls the financial system in Saudi Arabia.

6.2.1. The Saudi Arabian Monetary Agency (SAMA)

SAMA was formed in October 1952 to be responsible for development of the country's financial system and performs the general functions of a modern central bank. Since its establishment, its charter has been revised and its powers have been expanded several times. It has made an important contribution by encouraging diverse commercial banking development and promoting agricultural and industrial progress.

SAMA is responsible for overseeing the country's foreign assets, and acts as an interbank clearing house
administering the policies which prescribe statutory reserve requirements, basic liquidity quotas, and margins for the establishment of letters of credit. Among the other responsibilities held by SAMA is regulation of money exchange.

One of SAMA's major functions is economic research, which will enable it to advise the government on various economic issues and perform a key role in economic policy making. It gathers, classifies, and analyses monetary, exchange rate and bank activity data to assist the government in formulating and carrying out financial and economic policies, which in turn will promote economic development and growth (Abdeen and Shook, 1984).

SAMA, as a legislative body that regulates general and operational rules regarding share trade transactions, controls capital market activities. In 1985, a new department called the "Share Control Administration Department (SCAD)" was established within the Bank Control Division to be responsible for day to day control of share trade activities, which by that time had to be conducted through the commercial banks.

SAMA must perform all its functions in a manner consistent with Islamic law. For example, it cannot deal with interest, which is prohibited in Islam.
6.2.2. Commercial Banks

The major domestic money market institution is the commercial banking system, functioning in its normal banking role and as the main instrument through which Saudi ownership of the country's financial system is being accomplished. The commercial banks' activities are important to an expansion of private sector investment. Their long and medium-term lending activities should be expanded and their credit policies adjusted in collaboration with SAMA. The merging of many small private enterprises, engaged in similar activities, into large companies would help to reduce average production costs through the economies of large scale production, to improve competitiveness, and to promote greater financial strength. The development of commercial banking in Saudi Arabia has been significant.

The first commercial bank, a branch of the Netherland Trading Society, which today is called Al-Bank Al-Saudi Al-Hollandi, was established in 1927, to serve Indonesian pilgrims in Makka. Subsequently, it was followed by the establishment of the first local private bank, the National Commercial Bank (NCB) in Jeddah in 1938, and by Riyadh Bank in the form of a Saudi Joint Stock Banking Company in 1957.

Since then, the banking industry in Saudi Arabia has
witnessed significant growth and expansion, both in the number of branches and in the range of banking services. After 1973, the increased flow of oil revenues and the infusion of new capital into the commercial banking system from many sources, necessitated the expansion of banking services.

In 1976, the Council of Ministers introduced the Saudiization of the foreign owned banks operating in the country. These were to be reformed into joint stock companies with 60% of their ownership being transferred to Saudi Nationals. A primary reason stated for Saudiization was that the branches of the foreign banks in the country were functioning according to policies drawn up by their foreign parent banks. These policies, which were not always in harmony with Saudi Arabia’s development plans, resulted in a banking system which financed mainly foreign trade and gave no priority to long-term loans essential to the economic growth of the country.

In addition, the foreign banks were concentrated in the largest cities of the country and were not allowed to increase their capital base in order to provide banking services for the underbanked rural towns and villages. Further, as a result of the rapid development of the country, and the fact that the foreign banks were not properly regulated by SAMA, the high profits earned were
mostly transferred outside the country. The change obviously led to a significant development in the Saudi capital market in general and the Saudi stock market in particular.

As a result of the bank Saudiization programme, essentially completed in 1980, the commercial banks were classified into "local banks" and "other banks". The first category includes the two 100 percent Saudi-owned banks: National Commercial Bank (NCB), the largest commercial bank in the Middle East with 229 branches in Saudi Arabia, two overseas branches and four representative offices; and Riyadh Bank, the second largest bank in the country, with a nationwide network of 164 branches in Saudi Arabia and two branches in London, an agency in Houston, Texas, and shareholdings in various international banks and correspondent banking relationships worldwide (Riyadh Bank, 1991).

The second category includes nine banks: Saudi Holland Bank (SHB), Saudi French Bank (SFB), Saudi British Bank (SBS), Saudi Cairo Bank (SCB), Arab National Bank (ANB), Saudi American Bank (SAMBA), Saudi United Commercial Bank (SUCB), Al-Jazirah Bank, and Saudi Investment Bank (SAIB).

The process by which the foreign banks became Saudi joint stock companies was based on the calculation of the
book value of the foreign bank, which was set at 40% of the capital of the new bank. In this way the foreign banks were able to retain a 40% ownership, except in the case of Al-Jazirah Bank, which retained only 35%. The remaining 60% of capital was allocated between the Board of Saudi sponsors (24%) and the Saudi public (36%). However, when the foreign partner in Saudi Cairo Bank did not participate in the 100% capital increase of 1988, its foreign capital portion was reduced from 40% to 20% as a result.

Saudi Investment Bank (SAIB) is unlike the other banks, since its establishment was concerned with investment, rather than commercial banking, to provide long-term financing for Saudi industries, commercial and agricultural ventures. As a result, its rate of growth was slower than that of other banks. It has eight branches: five in Riyadh, and one in each of Jeddah, Al-Khobar and Dammam. Additionally, in the ordinary course of business, it routinely carries out substantive transactions with affiliated and correspondent banks and other financial institutions throughout the world (Saudi Investment Bank, 1991).

Several advantages have followed from the Saudiization programme. First, the Saudiized banks have been able to increase their capital base as well as the number of branches in the country on an equal and competitive basis
with the two 100 percent Saudi banks, resulting in the public receiving better banking services at a low cost. This in turn will affect the Saudi money market which is dominated by those commercial banks specializing in short and mid-term finance. Second, Saudi nationals had considerably more opportunities to work in and manage these banks, and the opportunity to own shares in them. Last but not least, bank services were expanded by virtue of the fact that the Saudiized banks were closer to the public and thereby able to respond more flexibly with appropriate banking services, including branches exclusively for women.

Bank deposits registered an increase of SR 5.9 billion or 4.0% over the first seven months of 1990. This was followed by a decline of SR 16.6 billion or 10.9% in August in the wake of the Gulf crisis, followed by a further but much smaller fall of SR 1.4 billion or 1.1% in September. Thereafter, public confidence revived and during October - December 1990, bank deposits rose by SR 9.5 billion or 7.1%, offsetting a sizeable part of the declines recorded in the preceding two months. Bank deposits in 1990 experienced a net fall of SR 2.6 billion or 1.8% as shown in Table 6.1.

The decline in bank deposits in 1990 was accounted for chiefly by time and savings deposits which fell by SR 5.3 billion or 12.0%. Demand deposits also declined by SR 0.4
## Table 6.1

**Percent Shares of Various Categories of Deposits**

*(At the end of fiscal years)*

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Demand Deposits</td>
<td>39.0</td>
<td>40.2</td>
<td>40.5</td>
<td>39.6</td>
<td>40.0</td>
</tr>
<tr>
<td>Business and Individuals</td>
<td>36.5</td>
<td>37.1</td>
<td>38.2</td>
<td>38.1</td>
<td>38.5</td>
</tr>
<tr>
<td>Official Entities</td>
<td>2.5</td>
<td>3.1</td>
<td>2.3</td>
<td>1.5</td>
<td>1.5</td>
</tr>
<tr>
<td>Quasi-Monetary Deposits</td>
<td>61.0</td>
<td>59.8</td>
<td>59.5</td>
<td>60.4</td>
<td>60.0</td>
</tr>
<tr>
<td>Time and Savings Deposits</td>
<td>33.6</td>
<td>31.9</td>
<td>28.4</td>
<td>30.5</td>
<td>27.3</td>
</tr>
<tr>
<td>Other Quasi-Monetary Deposits</td>
<td>27.4</td>
<td>27.9</td>
<td>31.1</td>
<td>29.9</td>
<td>32.6</td>
</tr>
<tr>
<td>For Letters of Credit</td>
<td>2.2</td>
<td>2.6</td>
<td>2.0</td>
<td>2.4</td>
<td>2.5</td>
</tr>
<tr>
<td>For Guarantees</td>
<td>1.6</td>
<td>1.4</td>
<td>1.1</td>
<td>1.0</td>
<td>1.1</td>
</tr>
<tr>
<td>Residents' Foreign Currency Deposits</td>
<td>23.6</td>
<td>23.9</td>
<td>28.0</td>
<td>26.5</td>
<td>19.0</td>
</tr>
<tr>
<td><strong>Total Deposits</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

billion or 0.7%. The decline in these categories of deposits was substantially neutralised by other quasi-monetary deposits which rose by SR 3.1 billion or 7.1%, largely under residents' foreign currency deposits, as shown in Table 6.2.

Bank deposits suffered another setback in January 1991 due to the outbreak of the Gulf war, their level declining by SR 3.9 billion or 2.7% over the month. However, this was followed by an upturn, with a sharp rise of SR 19.5 billion or 13.9% during February-June 1991. Over the first half of 1991, therefore, there was a net rise in bank deposits of the order of SR 15.6 billion or 10.9%.

The number of commercial banks' branches increased from 985 in December, 1989 to 1,032 in December, 1990 and further to 1,052 in June, 1991. Of these, 433 were in Western and Southern Provinces, 429 in the Northern and Central Provinces, and 190 in the Eastern Province, as shown in Table 6.3. Commercial banks increased their capital and reserves from SR 15.7 billion at the end of 1989 to SR 17.4 billion at the end of 1990 and further to SR 18.8 billion by the end of June 1991, in order to meet private investors' demand for financial services (SAMA, 1990).

As the Saudiized commercial banks move towards a more
TABLE 6.2

CONSOLIDATED BALANCE SHEET OF COMMERCIAL BANKS

(AT THE END OF FISCAL YEARS)

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>CASH BALANCES</td>
<td>13,918</td>
<td>18,594</td>
<td>10,689</td>
<td>11,751</td>
<td>11,636</td>
</tr>
<tr>
<td>FOREIGN ASSETS</td>
<td>86,672</td>
<td>102,198</td>
<td>114,741</td>
<td>118,844</td>
<td>123,467</td>
</tr>
<tr>
<td>LOANS AND INVESTMENTS</td>
<td>59,264</td>
<td>58,804</td>
<td>70,523</td>
<td>73,281</td>
<td>65,296</td>
</tr>
<tr>
<td>OTHER ASSETS</td>
<td>10,805</td>
<td>11,463</td>
<td>20,286</td>
<td>29,709</td>
<td>31,657</td>
</tr>
<tr>
<td><strong>T.ASSETS = LIABILITIES</strong></td>
<td>170,659</td>
<td>191,059</td>
<td>216,239</td>
<td>233,585</td>
<td>232,056</td>
</tr>
<tr>
<td><strong>LIABILITIES</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL DEPOSITS</td>
<td>121,927</td>
<td>129,305</td>
<td>142,473</td>
<td>146,304</td>
<td>143,663</td>
</tr>
<tr>
<td>FOREIGN LIABILITIES</td>
<td>14,288</td>
<td>24,485</td>
<td>28,727</td>
<td>34,603</td>
<td>30,172</td>
</tr>
<tr>
<td>CAPITAL AND RESERVES</td>
<td>13,148</td>
<td>13,542</td>
<td>14,954</td>
<td>15,719</td>
<td>17,359</td>
</tr>
<tr>
<td>OTHER LIABILITIES</td>
<td>21,296</td>
<td>23,727</td>
<td>30,085</td>
<td>36,959</td>
<td>40,862</td>
</tr>
</tbody>
</table>

# Table 6.3

**Regional Distribution of Bank Branches**

<table>
<thead>
<tr>
<th>AT THE END OF FISCAL YEARS</th>
<th>WESTERN &amp; SOUTHERN PROVINCES</th>
<th>NORTHERN &amp; CENTRAL PROVINCES</th>
<th>EASTERN PROVINCE</th>
<th>TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td>1406/07 (1986)</td>
<td>273 (43%)</td>
<td>232 (36%)</td>
<td>132 (21%)</td>
<td>637</td>
</tr>
<tr>
<td>1407/08 (1987)</td>
<td>293 (43%)</td>
<td>246 (37%)</td>
<td>135 (20%)</td>
<td>674</td>
</tr>
<tr>
<td>1408/09 (1988)</td>
<td>379 (41%)</td>
<td>375 (40%)</td>
<td>172 (19%)</td>
<td>926</td>
</tr>
<tr>
<td>1409/10 (1989)</td>
<td>409 (42%)</td>
<td>397 (40%)</td>
<td>179 (18%)</td>
<td>985</td>
</tr>
<tr>
<td>1410/11 (1990)</td>
<td>425 (41%)</td>
<td>421 (41%)</td>
<td>186 (18%)</td>
<td>1032</td>
</tr>
</tbody>
</table>

Note: Figures in brackets represent percentage shares in the total number of bank branches in Saudi Arabia.

competitive banking environment, the offshore banking units (OBUs) in Bahrain exert significant money and banking market influence on the Saudi money market institutions. The OBUs provide a vehicle to serve domestic banking needs in Saudi Arabia which can not be met onshore and provide many important services which enable government and private Saudi investors to enter the international money market.

The Saudi international banks and banking activities have grown in importance and independence, to provide another option and outlet for Saudi money market funds. They provide a means of diverting funds directly into the Western markets.

Development and trade spending in Saudi Arabia has been the major factor in the growth of the OBUs and the Saudi international financial institutions.

6.2.3. Money Exchangers

The money exchangers are the oldest known financial institutions in Saudi Arabia, their origin being an effort to serve pilgrims who came to Makkah with different currencies from all over the world. The money exchangers used to perform all functions normally handled by the commercial banks. They operated in a relatively unregulated environment, issuing money drafts, dealing in precious metals, and occasionally even arranging letters of credit.
There were no reporting requirements, no published balance sheets, and not even any clear legal control of the activities of the money exchangers.

This situation caused the Ministry of Finance and National Economy to initiate regulations on the money exchangers. Until late 1981, the Ministry of Commerce issued licences for the money exchangers, with only minimum financial requirements. The freedom from reserve and other banking restrictions also became a serious source of concern for SAMA, which considered regulation of the money exchangers to be an important aspect of the future development of the private financial system.

Despite the money exchangers' reputation for integrity, honesty, and reliability, SAMA by end of 1983, made them subject to the reserve requirements already imposed on the commercial banks and by 1985 the money exchangers were restricted to currency exchanges only. The only way the money exchangers could provide loans and take deposits was by registering as commercial banks under the control of SAMA regulations. As a result of these measures, the largest of the money exchangers, Al-Rajhi for Exchange and Trade registered as a commercial bank under the name of Al-Rajhi Banking Investment Corporation. Its inclusion in the banking system increased the number of fully owned Saudi banks to three and the overall total to twelve.
6.2.4. Islamic Financial Institutions

The other financial institutions operating in Saudi Arabia include representative offices of Islamic banks and investment companies. The only Islamic bank that operates in the country is the Islamic Development Bank (IDB) in Jeddah, which is owned by several Muslim governments, including Saudi Arabia which owns 25% of the IDB's total authorized capital. The IDB is not a commercial bank and therefore is not subject to Saudi banking regulations. It is an investment fund managed by representatives of the Muslim governments for the purpose of promoting economic development and social progress in the member countries and Muslim communities.

The IDB has introduced a short-term investment deposit scheme whereby funds are generated through the issuance of Investment Deposit Certificates. These funds are utilized in the foreign trade financing operations of the bank in accordance with Islamic principles. Although the IDB deposits most of its cash funds with SAMA, it uses the Gulf International Bank (GIB) in Bahrain for the purpose of collecting receipts and effecting payments related to the investment deposit scheme.

The Islamic Investment Company (IIC) is another Islamic financial institution that generates funds from
Saudi Arabia through its ten operating branches in the major cities of Saudi Arabia. It was begun in the Bahamas in June 1977 by a number of Muslim businesses as a multinational investment holding company whose primary purpose is to set up **mudarabah** companies in various parts of the Muslim world. The IIC shares are exclusively owned by its founders (Abdel-Magid, 1981:92).

The IIC is quite active in marketing and promoting its operations in Saudi Arabia and the Arabian Gulf area. In January 1982, the IIC became a subsidiary of Dar Al-Mal Al-Islami, the largest Islamic financial institution in the world, with headquarters in Geneva.

Appeals for investment in Dar Al-Mal Al-Islami savings accounts, time certificates, and cooperative life insurance centre around the prohibition on receiving or paying a fixed rate of return (interest) on the accepted deposit in accordance with the Islamic Shari'ah, with the depositor relying on the profit generated from the invested funds which fluctuates every month. Dar Al-Mal Al-Islami stocks, sold through IIC offices, rely on a return generated from the profits and appreciation in the market value of its share. By late 1982, IIC had 24 operating branches in Saudi Arabia, which compete for funds with the commercial banks there (Abdeen and Shook, 1984:128).
6.3. The Saudi Capital Market Intermediaries

Since commercial banks in Saudi Arabia are oriented towards short-term lending, until the financial market system is well-established the banks can not provide medium-term and long-term credit in the amounts required for effective economic development. Consequently, the government specialized credit agencies will continue for the indefinite future to effect the required blending of private and public sector credit activity.

In Saudi Arabia, the internal capital market intermediation is handled through specialized government credit or funding agencies, a quasi-private investment bank and the informal stock market which provides additional capital funding sources. These intermediaries are controlled carefully by SAMA, the Ministry of Finance and National Economy, and the Ministry of Commerce. The capital market in Saudi Arabia, providing primarily medium and long-term loans and equity investment, provides the basis for long-term economic diversification and is the motivation for private sector financial development.

6.3.1. Government Specialized Credit Institutions (SCIs)

The inability of the private banking sector to provide term credits to finance urgent private development projects led the government through the Ministry of Finance and
National Economy and SAMA to create six specialized credit agencies. These institutions are:

a) The Public Investment Fund (PIF).
b) The Saudi Industrial Development Fund (SIDF).
c) The Real Estate Development Fund (REDF).
d) The Saudi Arabian Agricultural Bank (SAAB).
e) The Saudi Credit Bank (SCB).
f) The Specialist Funding Programmes (SFP).

These institutions receive their capital and lending resources primarily from the government, to provide:

1) equity and loan support for major primary industries;
2) medium and long-term loan support for secondary industries;
3) interest-free individual and commercial housing loans;
4) agricultural development loans;
5) credit support for local contractors;
6) training and equipment loans for individuals commencing a business or trade.

These specialized credit agencies were formed during the First Plan period (1970-1975), in order to provide an effective vehicle for long-term government investment, the output of which will not necessarily be in terms of
financial profit, but in terms of economic and social benefit.

The total loans disbursed by these specialized credit institutions during 1990 was SR 4.3 billion and the repayment of their loans totalled SR 8.2 billion as shown in Table 6.4. The aggregate level of their outstanding loans at the end of 1990 was SR 159.5 billion as shown in Table 6.5 (SAMA, 1990:64).

The specialized credit agencies are not considered to be competitors to the commercial banks, but they contribute important support to the country's capital growth as they provide medium-term to long-term interest-free loans, with a low handling charge, approximately 3%. For example, the Real Estate Development Fund (REDF) is responsible for funding a substantial portion of private sector individual and commercial housing and borrowers are entitled to a 20% discount on their annual repayment premium if they pay it on time and an additional 10% discount for earlier settlement.

Some 140,000 REDF loans were granted during the Second Plan period, playing a significant part in ending the housing and rent shortage which developed during the early part of that period. In 1990, the REDF disbursed loans to a value of SR 69.3 billion.
TABLE 6.4

SPECIALIZED CREDIT INSTITUTIONS DISBURSEMENTS AND REPAYMENTS

(MILLION SAUDI RIYALS)

<table>
<thead>
<tr>
<th>FISCAL YEARS</th>
<th>DISBURSEMENTS (MILLION)</th>
<th>REPAYMENTS (MILLION)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1407/08 (1987)</td>
<td>5,863</td>
<td>6,420</td>
</tr>
<tr>
<td>1408/09 (1988)</td>
<td>4,874</td>
<td>6,927</td>
</tr>
<tr>
<td>1409/10 (1989)</td>
<td>4,821</td>
<td>6,590</td>
</tr>
<tr>
<td>1410/11 (1990)</td>
<td>4,381</td>
<td>8,175</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>ASSETS</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Balances with SAMA</td>
<td>11,767</td>
<td>14,666</td>
<td>14,890</td>
<td>12,624</td>
</tr>
<tr>
<td>Balances with Banks</td>
<td>1,747</td>
<td>2,301</td>
<td>2,987</td>
<td>3,142</td>
</tr>
<tr>
<td>Loans</td>
<td>167,167</td>
<td>165,114</td>
<td>163,345</td>
<td>159,551</td>
</tr>
<tr>
<td>Investments (Local)</td>
<td>9,682</td>
<td>9,964</td>
<td>9,954</td>
<td>14,523</td>
</tr>
<tr>
<td>Investments (Foreign)</td>
<td>4,144</td>
<td>4,201</td>
<td>4,208</td>
<td>4,479</td>
</tr>
<tr>
<td>Other Assets</td>
<td>3,064</td>
<td>1,089</td>
<td>1,301</td>
<td>9,432</td>
</tr>
<tr>
<td><strong>TOTAL ASSETS =</strong></td>
<td>197,571</td>
<td>197,335</td>
<td>196,685</td>
<td>203,751</td>
</tr>
<tr>
<td><strong>LIABILITIES</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Capital and Reserves</td>
<td>190,586</td>
<td>190,658</td>
<td>188,160</td>
<td>190,908</td>
</tr>
<tr>
<td>Other Liabilities</td>
<td>6,985</td>
<td>6,677</td>
<td>8,525</td>
<td>12,843</td>
</tr>
</tbody>
</table>

The Public Investment Fund (PIF) and the Saudi Industrial Development Fund (SIDF) play an important role in effecting economic diversification as well as expanding the long-term credit base in Saudi Arabia and the future secondary capital market which is necessary for completion of the country's financial system.

The PIF provides loans for financing and equity participation in a wide variety of economic development projects. It finances equipment loans to the Saudi Arabian Airline (Saudia), and provides project loans to Petromin, the oil refining and marketing arm of the Saudi Arabian government, and the Saudi Basic Industries Corporation (SABIC) which is responsible for all non-refinery primary industries. These are mostly government owned projects.

The loans made by PIF to SABIC and Petromin amount to about 60% of total project costs. PIF also purchases 15% equity shares from the joint venture partners involved with SABIC and Petromin in the primary industries being developed at the industrial complexes in Jubail in the Eastern Province and in Yanbu in the Western Province (Abdeen and Shook, 1984:140).

Another area of responsibility for PIF is equity participation in a wide range of Saudi joint stock companies requiring substantial government support: 20% of
Saudi Public Transport Co. (SAPTCO) and the National Agricultural Development Co. (NADEC), 40% of Saudi Fisheries Co., 65.7% of Saudi Real Estate Co., 25% of the National Shipping Co., 18% of Saudi Hotels and Resort Areas Co. (SHARACO), 10% of Saudi Vegetable Oil Co., Southern Cement Co., Yanbu Cement Co., and the Saudi Kuwaiti Cement Co., beside the Saudi Arabian Fertilizer Co. (SAFCO), and Saudi Consolidated Electric Co. (SCECO).

In 1988 PIF participated by 50% in the capital of the Saudi Cairo Bank, not only as an investment opportunity, but also to support its financial position. In addition, PIF was involved in financing the Multinational Companies which were formed jointly with other Arab and Gulf governments as closed-type companies. During the Fourth Plan period, PIF contributed to development projects a total loan of SR 63.5 billion, 27% of the total specialized credit institutions' contribution. In 1990, the loans disbursed by PIF amounted to SR 76.2 billion [including electricity loans of SR 37.9 billion] as shown in Table 6.6 (Ministry of Planning, 1990:162 and SAMA, 1990:64).

The Saudi Industrial Development Fund (SIDF) performs an important role in encouraging private capital investment in electricity generation and various secondary industrial projects. During fiscal year 1410/11 (1990), SIDF disbursed industrial loans of SR 648 million of which SR 254.8
### Table 6.6

**SPECIALIZED CREDIT INSTITUTION LOANS**

**CUMULATIVE VALUE TO THE END OF 1408/09 (1988)**

<table>
<thead>
<tr>
<th>Institution</th>
<th>Value (SR Billion)</th>
<th>Share (Percent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>REAL ESTATE DEVELOPMENT FUND (REDF)</td>
<td>91.7</td>
<td>39</td>
</tr>
<tr>
<td>PUBLIC INVESTMENT FUND (PIF)</td>
<td>63.5</td>
<td>27</td>
</tr>
<tr>
<td>SAUDI INDUSTRIAL DEVELOPMENT FUND (SIDF)</td>
<td>49.4</td>
<td>21</td>
</tr>
<tr>
<td>SAUDI ARABIAN AGRICULTURAL BANK (SAAB)</td>
<td>22.8</td>
<td>10</td>
</tr>
<tr>
<td>SAUDI CREDIT BANK (SCB)</td>
<td>3.0</td>
<td>1</td>
</tr>
<tr>
<td>SPECIALIZED CREDIT PROGRAMMES (SCP)</td>
<td>3.7</td>
<td>2</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>234.1</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

million or 39.3% went to the chemical industry, SR 115.1 million or 17.8% to the metal products industry, and SR 55.9 million or 8.6% to the paper products industry. The three industries accounted for 65.7% of total loan disbursements during the year (SAMA, 1990:108).

The most important achievement of the specialized credit institutions has been the encouragement of local investment and the creation of the first phases of a significant long-term credit development programme in Saudi Arabia. This effort could lead to the eventual expansion of the internal capital and secondary financial instruments market.

The specialized credit institutions provide long-term credit at a relatively low cost and in the past, they have been financed by budgetary appropriations. During the Fifth Plan period, it is expected that most of these institutions will achieve a higher level of self-financing, whereby outstanding loan repayments will be sufficient to meet their new lending activities to the various sectors of the economy. The assets of these institutions amounted to SR 197 billion in 1408/09 (1988), about 10% less than the combined assets of all commercial banks, and since their inception, loans have exceeded SR 234 billion as shown in Table 6.6 (Ministry of Planning, 1990:162).
6.3.2. Government Secondary Investment Sources

There are two government sources concerned with equity investment in Saudi Arabia. The first one is the General Organization for Social Insurance (GOSI), which is structurally controlled by the Ministry of Labour and Social Affairs. It supports development projects established mainly by the private sector and participates in the capital ownership of various Saudi joint stock companies, e.g. 10% of Saudi Public Transport Co. (SAPTCO), Saudi Kuwaiti Cement Co., Yanbu Cement Co., and 8% of Saudi Investment Bank (SAIB). In addition, it owns about 5% of the share capital of another seven Saudi joint stock companies.

The second source is the Retirement Pensions Agency which is under the control of the Ministry of Finance and National Economy. It participates in development projects to encourage private sector involvement in the development process. It also holds about 5% of the share capital in both Saudi Real Estate Co. and Taibah Co. For Investment, and it owns 10% of the share capital of Saudi Kuwaiti Cement Co. The above two government sources are self-financing.

6.3.3. Private Credit Institutions

The Private Credit Institutions are controlled by the
Ministry of Commerce, to provide short-term finance for household and small companies using methods in keeping with the Islamic *Shari'ah*.

An additional capital market institution, technically a commercial type bank, is oriented towards investment rather than commercial banking. The Saudi Investment Banking Co. (SIBC), was established by Royal Decree in June 1976, to encourage private sector economic development by providing long-term, interest-free, equity-type financing for Saudi industries, to conduct feasibility studies for proposed projects, to assist in project development and to supplement short-term bank lending. SIBC shares are divided among three groups: the Saudi public (36%); the Saudi sponsors, National Commercial Bank (NCB), Riyadh Bank, Bank Al-Jazirah, and the General Organization for Social Insurance (GOSI) (29%); and foreign sponsors, Chase Manhattan Overseas Corporation, Industrial Bank of Japan, and J. Henry Schroder Wagg & Company (35%) (Abdeen and Shook, 1984:145).

SIBC specializes in the provision of medium and long-term finance and provides a full range of corporate banking services including the issuance of letters of credit and guarantees, depository and investment services, foreign exchange, and cash management.
6.4. Summary

The financial system in Saudi Arabia is supervised by SAMA under the control of the Ministry of Finance and National Economy. SAMA carries out the general functions of a modern central bank. One of its most important functions is the day-to-day control of share trade activities which are conducted through the commercial banks. SAMA provides the government with the necessary data for the purpose of economic and social development.

The commercial banking system represents the major domestic money market institution in Saudi Arabia. It has developed significantly during the last two decades. In 1976, the government imposed its Saudiization programme on the foreign banks operating in the country. They were formed into joint stock companies with Saudi participation of 60% of their capitals, in order to achieve the government's goals clearly stated in the development plans. The programme was completed in 1982. Several advantages have followed from it which affect the banks' capital base, the number of branches and the range of services.

The banking policies of the Saudiized banks are being tied more closely to Saudi Arabian national economic and financial interests than to those of the bank source country, to ensure that monetary policy should be more
effective and more responsive to financial conditions. The Saudiized banks will benefit from government deposits which in the past were normally placed only with the 100 percent Saudi-owned banks and all the commercial banks will receive the opportunity to obtain shares in the major government-sponsored industrial companies which became public in the late 1980s. These in turn affect the Saudi money market.

The offshore banking units also influence the Saudi money market institutions. These units serve domestic banking needs and enable both the government and the private sector to be involved in international money market activities. In addition, the Saudi international banks have a great impact on the development of the money market institutions in the country.

The money exchangers have for long played an important role as money market intermediaries in Saudi Arabia, even though they used to operate without regulations to control their activities. However, since 1983, SAMA has regulated their activities and made them subject to the commercial banks' regulations in order to control their role in the future development of the private financial system.

There are six government specialized credit institutions dominating the internal capital market in Saudi Arabia under the control of SAMA, the Ministry of
Finance and National Economy, and the Ministry of Commerce. They provide medium and long-term interest-free loans at a relatively low cost for individuals and industry. They are not considered as competitors to the commercial banks.

Two secondary government investment sources also play an important role in the capital market in the country, as do the other private credit institutions.

Private enterprise has traditionally been the focus of economic activity in Saudi Arabia and engaging the private sector in the development process has been a consistent objective to accelerate the diversification of the economy. In the next chapter we will discuss the role of the private sector in the development process of Saudi Arabia.
CHAPTER SEVEN

The Role of the Private Sector in the Economic Development of Saudi Arabia
7.1. Introduction

The private sector includes all economic activities which are not performed by the government or government-owned companies. It encompasses all private firms operating for profit, whether formal or informal, in the industrial, agricultural or service sectors, as well as non-profit private organizations such as chambers of commerce and cooperative societies, insofar as those groups are engaged in economic activity.

Since the 1970s, the private sector has played a prominent role in the developing countries and has achieved significant results. Therefore, privatization has become a major trend all over the world.

During the 1980s, countries found privatization to be attractive for two reasons:

1) It was hoped that unprofitable enterprises could be divested, reducing the flow burden on the government budget;

2) The profitable enterprises could be sold at a price approximating the capitalized value of future profits (Bhaskar, 1992:1).

In this chapter we will examine the role of the
private sector in the process of the economic development of Saudi Arabia, with particular reference to the joint stock companies.

7.2. The Role of the Private Sector

Since the early stages of development of Saudi Arabia, the government has encouraged the private sector to participate in the investment opportunities available in the country through a programme of incentives, which include interest-free loans offered by various development funds, freedom from import duties for raw materials and machinery for manufacturing projects, guaranteed government purchase at a very favourable price for wheat products, priority in purchasing by government departments, and industrial and agricultural facilities including sites and land.

The importance of the private sector's role in the economy and in the broader development of Saudi Arabia has been a consistent feature throughout the past two decades. Initial leadership in economic development was provided by the government, particularly in the formation of physical infrastructure which was amplified during the period when rising oil revenues permitted the rapid implementation of a broad range of economic development programmes. The private sector played two important roles during the phase of
development: as a participant in development projects, and as a provider of services to government.

The private sector carried out the infrastructure projects with the cooperation of foreign experience and technology. It identified and developed new opportunities, such as the increased investment in agriculture; the formation of new companies dedicated to operations and maintenance for both physical infrastructure and industrial plant and equipment; the rapid growth of high quality medical services; and the investment in consumer goods industries to meet the growing needs of the population (Ministry of Planning, 1990:39).

The private sector has emerged from the economic difficulties of recent years in a reasonably positive position. The earlier concentration of private sector businesses in the construction and trade sectors has widened to include major agricultural enterprises and a profitable range of manufacturing firms. Assisting the formation of these new manufacturing companies has been the establishment in recent years of a number of new investment companies which pool the resources of individual businessmen and combine aspects of venture capital, portfolio investment, and project development. Four such companies are the National Industrialization Company (NIC), the Saudi Advanced Industries Company (SAIC), the Saudi
Venture Capital Group (SVCG), and the Saudi Industrial Development Company (SIDC).

The private sector at present accounts for about 58% of the non-oil GDP, 77% of the value added in the producing/service sectors, and 38% of total GDP in 1409/10 (1989) as shown in Table 7.1. The private sector is projected to increase its share of value added during the Fifth Development Plan period in real terms by 0.3% in the producing/service sectors, about 3% in non-oil GDP, and about 2% in total GDP as shown in Table 7.2. These percentage shares could be considerably increased through the implementation of the privatization concept.

The performance of the private sector has remained positive within the non-oil sector, as its contribution to real GDP measured at constant prices of 1404/05 (1984) rose from SR 27.6 billion in 1389/90 (1969) to SR 131.4 billion in 1405/06 (1985). Although it declined to SR 126.8 billion in 1406/07 (1986), it rose gradually again to SR 137.8 billion in 1410/11 (1990). The average annual growth rate of real GDP at constant prices of 1404/05 (1984) amounted to 15.5%, 6.5%, -4.9%, and 1.8% during the first Four Plans respectively, whereas the average annual growth rate between 1389/90 (1969) and 1410/11 (1990) was 3% (Ministry of Planning, 1991:80).
TABLE 7.1
ESTIMATED GDP CONTRIBUTION BY THE PRIVATE SECTOR
(IN CONSTANT 1404/05 PRICES)

(Billion Saudi Riyals)

<table>
<thead>
<tr>
<th>PRODUCING SECTORS</th>
<th>VALUE ADDED 1409/10 (1990)</th>
<th>ESTIMATED PRIVATE SECTOR SHARE (%)</th>
<th>ESTIMATED PRIVATE SECTOR VALUE ADDED</th>
</tr>
</thead>
<tbody>
<tr>
<td>AGRICULTURE</td>
<td>88.0</td>
<td>79.4</td>
<td>69.9</td>
</tr>
<tr>
<td>OTHER MINING</td>
<td>22.2</td>
<td>99.0</td>
<td>22.0</td>
</tr>
<tr>
<td>MANUFACTURING</td>
<td>1.7</td>
<td>95.0</td>
<td>1.6</td>
</tr>
<tr>
<td>PETROLEUM REFINING</td>
<td>33.1</td>
<td>48.6</td>
<td>16.1</td>
</tr>
<tr>
<td>PETROCHEMICALS</td>
<td>17.9</td>
<td>18.0</td>
<td>3.2</td>
</tr>
<tr>
<td>OTHER MANUFACTURING</td>
<td>4.9</td>
<td>63.0</td>
<td>3.1</td>
</tr>
<tr>
<td>PUBLIC UTILITIES</td>
<td>(0.8)</td>
<td>18.0</td>
<td>---</td>
</tr>
<tr>
<td>CONSTRUCTION</td>
<td>31.8</td>
<td>95.0</td>
<td>30.2</td>
</tr>
<tr>
<td>SERVICE SECTORS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>TRADE</td>
<td>82.8</td>
<td>74.9</td>
<td>62.0</td>
</tr>
<tr>
<td>TRANSPORT, COMMUNICATIONS</td>
<td>28.2</td>
<td>99.0</td>
<td>27.9</td>
</tr>
<tr>
<td>FINANCE, REAL ESTATE</td>
<td>21.7</td>
<td>15.0</td>
<td>3.3</td>
</tr>
<tr>
<td>COMMUNITY AND PERSONAL SVC</td>
<td>23.0</td>
<td>95.0</td>
<td>21.9</td>
</tr>
<tr>
<td></td>
<td>9.9</td>
<td>90.0</td>
<td>8.9</td>
</tr>
<tr>
<td>SUB-TOTAL: NON-OIL PRODUCING/SERVICE SECTORS</td>
<td>170.8</td>
<td>77.2</td>
<td>131.9</td>
</tr>
<tr>
<td>GOVERNMENT SERVICES</td>
<td>56.2</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>SUB-TOTAL: NON-OIL SECTORS</td>
<td>227.0</td>
<td>58.1</td>
<td>131.9</td>
</tr>
<tr>
<td>CRUDE OIL/GAS SECTOR</td>
<td>122.3</td>
<td>---</td>
<td>---</td>
</tr>
<tr>
<td>GROSS DOMESTIC PRODUCT</td>
<td>349.3</td>
<td>37.8</td>
<td>131.9</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>VALUE ADDED (SR BILLION)</th>
<th>AVERAGE ANNUAL GROWTH (PERCENT)</th>
</tr>
</thead>
<tbody>
<tr>
<td>NON-OIL PRODUCING/ SERVICE SECTORS</td>
<td>170.8</td>
<td>214.2</td>
</tr>
<tr>
<td>PRIVATE SECTOR</td>
<td>131.9</td>
<td>166.1</td>
</tr>
<tr>
<td>PERCENT PRIVATE SECTOR</td>
<td>77.2%</td>
<td>77.5%</td>
</tr>
<tr>
<td>NON-OIL SECTOR</td>
<td>227.0</td>
<td>272.6</td>
</tr>
<tr>
<td>PRIVATE SECTOR</td>
<td>131.9</td>
<td>166.1</td>
</tr>
<tr>
<td>PERCENT PRIVATE SECTOR</td>
<td>58.1%</td>
<td>60.9%</td>
</tr>
<tr>
<td>GROSS DOMESTIC PRODUCT</td>
<td>349.3</td>
<td>409.2</td>
</tr>
<tr>
<td>PRIVATE SECTOR</td>
<td>131.9</td>
<td>166.1</td>
</tr>
<tr>
<td>PERCENT PRIVATE SECTOR</td>
<td>37.8%</td>
<td>40.6%</td>
</tr>
</tbody>
</table>

The stage of infrastructural development in Saudi Arabia has largely ended, and with the emergence of a new phase both the government and the private sector are adopting new roles. The need for economic diversification and greater mobilization of private capital will require the private sector to assume a more leading role in future economic development. To this end, the government aims to create a positive environment for private sector activity, by implementing a wide range of policies and incentives to support the private sector, and establishing new institutions to further private sector interests. At the same time, the private sector will be expected to undertake some new roles to extend and strengthen its existing productive and export capacities and place more emphasis on manpower development through training and on developing of non-oil exports. In the past, these roles have been performed mainly by the government, but the private sector has gradually taken on a more direct participation, mainly through the Chambers of Commerce and Industry.

Many studies show that during the Fifth Development Plan period, the private sector has developed rapidly and now enjoys several strengths and advantageous conditions that will enhance private investment, productivity, and organizational capabilities. These include: the existence of a large number of diversified companies with experienced
management; extensive capital resources for investment; efficiency in investment, productivity, organization and management resulting from competition during the recent economic downturn; a favourable environment that has laid the foundation for more extensive efforts to strengthen growth and diversification during the Fifth Plan period.

A strong private sector depends on both attractive investment opportunities and on the ability of private sector companies to operate effectively in a competitive environment to pursue these opportunities. Saudi Arabia has a number of large companies that are fully capable of competing with businesses anywhere in the world.

The types of firms formed by the private sector vary from individual proprietorship to multinational corporations, with corresponding variation in the number of employees.

According to the Saudi Companies Act, a company is defined as

"a contract under which two or more persons, with each contributing a share in the form of money or services, with a view to dividing any profits (realized) or losses (incurred) as a result of such enterprise (Article 1).

The registered companies in Saudi Arabia, are classified into the following categories:
1) General Partnerships.
2) Limited Partnerships.
3) Joint Adventures.
4) Partnership Limited by Shares.
5) Corporations (Joint Stock Companies).
6) Limited Liability Partnerships.
7) Companies with Variable Capital.
8) Cooperative Companies.

The total number of companies registered in Saudi Arabia rose from 1,181 in 1975 to 6,689 in 1985 and to 7,107 by the end of 1990. Their capital rose from SR 43 billion in 1981 to about SR 66 billion in 1985, and to SR 86.8 billion by the end of 1990. Table 7.3 shows that during 1990, 367 new companies were registered in the country, with a total capital of SR 2.5 billion. Six of these were Joint Stock Companies with a total capital of SR 809.3 million and 241 were Limited Liability Partnerships with a total capital of SR 1,602.5 million. The total capital of these two types of companies accounted for 96.2% of the total capital of all new companies registered during 1990.

By the end of 1990, the total number of Joint Stock Companies registered in the country had reached 85, and their total capital was SR 48.7 billion. There were 4,096 Limited Liability Partnerships with a total capital of SR
### TABLE 7.3

NUMBER OF COMPANIES OPERATING IN SAUDI ARABIA

(Capital in Million Saudi Riyals)

<table>
<thead>
<tr>
<th>NATURE OF COMPANIES</th>
<th>1409 (1989)</th>
<th>1410 (1990)</th>
<th>CUMULATIVE TOTAL</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>NUMBER</td>
<td>CAPITAL</td>
<td>NUMBER</td>
</tr>
<tr>
<td>JOINT STOCK COMPANIES</td>
<td>4</td>
<td>1,437.9</td>
<td>6</td>
</tr>
<tr>
<td>LIMITED LIABILITY PARTNERSHIPS</td>
<td>180</td>
<td>934.2</td>
<td>241</td>
</tr>
<tr>
<td>SAUDI</td>
<td>154</td>
<td>391.5</td>
<td>190</td>
</tr>
<tr>
<td>NON-SAUDI</td>
<td>1</td>
<td>0.5</td>
<td>5</td>
</tr>
<tr>
<td>JOINT VENTURE</td>
<td>25</td>
<td>542.2</td>
<td>46</td>
</tr>
<tr>
<td>JOINT LIABILITY PARTNERSHIPS</td>
<td>70</td>
<td>29.3</td>
<td>80</td>
</tr>
<tr>
<td>SAUDI</td>
<td>69</td>
<td>29.1</td>
<td>80</td>
</tr>
<tr>
<td>NON-SAUDI</td>
<td>--</td>
<td>---</td>
<td>--</td>
</tr>
<tr>
<td>JOINT VENTURE</td>
<td>1</td>
<td>0.2</td>
<td>--</td>
</tr>
<tr>
<td>MIXED LIABILITY PARTNERSHIPS</td>
<td>29</td>
<td>11.9</td>
<td>40</td>
</tr>
<tr>
<td>SAUDI</td>
<td>29</td>
<td>11.9</td>
<td>40</td>
</tr>
<tr>
<td>NON-SAUDI</td>
<td>--</td>
<td>---</td>
<td>--</td>
</tr>
<tr>
<td>JOINT VENTURE</td>
<td>--</td>
<td>---</td>
<td>--</td>
</tr>
<tr>
<td>MIXED LIABILITY PARTNERSHIPS BY SHARES</td>
<td>--</td>
<td>---</td>
<td>--</td>
</tr>
<tr>
<td>TOTAL</td>
<td>283</td>
<td>2,413.3</td>
<td>367</td>
</tr>
</tbody>
</table>

33.5 billion. The Joint Stock Companies represent 1.2% of the total number of registered companies in the same period and the Limited Liability Partnership companies represented about 57% of the total number of registered companies. The total capital of these two types of companies constituted 94.7% of the total capital of the companies operating in Saudi Arabia (SAMA, 1990:105).

The total number of Individual Proprietorships and Firms which were registered in Saudi Arabia during 1410 (1990) was 26,000. 37.6% of these firms were located in the Western Province, 30.8% in the Central Province, 18.6% in the Eastern Province, 6.7% in the Southern Province, and 6.4% in the Northern Province, as shown in Table 7.4. The total number of Individual Firms registered in the country up to the end of 1410 (1990), amounted to 288,924. Of these, 25.3% or 73,237 were in Riyadh, 21.1% or 60,856 in Jeddah, 12.3% or 35,671 in Dammam, 5.5% or 15,757 in Makkah, and 4.8% or 13,888 in Ta'if (SAMA, 1990).

7.2.1. The Policy of Privatization

Experience around the world has demonstrated that private enterprise, operating in a competitive environment, is usually more likely than the public enterprise to meet goals of economic efficiency and growth. An effective privatization programme can contribute to a number of key
TABLE 7.4

INDIVIDUAL PROPRIETORSHIPS AND FIRMS REGISTERED IN SAUDI ARABIA

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>CENTRAL</td>
<td>3,837</td>
<td>5,668</td>
<td>7,999</td>
<td>88,983</td>
</tr>
<tr>
<td>WESTERN</td>
<td>5,050</td>
<td>8,322</td>
<td>9,773</td>
<td>105,194</td>
</tr>
<tr>
<td>SOUTHERN</td>
<td>1,076</td>
<td>1,669</td>
<td>1,736</td>
<td>20,662</td>
</tr>
<tr>
<td>EASTERN</td>
<td>2,398</td>
<td>3,764</td>
<td>4,830</td>
<td>47,166</td>
</tr>
<tr>
<td>NORTHERN</td>
<td>1,220</td>
<td>1,373</td>
<td>1,662</td>
<td>26,919</td>
</tr>
<tr>
<td>TOTAL</td>
<td>13,581</td>
<td>20,796</td>
<td>26,000</td>
<td>288,924</td>
</tr>
</tbody>
</table>

goals of the plan: increasing private sector investment in the economy; increasing economic efficiency and innovation; increasing competition; reducing subsidies; and encouraging a wider distribution of ownership of economic resources.

In Saudi Arabia, the government since the implementation of the First Development Plan has emphasized the participation of the private sector in the process of development. As a result, the government has gradually reduced its involvement in economic activities that can be efficiently and profitably performed by the private sector. Government agencies in Saudi Arabia used to provide most of the public services, such as postal services; communication services; airlines; railways and water supply. The implementation of privatization programmes requires that the associated process and procedures be institutionalized effectively and at a gradual pace. In some cases, the initial step will be the establishment of joint companies between the private sector and the government, in which the private sector will initially hold a minority share, but will participate actively in their management. The longer term objective is for the private sector to have 70 to 80 percent ownership in most joint venture enterprises.

Thus, in 1979, the government initiated its privatization strategy by selling 100,000 shares of the Saudi Fertilizers Co. (SAFCO), which was formed early in
1965 as a government owned-company, to the company's Saudi employees. Subsequently, another 49% of the company's capital was transferred to the private sector.

During 1983, the government decided to float publicly 30% of the capital of the Saudi Basic Industries Co. (SABIC), which was established by the government as a joint stock company and as the biggest industrial company in the country to produce a wide range of petrochemical products.

The government continued its strategy of privatization during the Fourth Plan period and implemented a broad range of measures in the first year of the Fifth Plan, to increase private sector participation. These measures include: increasing the number of leading businessmen on the governing boards of government-owned enterprises; selling selected government enterprises to the private sector; selling shares in selected government enterprises to private investors; encouraging the private sector to compete with certain government monopolies; contracting with private businesses for services currently provided by the government; encouraging the private sector to offer new services in sectors such as communications, that traditionally have been provided only by the government; and identifying projects that can be undertaken through lease-purchase or build and operate agreements with the private sector (Ministry of Planning, 1990).
7.3. The Development of the Joint Stock Companies

The formation of Joint Stock Companies in Saudi Arabia before 1982 was subject to an authorization issued in a Royal Decree based on the approval of the Council of Ministers (for more details see Appendix 1). Since 1982, the formation of such companies in general requires authorization only by the Minister of Commerce, provided the company's objectives are economically feasible. However, the formation of the following is still subject to the approval of the Council of Ministers:

a) Concessionary Companies.
b) Companies managing a public utility.
c) Companies receiving subsidy from the government.
d) Companies in which the government or any other public juristic person participates.
e) Companies engaged in banking activities.

The first joint stock company in Saudi Arabia was formed in 1934 for the transportation of pilgrims. It had a total capital of SR 21 million. This was followed by the establishment of three electricity companies. In 1954, the Arab Cement Limited Co. was formed in Jeddah, with a total capital of SR 25 million, increased to 50 million, then to 150 million and eventually to SR 1,050 million. This was the first industrial company to be established in the
country, and was followed by a company specializing in publishing and printing. By the end of 1934 the total capital of these companies was SR 943 million, comprised of 9.3 million shares (Riyadh Chamber of Commerce and Industry: 84).

From 1955 to 1964, eleven joint stock companies were formed including, three petroleum refining and services companies, two cement companies, and three electricity companies. In 1957, Riyadh Bank was formed as the first joint stock company in the financial sector with an initial capital of SR 50 million. The first two joint stock companies with foreign equity participation were Arab Petroleum Services Co., which was formed in 1960 with a total capital of SR 6 million and the Arab Petroleum Investment Co., which was formed in 1963 among the Arab Petroleum-Exporting countries with a total capital of SR 3.6 billion comprising of 3 million shares. The foreign partners held 49% of the equity of these two companies and their shares were not publicly tradeable as they were closed joint stock companies. By the end of 1964 the total number of joint stock companies was 17, with an issued capital of SR 2,955 million comprised of 28.9 million shares.

During the period from 1965 to 1974 the number of joint stock companies increased significantly. 37 companies
were formed, 31 of which were electricity companies formed to supply the growing demand for power. These companies were subsidized by the government. Four of the remaining six were multi-government closed joint stock petroleum companies. Their shares are not available to the public at present but there are plans to privatize them in the future. The remaining two companies were the Saudi Arabian Fertilizer Co. (SAFCO) and the National Gas Industry Co., which was formed by the merger of two existing gas companies. As a result, the number of joint stock companies reached 54 by the end of 1974, with a total capital of SR 6,509 million comprised of 44.8 million shares.

When the government implemented the Second Development Plan (1975-1980), a further 44 joint stock companies were established, including nine electricity companies, and four companies with foreign equity participation. By the end of 1980 the total capital of the joint stock companies was SR 33,634 million comprising 186.6 million shares.

In fact, the number of joint stock companies decreased because a number of the 60 electricity companies were merged to form regional electricity companies for the purpose of economic efficiency. The first of these was the Eastern Electricity Co. which was formed in 1976 with an issued capital of SR 5,000 million, followed by the Central
Electricity Co. which was formed in 1979 with an issued capital of SR 8,000 million.

When the government implemented the Saudiization policy on the banks operating in the country, seven joint Saudi/Foreign banks were formed as joint stock companies with 60% Saudi equity participation (65% in the case of Al-Jazirah Bank). The first, in 1976, was Al-Jazirah Bank, formerly the Pakistani National Bank, with a total capital of SR 10 million. The second in 1977, was the Saudi Investment Bank (SAIB), formerly the Saudi Exchange for Investment, with a capital of SR 30 million. This was followed in the same year by the Saudi Holland Bank (SHB) with a total capital of SR 35 million. In 1978, the Saudi French Bank (SFB), with a capital of SR 200 million, and the Saudi British Bank (SBB), with a capital of 100 million were formed. During 1979 the Saudi Cairo Bank (SCB) was formed with a total capital of SR 150 million, followed by the Arab National Bank (ANB), formerly the Limited Arab Bank, with a capital of SR 150 million. At a later stage all these banks increased their issued capital.

In 1976 the government established the Saudi Basic Industries Corporation (SABIC) as a government-owned company with capital of SR 10,000 million comprised of 10 million shares, to undertake the industrial development programme. The company has been subject to a privatization
programme since 1984 when the government sold 30% of its capital to the public.

During the Third Development Plan period (1980-1985), the five remaining foreign banks operating in Saudi Arabia joined the Saudiization programme by forming two banks, namely, Saudi American Bank (SAMBA) and the Saudi United Commercial Bank (SUCB), with 60% Saudi equity participation. In the Southern and Western regions two electricity companies were formed by merging the smaller companies operating in these two regions; the six electricity companies in the Northern region, however, remained unmerged.

The formation of the joint stock companies continued during the period of the Third Plan, as five agricultural companies were established to undertake agricultural development projects. This was followed by the formation of the Saudi Bahraini Cement Co. and the Saudi Kuwaiti Cement Co. with Gulf equity participation. In the same period, a large joint stock company, Tihama, was formed for advertising, publishing and public relations, with a capital of SR 200 million. Tihama had formerly been a limited liability partnership.

At the beginning of the Fourth Development Plan period (1985-1990), the establishment of the joint stock companies
decreased. One joint stock company was formed in the banking and financial sector, namely, Al-Rajhi Banking Investment Corporation and one joint stock company was formed in Madinah, namely, Taibah Investment Co.

There was an ownership connection among the joint stock companies, as some companies participated in the formation of others in the same line of activity, which reflects the important role played by those joint stock companies in the development of their group.

### 7.3.1. The Classification of Joint Stock Companies

There are 78 joint stock companies which have tradeable shares in the secondary market in Saudi Arabia. In 1985, SAMA classified these companies into four groups based on the area of the activity in which the company is engaged. These groups were: Financial (Banking); Industrial; Services; and Utilities. In 1987, SAMA expanded the classification to six sectors, namely, Financial (Banking); Industrial; Cement; Services; Electricity; and Utilities as shown in Figure 7.1. The combined capital of these companies totalled SR 55.4 billion in 1990.

The classification of these companies according to their sectors is as follows:

1) The Banking (Financial) Sector: This consists of
FIGURE 7.1
CLASSIFICATION OF JOINT STOCK COMPANIES

- Services: 21.8%
- Industrial: 21.8%
- Financial: 20%
- Electricity: 7.2%
- Agricultural: 14.6%
- Cement: 14.6%
eleven banks in the form of joint stock companies with a total capital of SR 7,000 million and total shares of 70 million. Two of these companies, Riyadh Bank and Al-Rajhi Banking Investment Co. are fully Saudi-owned. The rest are associated with foreign capital.

2) The Industrial Sector: This is comprised of 12 companies with a combined paid-up capital of SR 2,710 million and total shares of 133.7 million. These companies are fully Saudi-owned except the National Pharmaceutical Industrial Co., which has a foreign share capital of 25%. SABIC has the largest capital among all the joint stock companies.

3) The Cement Sector: This consists of eight companies with a total capital of SR 5,765 million and total shares of 61.85 million. The Saudi Bahraini Cement Co. and the Saudi Kuwaiti Cement Co. are associated with foreign capital of 15% and 45% respectively.

4) The Services Sector: This includes 12 companies with a combined total of SR 6,892 million and total shares of 93.13 million.

5) The Electricity Sector: This consists of four consolidated companies and six small companies. The total capital of this sector is SR 23,764.94 million with total shares of 237.94 million.
6) The Agricultural Sector: This is comprised of eight companies. The total capital is SR 1,557.2 million and the total shares is 21.1 million.

The total capital of these companies increased to SR 180.80 billion by the end of 1991, with a further increase of 13.98% to SR 206.06 billion by the end of 1992 following the increase in capital of some companies.

7.4. Summary

Although the government has played the major role in the process of the development of Saudi Arabia, the private sector has also been made responsible for participating in development projects, with government incentives and encouragement. In order to meet the need for economic diversification, the focus of planning has shifted towards placing a higher priority on the role of the private sector; on the policy and institutional innovations essential to economic diversification; on maintaining flexibility in government expenditures within the boundaries of approved programme structures; and on improving the private sector's efficiency in achieving the government's development goals.

Thus, the pattern of growth will in the future be less influenced by the size and distribution of government expenditures; rather, it is the extent and direction of
private sector investment that will increasingly influence the shape of the economy.

Joint Stock Companies are an important component of the Saudi economy, the first having been formed in 1934. The number of companies and their capital have increased gradually to provide the required power, facilities and revenue necessary for the development of the country. The implementation of the Saudiization programme has increased the number of joint stock companies, particularly in the banking and financial sector. The quantitative development of the joint stock companies was actively encouraged by the government.

The joint stock companies which have tradeable shares in the secondary market in Saudi Arabia are classified by SAMA into six sectors according to the area of the activity in which the company is engaged. This classification was one of a number of procedures implemented by SAMA in order to regulate the Saudi stock market which will be discussed in the next chapter.
CHAPTER EIGHT

The Stock Market in Saudi Arabia
8.1 Introduction

Plans for a Saudi stock market were in the making for several years. However, due to the many development problems, such as the general public's relative lack of sophistication with regard to stock issuance and trading, the small potential market, and the government's concern about stock market excesses in other Gulf states there was, initially, little sustained interest in developing a formal exchange. Nevertheless, the idea received great support from various ministry officials, regional and national businessmen's groups, chambers of commerce, and bankers who argued that in general, a stock market would provide an important element in the generation of the private sector capital required in the next stage of economic development (Abdeen and Shook, 1984:145).

The Saudi stock market was officially regulated in 1984. At that time, there were approximately 40 public traded companies (Abdelsalam and Satin, 1991:302). By 1990, there were 78 companies with a combined paid up capital of SR 53.3 billion, which rose to SR 55.4 billion following the recent increases in capital of some corporations.

This chapter provides an overview of the structure of the Saudi stock market (SSM), discussing the primary and secondary markets, the activities of the official and
unofficial brokers as market makers, and the sources of information available for investors.

8.2. The Primary Market

The primary market has existed in Saudi Arabia since 1934, when the Arabian Automobile Company (AAC) was formed as the first joint stock company in the country, under the Commercial Law of 1931.

Although the total number of joint stock companies had risen to 17 by the end of 1964, the provisions of the regulations governing these companies consisted merely of a few articles set forth in the Regulations for the Commercial Court. These were inadequate to cope with all the questions related to the companies, whether upon their incorporation or dissolution and liquidation, or during the conduct of their business. Due to this deficiency, individuals resorted to adopting the rules in force in other countries when incorporating and managing the affairs of their companies.

Hence there arose a pressing need for the drafting of comprehensive regulations for the companies, to set forth the provisions to be observed upon their incorporation, dissolution, liquidation, and in connection with the conduct of their business and to determine the extent of the powers of the Ministry of Commerce in connection with
their control and supervision, so as to safeguard the public interest, protect the private funds put at their disposal and to prescribe penalties for violations of such provisions.

In July 1965, the government issued for the first time a Companies Act, comprised of 234 articles. The Act which contained a comprehensive range of regulations to control the functioning of joint stock and other types of companies, was revised in 1967, 1982, and 1985 when an amendment was attached to it. The Act regulates the primary market in Saudi Arabia through 100 articles concerned with the regulations and procedures for establishing a new joint stock company and issuing the financial instrument, either by shares or bonds. In this respect, Article 116 provides:

"A corporation may issue against the loans contracted by it indivisible negotiable bonds of equal value." (Ministry of Commerce, Companies Act, 1965:40).

The Act permits the joint stock company, to issue in addition to ordinary shares, preferred shares of stocks with a par value of SR 100, or to convert common shares to preferred shares of stocks (Article 103). Shares remain the only instrument issued by joint stock companies, none of which has ever exercised the right to issue bonds. The Act also includes the rules which control the board of directors, the regular general meetings, the company's
final accounts, and the obligations and benefits of the shareholders.

Shares obtained through the primary market should be a new issue for new companies or existing privatized companies which have never before traded their shares, or a secondary issue for companies which have transferred a part of their ownership to the public at an earlier date. There is a standard mechanism for offering shares to the public, similar to "Offer for Sale" in the UK. When the company is a closed type, its shares are offered to the public through a method similar to the "Introduction" method used in the UK.

The establishment of a joint stock company in Saudi Arabia is subject to a specific procedure. The company is established with specific objectives based on market and feasibility studies. The company founders (the principal shareholders) are responsible for all the initial planning requirements of feasibility and market studies, financial forecasts, and procuring the necessary technical support for their operations. Based on these plans, they approach the Ministry of Commerce to secure licensing as a joint stock company. The Ministry of Commerce has a committee to evaluate the principal shareholders' efforts. If approval is granted, the committee approves the capital requirements and the number of shares to be sold at par value.
The invitation for public subscription should be set out in a prospectus containing the following information, in accordance with the Companies Act:

1) The founders' names, residence, addresses, occupations, and nationalities.

2) The company's name, object, head office, and term.

3) The amount of authorized capital, the classes of shares to be issued, their values and numbers, the amount subscribed for by the founders, and the restrictions imposed on the negotiability of shares.

4) Particulars of contributions in kind and the rights attached thereto.

5) Any special privileges granted to the founders or others.

6) The method for distribution of profits and losses.

7) The estimated amount of the company's preliminary expenses.

8) The offer duration and the place and terms thereof.

9) The allocation method in the case of over-subscription.

10) The date of issue of the Royal Decree authorizing the formation of the company and the issue of the newspaper in which it was published.

11) The date of the decision issued by the Minister of Commerce announcing the incorporation of the company and
the number of the newspaper issue in which it was published.

12) The minimum and maximum numbers of shares available to each applicant.

The prospectus should be published in a daily newspaper at least five days prior to date of the offer. Only Saudi nationals may subscribe in a joint stock company. Recently the Gulf Cooperation Council (GCC) has proposed a law allowing nationals of GCC States to participate in publicly traded companies in other GCC countries, but this law is not yet in effect.

Share subscriptions are open to the public over a period of several weeks, with local banks acting as intermediaries in selling the shares. The principal shareholders are prohibited from selling their shares until the company is operational and two years of financial statements have been reported to the public, in order to protect the public from insider abuses (Article 100). At the share deadline, all applications are sent to the financial consultant office, which has been assigned by the joint stock company to undertake the share allocation on behalf of the company. The office will then submit three alternative share allocation equations to the Ministry of Commerce, which will approve the option it considers to be in the best public interest.
The offer in the primary market in Saudi Arabia differs from the underwriting form which exists in the international capital market. It is based on "all or nothing", where the selling company and the intermediaries (banks) need not sell any of the offering unless all the shares offered can be sold at the established price. This can lead to loss of confidence and stability in the market.

During the period of the Second and Third Development Plans (1975-1985), the primary market witnessed a tremendous shareholder interest in the Saudi stock market, resulting in a large segment of the population becoming involved in buying and selling shares. The formation of the joint stock companies and the increase in the issued capital of these and other companies during this period have been essential to the development of the basis of the primary stock market.

The government activated the primary stock market by supporting and participating in the formation of many joint stock companies through its secondary investment agencies, such as the General Organization for Social Insurance (GOSI) and the Retirement Pensions Agency (RPA), which were among the founder groups of several joint stock companies. The government specialized credit institutions (SCI), played an essential role in the development of the primary market by investing a great portion of their funds in the
formation of the joint stock companies. The privatization of 30% of the capital of the Saudi Basic Industries Corporations (SABIC) in 1984 activated the market when a value of SR 3 billion offered to the public. In addition, the local commercial banks, the money changers, and the other institutional investors, as private financial sources, were heavily involved in the establishment of most of the joint stock companies and helped to activate the primary market.

Although the regulations issued by SAMA in 1985 required the joint stock companies to complete the procedures for issue of share certificates within a maximum period of two months from the date of the Minister of Commerce decision which declares the formation of the company, the major problem in the primary market has been the delay in issuing share certificates after the close of the subscription (SAMA, 1985).

8.3. The Secondary Market

During the 1970s, share investment in Saudi Arabia was unfavourable because most of the public were more interested in real estate investment. The public awareness began to grow gradually after the establishment of the stock exchange in some neighbouring countries, such as Kuwait and Jordan. Investment on the stock market then
became a very attractive alternative to investment in real estate, which reached its peak in 1980.

The secondary market started to be active in terms of transactions and marketability as a result of implementation of the government's development plans, coupled with events which accelerated the activation of the market, such as the electricity companies merger, the privatization programme of the local banks, the distribution of good dividends by the existing joint stock companies, and the formation of many new joint stock companies in several sectors (Felemban, 1986:79).

Share trading in the secondary market was based on the direct negotiation system, whereby both the seller and the buyer exchanged the shares against the payment in front of the company concerned. Later, a brokerage negotiation system developed; about 80 stockbrokers were informally putting sellers and buyers of stocks in touch. These brokers had no license, capital or credential requirements. Trading in the secondary market remained unchanged until the end of 1983.

By then, and due to the collapse of the Kuwaiti stock market, Souk Al-Manakh, the government issued regulations to control and monitor trading activities in the secondary market, with the aim of avoiding the kind of speculation
which was considered a factor in that collapse. However, trading control was left in the hands of the Saudi banks.

In April 1983, a Royal Decree (No 1320/8) approved the formation of a joint ministerial committee including delegates from the Ministry of Finance and National Economy, the Ministry of Commerce, and the Saudi Arabian Monetary Agency (SAMA), to study and review the Saudi stock market, especially the secondary market. The committee recommended not only the establishment of an organized stock market, but also that the government should introduce measures to avert the risk of a market crash due to the high level of speculation. This committee issued new regulations and rules to control and supervise the Saudi stock market (SSM) as a new system for trading in shares of the Saudi joint stock companies through share departments in Saudi commercial banks. In June 1984, SAMA circulated these regulations to all commercial banks in Saudi Arabia which were responsible for all negotiations and dealing pertaining to shares in Saudi joint stock companies, as of 1st January 1985.

The government, by implementing the new system, placed the control of both the capital and money markets in the hands of SAMA, and showed a great deal of confidence in the commercial banks entrusted the brokerage business. However, since the public understanding of share investment was
limited to the speculative aspect and the tradeable share volume was very small, the government was cautious about establishing an organized stock exchange at this stage, preferring to await further development of the market, resulting from regulation of the brokerage system.

The implementation of the new system required the establishment of the following departments (SAMA, 1985 and Malaikah, 1990):

a) A supervisory body for all securities trading. This is a committee whose members are representatives from the Ministry of Commerce, Ministry of Finance and National Economy, and SAMA. Its main functions are: to supervise negotiation transactions and monitor compliance with the instructions issued by the ministerial committee; to review directives and rules regulating negotiation transactions; to promote development and increased efficiency by exercising its right to request the necessary financial information either from the commercial banks or from the joint stock companies; and to set a ceiling on the share trade of a particular company or hold the negotiation of its shares, in the public interest. This committee meets regularly to review market conditions and reports to the ministerial committee which has the power to issue new rules for the market.
b) Shares Control Administration Department (SCAD) under the jurisdiction of SAMA to handle day-to-day securities trade control. This department monitors the working hours for share negotiation in the Central Negotiation Units (CNU) in the commercial banks. These have been set at two hours each morning, from 10.00 am. to 12.00 noon, and two hours each afternoon, from 16.30 pm. to 18.30 pm., except on Thursday, when there is no trading in the afternoon, as the commercial banks work only a half-day and Friday, when there is no trading at all, Friday being the day off for the banks and government. SCAD is involved in the appointment of personnel to the bank's CNUs, analyses the daily negotiation transactions received from the CNUs, and circulates the ministerial committee's and supervisory body's instructions to the companies and banks. It also reports the share price list and the daily and weekly financial summary to the local media, and issues briefing brochures in the public interest.

c) Securities trading company. Share trading under the new system requires a clearing house after trades are executed. Thus in 1985, the twelve commercial banks operating in Saudi Arabia jointly formed the Saudi Shares Registration Company (SSRC), based in Riyadh, with a total capital of SR 11 million shared equally by them. SSRC was formed in accordance with SAMA's instructions in order to
provide share registration and transfer services to the joint stock companies, including the twelve banks themselves. This company is responsible for all brokerage activities, constituting a central unit to coordinate buy and sell orders between CNU s in the banks. The CNU s in Riyadh have direct access to the central unit of SSRC. The company acts as an integrated central registry for all shares traded in the market. According to the company's articles of association, its other functions include:

- Monitoring the issue of shares and signing share certificates upon issue;
- Receiving, recording and dealing with probates, succession certificates, powers of attorney, dividend receiving mandates, powers vested, certificates of death, and other documents affecting the title to the shares;
- Publishing and despatching circulars and invitations to meetings, reporting financial statements;
- Handling and classification of proxies;
- Maintaining statutory periodic returns required by the company law.

Although SAMA encouraged the commercial banks to use the SSRC, most of the joint stock companies were reluctant to do so because they did not want to hand over their confidential papers or to duplicate their function regarding this matter.
In interviews with officials in charge of the SSRC they admitted that the original aim when the company was formed to give all the Central Negotiation Units (CNU) and the Branch Negotiation Units (BNU) access to the company's central unit for order processing. However, when it was discovered that such a procedure would reduce the importance of the CNUs located in Riyadh, leaving no difference in function between the CNUs and BNUs, they abandoned that plan in favour of having all the BNUs connected to their CNUs in Riyadh. Figure 8.1 shows the regular structure of the Saudi stock market.

8.3.1 Share Negotiation System through Commercial Banks

Only shares of Saudi companies can be transacted in Saudi Arabia. Shares may only be acquired by Saudi citizens, except in special circumstances, such as the 1984 Saudi Basic Industries Corporation (SABIC) issue, when a specified proportion was made available to Gulf Cooperation Council (GCC) citizens. Recently, the Arab National Bank was given the green light to launch the first fund for local investment, with around 30% to be placed in Saudi shares. Non-Saudis may invest in this fund, and other banks in the country have been allowed to launch similar funds.

The share negotiation system (SNS) is defined as a sale or purchase negotiation of shares of Saudi joint stock
FIGURE 8.1

THE REGULAR STRUCTURE OF THE SAUDI STOCK MARKET (SSM)

THE MINISTERIAL COMMITTEE
DELEGATIONS FROM

1) THE MINISTRY OF FINANCE AND NATIONAL ECONOMY
2) THE MINISTRY OF COMMERCE
3) THE SAUDI ARABIAN MONETARY AGENCY (SAMA)

THE SUPERVISORY COMMITTEE
REPRESENTATIVES FROM

1) THE MINISTRY OF FINANCE AND NATIONAL ECONOMY
2) THE MINISTRY OF COMMERCE
3) THE SAUDI ARABIAN MONETARY AGENCY (SAMA)

SHARES CONTROL ADMINISTRATION DEPARTMENT
(SCAD)

SAUDI SHARES REGISTRATION COMPANY
(SSRC)

CENTRAL NEGOTIATION UNITS (CNU) OF THE TWELVE SAUDI COMMERCIAL BANKS

BRANCH NEGOTIATION UNITS (BNU) OF THE SAUDI COMMERCIAL BANKS
companies fully owned by Saudi citizens or corporate bodies, as well as companies with a foreign participation. The staff of the commercial banks undertake the negotiation between the seller and buyer, or their duly authorized agent, under the system regulations. Commercial banks should have a Central Negotiation Unit (CNU) located in Riyadh and Branch Negotiation Units (BNU) located in the other cities of the country. Commercial banks are not allowed to take positions in the share negotiations. The system incorporates some restrictions to protect the market tradings. For example, forward dealings, telephone instructions for buying and selling shares, and the acceptance of post-dated cheques are prohibited.

8.3.1.1. Types of Order

There are two types of order: The first type is a limited order, whereby the client determines a specific price for any share he wishes to sell or buy; the bank in this case must not change the price without the client's permission. The second type is a market order, whereby the client authorizes the bank to sell at the best price available or to buy at the lowest price demanded.

8.3.1.2. Mechanism of the Secondary Market

The mechanism of share transaction is as follows: those wishing to buy or sell shares in the market would
approach a negotiation unit at the branch of any commercial bank and complete an application form indicating amount and preferred prices. The application form also contains the identification data of the client, name of the company, method of payment (cash, certified cheque or debit to the account), and the provision whereby the client authorizes the bank to carry out the transaction on his behalf, in accordance with the conditions stipulated in the order. Certain documents should be attached to the application, such as, a power of attorney if an agent is acting on behalf of a client, share certificates for selling or voucher for buying representing the value of shares to be purchased, and the commission which has been paid. Buyers must make their payment in advance.

Using a cumbersome system of telex, telephone calls, and facsimile machines, the branch negotiation unit sends the order to the Central Negotiation Unit (CNU) of the bank in Riyadh, accompanied by the delivery of the original documents of the transaction. Once the CNU in Riyadh has received the order, it checks the details and inputs them into the computer. The CNU first try to match buyers and sellers within their own branch network, and then with the central coordinating unit of other banks through a clearance office at SAMA. When the reconciliation is made, the CNU produces through the computer a processing order.
specifying the details of the original order, the middleman's name and his CNU, number of shares, share price, date of executed transaction, the amount of commission and method of payment.

After the completion of the transaction both branches will be supplied with copies of the processing order to inform the client and pay the value to the seller, if the transaction is completed in the same bank's CNU. In the case that two banks' CNUs are involved in the transaction, the settlement will be reconciled through the clearing office of SAMA.

In accordance with SAMA regulations on share trading, the CNU which undertakes the sale transaction has to provide SAMA with a copy of the processing order, along with a share certificate, so SAMA can verify and record the transaction data for the market information system, send it to the SSRC for the ownership transferring, and pass it to the clearing office within SAMA for payment clearance, if two bank's CNUs were involved.

The bank's CNU forwards the share certificates that have already been transferred to the name of the buyer to the buyer's bank's CNU within five working days from the date of the sale order, so it can be delivered to the buyer by the bank branch no later than fourteen days from the
date of the purchase order. The payment of the value of shares bought should be made within two days from the date of execution of the transaction by the bank branch.

Banks charge a maximum commission of 1% of the value of the shares traded, split equally between both the buyer and the seller. This charge covers the cost of registering the transaction and transferring the ownership of the concerned shares.

Share trading through the companies is still in practice, since share traders prefer to trade their shares through the company and save the commission that banks would charge for the transaction. Therefore, joint stock companies are required by the system to submit to SAMA a daily statement showing share ownership transfers occurring as a result of direct negotiation between sellers and buyers before the company. Sometimes a large number of transactions are routed through companies rather than through bank branches or through brokers, especially if the buyer and seller were already identified to avoid the commission payment (Ahmad, 1989:11). Figure 8.2 shows the process of the share negotiation system (SNS).

In May 1987, SAMA opened a Central Trading Hall (CTH) where a simple call-over system was used. It was operated in the presence of the controlling authorities, twelve
Figure 8.2
Share Negotiation System

- Share Negotiation System through Commercial Banks.
- Transactions through Joint Stock Companies.
brokers who called each share, one after another, upon which bids and offers were reconciled and an open price was set. Although the CTH was abruptly cancelled because the number of the dealers was too small and there was considered to be a high risk of unscrupulous inside dealing among the brokers, the CTH provided good experience on which SAMA could draw in establishing an organized stock exchange in the future.

The Saudi stock market (SSM) has expanded in recent years whereas the value of shares traded through the commercial banks reached SR 1.9 billion in 1408/09 (1988) as Table 8.1 show. However, the percentage of the value traded each year relative to the total value of the shares listed has decreased (Ministry of Planning, 1990:163).

In August 1990, SAMA introduced a new off the floor screen trading system, the Electronic Securities Information System (ESIS) to run parallel to the Share Negotiation System (SNS). The ESIS is a strictly computerized dealing scheme which will allow greater liquidity in the market. There are no brokers and banks are forbidden to act as market makers. In March 1991, SAMA fully implemented the new system for share trading in the stock market in Saudi Arabia.

By the end of 1991, the total value of shares traded
# TABLE 8.1

SHARES TRADED THROUGH COMMERCIAL BANKS AND
JOINT STOCK COMPANIES LISTED

<table>
<thead>
<tr>
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<th>1408/09 (1988)</th>
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</thead>
<tbody>
<tr>
<td>SHARES LISTED (SR BILLION)</td>
<td>80.6</td>
</tr>
<tr>
<td>SHARES TRADED (SR BILLION)</td>
<td>1.9</td>
</tr>
<tr>
<td>VALUE TRADED AS PERCENT OF LISTED VALUE</td>
<td>2%</td>
</tr>
<tr>
<td>NUMBER OF SHARES TRADED (MILLION)</td>
<td>14.6</td>
</tr>
<tr>
<td>NUMBER OF JOINT STOCK COMPANIES LISTED</td>
<td>52</td>
</tr>
</tbody>
</table>

was SR 8.5 billion. This increased to SR 13.7 billion by the end of 1992, a rate of growth of 61%. The total number of shares traded by the end of 1991 was 30.8 million shares, increasing to 35.2 million by end of 1992, with a rate of growth of 14%. The total of executed transactions at the end of 1991 was 90,500 transactions which then increased by 200% to 272 thousand by the end of 1992. In the first nine months of 1993, the market was active, as the total value of shares traded was SR 11.4 billion, the total number of shares traded was 34.6 million shares, and the total number of executed transactions was 226 thousand.

In an interview with officials in charge of share control departments at SAMA they expressed the belief that the SNS and ESIS work efficiently under their control within the regulations and rules approved by the ministerial committee. They pointed out, however, that they are still studying the outcome of the market and working for further improvement regarding the market efficiency and any violations of the system's regulations, either by the brokers in the CNUs or by the joint stock companies, as at present, no penalties are enforced against any violations of the dealing rules.

SAMA has, on occasion, appointed experts from the international market to conduct surveys and studies for the
Saudi stock market in order to develop the market performance and increase its efficiency.

8.4. The Official and Unofficial Brokers

The brokerage business in Saudi Arabia has existed since 1930, when it was focused on real estate investment. By 1980, brokers had moved their activities to the share investment as an alternative investment, either for their clients or for their own interests, using the concept of the real estate business. The most prominent such broker was the Saudi Investment Company (SIC) based in Jeddah, which was traded in both domestic and international shares, as well as options and precious metals. The early brokers had no qualifications or credential requirements and ran their business at minimum cost. Their main motive for involvement in share investment was speculation. Brokers operated their business with a trade commission licence which did not specifically cover share dealings, because there was no licence for such business at that time.

Brokers played the role of market makers and share traders, rather than brokers looking for the commission. Due to the absence of an official brokerage system for share dealings, brokers had dual functions. A broker could act as an agent on behalf of his client and as a dealer buying and selling shares for and from his own account.
Brokers were allowed to make multiple transactions, in sense that they executed transactions without any registration of the individual transfers, by handing over the share certificate from the seller to the buyer accompanied by a receipt of sale signed by both the seller and buyer. In this case, speculative buyers were satisfied with a contract signed by one party (the original holder as the first seller), leaving the space for the buying party unsigned, to be filled in by the last buyer, who wished to keep the shares in his name and then complete the ownership transfer procedure. These brokerage activities continued until 1985.

When SAMA implemented the new share negotiation system and handed all the brokerage business to the commercial banks, it specified that the function of the broker was as a middleman, executing share orders on behalf of the bank's clients. The system laid down conditions for the appointment of the middlemen, whether in the central negotiation units or in the branch negotiation unit. A middleman must be a Saudi National, highly qualified, never have been the subject of any criminal proceedings, and be adequately trained prior to assignment in negotiation transactions.

During the first two years of implementation of the new system, commercial banks were unable to undertake the
brokerage activities properly because they had to train a great number of staff to carry out the negotiation transactions, both in the CNU and in the other branches. In the meantime, the general public had little confidence in the banks. Eventually, the banks were forced to make a covert approach to the unofficial brokers, requesting their help and experience. Thus, those brokers started to activate the market by buying and selling blocks of shares in their own names, on behalf of unknown clients.

Although their activities remained unofficial, they played a significant role as market makers. They were considered to be big individual investors, focusing their interests on certain companies and using their ability to make a quick sale as a bargaining point to reduce share prices. They began to be widely considered by the public as share traders, because of their daily advertisements in the local media, and became competitors of the official brokers, because their transactions are quicker, involve less paperwork, and they do not charge commission. Their procedure is based on direct payment for any purchase transactions, receiving the share certificates from the seller, who signs a sale contract which must be presented to the company with the certificates for transfer of ownership. This procedure is preferred by many share sellers.
The role of the unofficial brokers is significant, because they are interested in dealing in some selective shares and have become a good source of supply of these shares to the official brokers in the banks, who may buy from them on behalf of their clients.

8.5. Information Sources

In Saudi Arabia, financial information is made available through the local press and by direct distribution from the joint stock company to its shareholders. The Companies Act requires corporations to report their audited annual balance sheets, income statements, the company's operations and financial position, and the method by which they propose to distribute net profits to the public, through at least one of the local newspapers. Companies are also required to report their annual statements to the Share Control Administration Department (SCAD) and the Ministry of Commerce. The latter has a division which keeps up-to-date, accurate basic structural data on all corporations and their financial annual statements for the public use. By law, the company's board of directors are not allowed to disclose inside information to the shareholders or to the public, except at the time of the annual general meeting.

Although the Companies Act requires the Companies to
report their financial statements annually, SCAD requires the companies to report their quarterly financial statements within two months from the end of each quarter. According to the ministerial committee's regulation on stock trading procedures, any company which does not comply with the quarterly disclosure requirements is subject to suspension of its share trading, in addition to the penalties stated in the Act. Some companies have complied with quarterly disclosure requirements, but the majority have not.

At the present, with the full implementation of the SNS and ESIS, SCAD and SSRC prepare and report quarterly financial and non-financial information on corporations for the use of shareholders and the public. This information can be obtained through the screen of the trading system during trading time. In addition, the share price list prepared daily by SCAD and published in local media is considered to be a significant source of market information, in addition to other information published by corporations, quarterly or annually. The latter is not published regularly and accurately, despite the rules and regulations that require this information for the use of the public.

The share price list is a result of transaction data being sent into one pool by banks' CNUs and by the joint
stock companies, when transactions are executed through the commercial banks and through direct negotiation before the company. In March 1985, the share price list was issued on a weekly basis then in April 1986, it developed to a daily basis. It includes transaction data of all corporations that have tradeable shares in the market, classified into six activity sectors. The daily list indicates the number of transactions per issue; the number of shares traded; the highest and lowest average and the last average price; the accumulation figures of the number of transactions; volume and value of traded shares; and number of companies in which shares are traded. SCAD also issues a weekly list of the accumulation figures, classified by activity sector, with comparative percentages and the numbers of companies whose share prices increase, decrease and remain constant.

The daily share price list is prepared by SCAD once a day at twelve noon, to show all transactions executed on the previous day. It is distributed to all banks' CNU, BNUs, and the local media by fax. This list is considered to be the initial source for the weekly share price indices produced by the National Centre of Financial and Economic Information (NCFEI), which is a division under the control of the Ministry of Finance and National Economy.

In Saudi Arabia, there are eight Arabic-language daily newspapers, and three English-language daily newspapers
which have reported financial information since March 1985. One of the eight newspapers and two daily financial newspapers report daily trading information for all shares on a regular basis with details about comparative prices, transactions data, and accumulated figures.

As a result of competition, commercial banks seek to attract investors by publishing brochures and leaflets of introduction to share investment which include financial data of most corporations, their latest activities, their board of directors, comparative data of prices and dividend, and financial analysis of the performance of the share market. This initiative taken by commercial banks has further developed the base of market information sources for Saudi investors. Another development is that some commercial banks, such as Riyadh Bank and the National Commercial Bank (NCB), publish a monthly report focusing on the share market activities, with financial analysis of the joint stock companies and their performance.

The Chambers of Commerce and Industry in the country also make a contribution by publishing structural and financial data on the corporations, accompanied by financial analysis prepared by financial specialists and experts on the share market, such as the Consulting Centre for Finance and Investment (CCFI). Table 8.2 shows the activity in the Saudi stock market from 1985 to 1992.
TABLE 8.2

ACTIVITY IN THE SAUDI STOCK MARKET

1985 - 1992

<table>
<thead>
<tr>
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<th></th>
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</thead>
<tbody>
<tr>
<td>NUMBER OF TRANSACTIONS</td>
<td>23,267</td>
<td>41,960</td>
<td>110,030</td>
<td>85,298</td>
<td>90,559</td>
<td>272,075</td>
</tr>
<tr>
<td>VOLUME ('000 SHARES)</td>
<td>12,012</td>
<td>14,641</td>
<td>15,272</td>
<td>16,938</td>
<td>30,758</td>
<td>35,199</td>
</tr>
<tr>
<td>VALUE (SR MILLION)</td>
<td>1,686</td>
<td>2,037</td>
<td>3,364</td>
<td>4,403</td>
<td>8,527</td>
<td>13,699</td>
</tr>
<tr>
<td>PERCENT INCR. FROM PREVIOUS YEAR</td>
<td>102.9</td>
<td>20.8</td>
<td>65.1</td>
<td>30.9</td>
<td>93.7</td>
<td>60.7</td>
</tr>
<tr>
<td>AVERAGE MARKET CAPITALIZATION (SR BILLION)</td>
<td>78.3</td>
<td>92.2</td>
<td>112.4</td>
<td>118.1</td>
<td>150.0</td>
<td>199.1</td>
</tr>
<tr>
<td>VALUE OF TRANSACTIONS AS % OF MARKET CAPITALIZATION</td>
<td>2.1</td>
<td>2.2</td>
<td>3.0</td>
<td>3.7</td>
<td>5.7</td>
<td>6.9</td>
</tr>
</tbody>
</table>

Source: The Consulting Centre for Finance and Investment (CCFI).
8.6. The Market Indices

In 1985 the National Centre for Financial and Economic Information (NCFEI) produced indices of the Saudi share market for the first time as a contribution to the market information system, but these were not published until the 6th of March 1987. According to NCFEI, the indices system was given a two-year trial period, after which time it was considered to be the official index of the Saudi Stock Market (SSM). The indices include a general market index and six sub-indices for the various sectors, namely financial (banks), industry, services, agriculture, electricity, and cement. They are based on the share price data supplied by the SCAD. The indices, calculated weekly and prepared in decimal and graphical forms, have been produced since the week of 2nd - 7th of March 1985 with a commencing date of 02.03.1985, on which the index value was considered to be 100 points. Table 8.3 shows the stock market price indices for the six sectors for the period January 1992 to January 1993.

There is another index of Saudi share prices prepared by the Consulting Centre for Finance and Investment (CCFI), which specializes in managing the public flotation of shares in the Saudi stock market. In 1982, the CCFI index rose by nearly 306%. In 1985, it dropped by 23% but stabilized in 1987 and went up by 11% in 1988. Figure 8.3
<table>
<thead>
<tr>
<th>MONTH</th>
<th>BANK</th>
<th>INDST.</th>
<th>SVCS.</th>
<th>AGRI.</th>
<th>ELECY.</th>
<th>CEMENT</th>
<th>TOTAL</th>
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<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>WEEK ONE</td>
<td>423.89</td>
<td>287.29</td>
<td>115.80</td>
<td>135.86</td>
<td>58.65</td>
<td>141.10</td>
<td>175.79</td>
</tr>
<tr>
<td>WEEK TWO</td>
<td>439.85</td>
<td>289.30</td>
<td>116.08</td>
<td>134.88</td>
<td>58.48</td>
<td>143.26</td>
<td>178.69</td>
</tr>
<tr>
<td>WEEK THREE</td>
<td>457.61</td>
<td>296.59</td>
<td>119.46</td>
<td>141.30</td>
<td>58.48</td>
<td>142.30</td>
<td>183.20</td>
</tr>
<tr>
<td>WEEK FOUR</td>
<td>453.98</td>
<td>296.96</td>
<td>122.32</td>
<td>141.40</td>
<td>58.48</td>
<td>144.60</td>
<td>183.35</td>
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<td>FEB.1992</td>
<td></td>
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<td></td>
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</tr>
<tr>
<td>WEEK ONE</td>
<td>457.82</td>
<td>307.11</td>
<td>126.46</td>
<td>145.22</td>
<td>58.26</td>
<td>143.78</td>
<td>186.28</td>
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<tr>
<td>WEEK TWO</td>
<td>470.70</td>
<td>319.57</td>
<td>134.48</td>
<td>153.52</td>
<td>58.59</td>
<td>146.93</td>
<td>192.25</td>
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<tr>
<td>WEEK THREE</td>
<td>529.29</td>
<td>331.49</td>
<td>140.96</td>
<td>155.79</td>
<td>60.43</td>
<td>149.71</td>
<td>205.23</td>
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<td>WEEK FOUR</td>
<td>541.55</td>
<td>326.29</td>
<td>141.01</td>
<td>151.80</td>
<td>59.42</td>
<td>162.94</td>
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<td>MAR.1992</td>
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<tr>
<td>WEEK ONE</td>
<td>538.24</td>
<td>327.11</td>
<td>141.31</td>
<td>148.29</td>
<td>58.76</td>
<td>164.37</td>
<td>206.24</td>
</tr>
<tr>
<td>WEEK TWO</td>
<td>538.49</td>
<td>331.72</td>
<td>150.60</td>
<td>148.56</td>
<td>59.09</td>
<td>170.74</td>
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<td>WEEK THREE</td>
<td>539.81</td>
<td>336.82</td>
<td>151.02</td>
<td>148.31</td>
<td>58.76</td>
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<td>210.78</td>
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<tr>
<td>WEEK FOUR</td>
<td>555.28</td>
<td>332.45</td>
<td>149.83</td>
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<td>58.76</td>
<td>191.30</td>
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<td>WEEK ONE</td>
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Source: The National Centre for Financial and Economic Information (NCFEI).
shows the CCFI index of Saudi share prices from November 1981 to December 1992.

8.7. Summary

In this chapter we have seen that the primary market in Saudi Arabia has existed since 1934 and the total number of joint stock companies has increased gradually. As a result, the government issued the Companies Act to regulate the primary market in order to safeguard the public interest and protect private funds. Most companies that go public are newly established corporations with no operating history and large capital requirements, existing companies which have been subject to the privatization programme, or companies which have transferred a part of their ownership to the public.

Companies law has laid down clear procedures for the formation of any joint stock company, including the invitation to public subscription. Although subscription in joint stock companies in Saudi Arabia is limited to Saudi nationals, the country as a member of the Gulf Cooperation Council (GCC) has approved the participation of GCC nationals in the publicly traded companies in the GCC countries.

The mechanism for offering shares to the public in the primary market is similar to "Offer for Sale" which is used
FIGURE 8.3
CCFI SHARE PRICES INDEX
FROM NOVEMBER 1981 TO DECEMBER 1992
in the UK. In the primary market, commercial banks act as intermediaries in selling shares to the public without taking part in this process. Corporations, in accordance with the law, have to appoint a financial consultant agency to carry out the allocation process, which requires final approval by the Ministry of Commerce. Thus, the offer system in the Saudi primary market is different from the form of underwriting that exists in the international market.

The government and its agencies helped to activate the primary market through participation in the establishment of many corporations; private sectors such as institutional investors and the commercial banks also played an important role. As a result, the public showed great interest in investing in the joint stock companies and played a significant role in the development of the base of the primary market.

The public awareness of investment was dominated by real estate investment until the 1980s, when share investment became popular as an alternative investment opportunity. This in turn, activated the Saudi secondary market and share dealings increased due to many events such as the implementation of the privatization programme. Share trading in the secondary market before 1985, was based on
direct negotiation between the seller and buyer before the company.

The government issued new rules and regulations to monitor and control the shares trading in the secondary market in order to avoid the unofficial brokers' speculations which were very high at that time and to protect the market from the possibility of a crash such as occurred in the Kuwaiti stock market, Souk Al-Manakh. The Share Negotiation system (SNS) placed control in the hands of commercial banks, under the supervision of SAMA through the Shares Control Administration Division (SCAD). This placed the control of both the money and capital markets under the supervision of SAMA and prepared the market to be an organized stock market supported by an official brokerage system.

At the beginning of 1985, SAMA enforced the new system through the Central Negotiation Units (CNU) and the Branch Negotiation Units (BNU) of the commercial banks in the country, which trade shares on behalf of their clients in accordance with specific procedures, charging a commission of 1% of the value of the shares traded, divided equally between the buyer and seller, to cover the transaction cost. However, transactions may alternatively be processed direct through the corporations or through the unofficial
brokers to avoid the commission payment especially in the case of large transactions.

Although SAMA, in 1987, introduced the Central Trading Hall (CTH) for share dealing, as an initial step towards the formation of an organized stock exchange, it was closed after one month's trial, due to the failure of its functions. On March 1991, SAMA fully implemented the Electronic Securities Information System (ESIS) to work with the Share Negotiation System (SNS).

The brokerage business has existed in Saudi Arabia since 1930, due to the early interest in real estate investment. During the 1980s, the unofficial brokers focused their activities on share investment using their experience in the real estate business but without any qualification, licence, or credential requirements. They were market makers rather than brokers. After the implementation of the SNS and ESIS the official brokers in the commercial banks were entrusted with the brokerage business which affected the role of the unofficial brokers.

Due to the inability of the commercial banks fully to carry out the brokerage business in the early years of the SNS and ESIS, the unofficial brokers played a significant role, cooperating with the commercial banks and supplying
them with their experience and making available shares in specific companies in which they were interested to deal.

The SSM has few market information sources compared to other markets. The share price list, prepared by SCAD and published in the local media, is considered to be the most reliable source of the market information. Ordinary investors rely heavily on this list, as well as on the financial statements published by the corporations and the financial analysis prepared by financial specialists and published by economic departments of the commercial banks through their monthly reports and newsletters. Chambers of Commerce and Industry and Consultant Centres also play a role through the publication of their financial reports which include useful information, such as comparative data of prices, financial data of most companies, and analysis of the share market performance.

The official index of the Saudi stock market (SSM) which has been prepared and published by the National Centre for Financial and Economic Information (NCFEI) on a weekly basis since 1985, shows the market activities as a whole and the activity of each sector of the market. There is another index prepared and published by the Consultant Centre for Finance and Investment (CCFI).
CHAPTER NINE

The Research Survey in Saudi Arabia
9.1. Introduction

The stock market, like any market, depends on supply and demand. Joint stock companies are the suppliers of shares to investors who demand them. A major objective of corporate financial reports is to convey information about a company's profit or loss and state of affairs to those interested in its economic progress and performance, among them the investors, who represent a particularly important user group for financial and accounting information, as they need it to assist them in making rational investment decisions. For communication between the company and those interested in its financial welfare to be effective, however, the report must be both understandable to and read by its recipients.

Small investors might buy shares for the following reasons: for investment; for capital appreciation in the light of some expected development; or a combination of the two. They might sell their shares to raise money, whether it be to buy a business, or to buy other securities which at the time appear more attractive, or to release capital in the expectation of favourable opportunities of investing it to greater advantage later on. Another reason for selling stocks is the belief that the particular stock to be sold is standing at a higher price than its real value.
In order to find out whether individual investors actually use the accounting information disclosed in the corporate financial reports when they make investment decisions related to buying, holding, or selling shares in the Saudi stock market, a questionnaire survey was addressed to them, and interviews were conducted both with small investors and with official and unofficial brokers.

In this chapter we will discuss the findings of previous studies on investors' individual use of financial reports, and on what information in those financial reports they most heavily rely for equity investment decisions, the usefulness of the financial statements for such investment decisions, and the information needs of the private shareholders and investors. Finally, the methodology by which the survey research was conducted will be described and the attributes of the investors studied will be discussed.

9.2. Review of Previous Studies

It is generally recognized that information contained in the company financial reports should be useful to shareholders and investors in their investment activities. There have been several approaches to examining information needs of investors and the role of corporate reports in providing part of this information. One example of this
approach is the study by Baker and Haslem, (1973) who studied a range of decision variables used by equity investors in analysing their share transaction decisions. This approach considered information that is or may be generated from both within and outside the corporate reporting framework.

Furthermore, several empirical studies of individual investors' use of financial statements have been conducted in recent years in the United States (Epstein, 1975; Chang and Most, 1977), the United Kingdom (Lee and Tweedie, 1976), Australia (Chenhall and Juchau, 1977; Winfield, 1978), and Saudi Arabia (Felemban, 1989; Abdelsalam, 1990).

The nature and findings of these studies are discussed below, by way of background and introduction to the present study.

The study of Baker and Haslem (1973), investigated the information needs of individual investors in common stocks and identified the important sources of information used by this group of investors in their investment decisions. The researchers sent questionnaires to common stock investors in metropolitan Washington, D.C., the eighth largest metropolitan area in the United States in terms of number of stockholders, asking them to indicate the most important sources of information they used in evaluating common
stocks. The results of their survey indicated that 46.8% of the respondents rated stockbrokers as their most important source of information, while only 7.9% cited the corporate annual financial statements as their most important source. Further, investors were asked to indicate on a 5-point scale the relative importance of each of thirty-three items of information, some of which were currently reported in the corporate annual reports. The three most important items rated by the respondents were the future economic outlook of the company, the quality of the management, and the future economic outlook of the industry in which the company is involved.

The authors found that, although individual investors were primarily concerned with information relating to future expectations, they were also interested in historical information. They concluded that individual investors use many different factors in the evaluation of common stock, but expectational factors dominate and their needs of information for investment decisions may well differ. Moreover, when they compared their survey results with other research findings, they suggested that individual investors' information needs may differ from those of professional analysts (Baker and Haslem, 1975:64-69).

Hoping to determine the usefulness of annual financial
reports, Epstein (1975) found that only 15% of his respondents relied on annual reports as their primary basis for investment decisions while 48.8% of them relied on stockbrokers' advice. The study found that 14.1% of the shareholders surveyed stated that corporate annual reports were very useful, 46.7% stated they were of moderate usefulness, 18.8% stated they were of little use, and 26.4% stated they were not useful at all. Epstein concluded that corporate annual reports were not very useful to shareholders for investment decisions (Epstein, 1975:34-42).

Chang and Most conducted research on investors' use of financial statements for investment decisions through a questionnaire survey addressed to individual investors, institutional investors, and financial analysts. The questionnaires were identical except that certain questions were adapted to the circumstances of each of the three groups. The questionnaires included four questions common to all three groups, plus three additional questions for investors and four additional questions for financial analysts.

Part One of the questionnaire asked for respondents' investment objectives and views on the relative importance and usefulness of different sources of information currently available for making decisions about buying and
holding or selling common stocks. It also questioned user needs for additional kinds of investment information not generally reported at present. Respondents were asked to answer questions in this part using a 5 point scale. Part Two asked respondents to disclose their personal characteristics, such as age, education, and investment experience (Chang and Most, 1981:47).

To give the research study an international dimension, similar surveys of the three user groups were conducted in the United Kingdom and New Zealand at the same time as in the United States, as all these three countries have large capital markets and well-organized stock exchanges which tend to function in a similar manner. For investors in the United Kingdom and New Zealand, the questionnaires were modified slightly to accommodate the circumstances (Chang and Most, 1985:9). Our focus in this study will be on the responses of the individual investors only.

Investors' investment objectives will influence their choice of information sources. Individual investors were asked what were their important objectives when making investment decisions about buying, selling, or holding common stocks. For the United States investors, the most important objective was long-term capital gains; for the United Kingdom and New Zealand investors, it was a combination of dividend income and long-term capital gains.
This difference should cause no surprise, since at the time the questionnaire was being completed, dividend yields were substantially higher in the United Kingdom than in the United States. The different tax systems may also have been a factor. That the New Zealand responses were identical in ranking and relative weights to the United Kingdom responses lends weight to this view, because the two countries have similar income tax laws. Investors in all three countries rated dividend income third and short-term capital gains fourth. Their responses showed that the objective of short-term capital gains was rated more important by investors in the United States and New Zealand than by those in the United Kingdom. Long-term gains, however, were rated slightly more important by the United States and New Zealand investors than by investors in the United Kingdom (Chang and Most, 1985:28).

The United States individual investors rated the corporate annual reports their most important source of information (45.7%), followed by newspapers and magazines (37.1%). Advisory services ranked third in importance, slightly above stockbrokers' advice. Proxy statements ranked fifth in importance, while the other two information sources, advice of friends and tips and rumours, were considered of minor importance (Chang and Most, 1985:31).

Both the United Kingdom and New Zealand individual
investors rated newspapers and magazines their most important source of information. In fact, individual investors in these two countries ranked the seven information sources in almost identical order. They rated sharebrokers' advice second, corporate annual reports third, and published statements of company directors (proxy statements in the United States survey) fourth and ahead of advisory services. Like their counterparts in the United States, the United Kingdom and New Zealand individual investors rated advice of friends and tips and rumours as relatively unimportant (Chang and Most, 1985:32).

The survey results show that corporate annual reports are significantly more important to investors in the United States than in the United Kingdom, stockbroker's advice is most important in New Zealand than in the United States, and advisory services are more important in the United States than in either of the other countries. The reasons for these differences may lie in qualitative differences between the information sources themselves in the three countries. Corporate reporting by U.S. companies may be more informative. The financial press in the United Kingdom and New Zealand may be more analytical than its U.S. counterparts and therefore may perform for investors in those countries some of the services that U.S. investors must perform for themselves. In the United Kingdom and New
Zealand, stockbrokers are not permitted to deal on their own accounts and are restricted to functioning as agents. This fact would explain why investors in those countries have considerable confidence in brokers' recommendations and rely upon them as a source of advice (Chang and Most, 1985:33).

Individual investors in the United States rated the income statement the most important part of the corporate annual report for buying, selling, or holding decisions. They rated summaries of operations for the last five to ten years, balance sheet, and statement of changes in financial position very important. Sales and income by product line, management's discussion and analysis of the summary of operations, accounting policies, and auditors' reports were rated important.

Responses of individual investors in the United Kingdom and New Zealand indicate that they rated corporate annual report items almost identically. They rated the summary of operations for the last five to ten years and the profit and loss account very important. They rated the balance sheet third in importance and the statement of changes in financial position fourth, followed by management's discussion of the summary of operations.

Sales and profit by product line, chairman's letter,
accounting policies, and auditor's report were considered somewhat important (Chang and Most, 1985:43).

The authors concluded that the annual financial reports represent information considered to be useful for investment decisions in the United States, the United Kingdom and New Zealand.

Lee and Tweedie conducted a study to examine whether or not shareholders use information from company financial reports and whether or not they understand the accounting terminology used in the production of these reports (Lee and Tweedie, 1975:280). They sent 1,594 questionnaires to individual shareholders of one of the largest industrial companies in the United Kingdom and 374 usable replies were received in time for processing, a response rate of 23.5%. The responses indicated that most respondents regarded annual financial reports as an important source of information for investment decisions. Financial press reports were considered the most important of all the other sources of information on companies. Stockbrokers' reports were read by many shareholders, but they were not considered as such an important source as half-yearly financial reports (Lee and Tweedie, 1975:280-291).

The study revealed that of the 67.9% of the respondents who said they understood the information
contained in the annual financial reports, 38.8% indicated that they found it relevant to their investment decisions while 28.1% found it irrelevant (Lee and Tweedie, 1975:5). Rating importance on a 5-point scale (1 = maximum importance; 5 = no importance), profit and loss account headed the list, chairman's report came second, and auditor's report was considered least important. Regarding understanding of reporting objectives, 59.3% realised that a main aim of annual reporting is to make company directors accountable to shareholders and 19.7% thought reports are intended for investment decisions, while 13.3% believed that annual reports could be used for the purpose of assessing the market value of shares. 29.9% of the respondents thought that annual reports help to justify dividend proposals and 7.1% of them either did not know any reporting objectives or were unwilling to give any response (Lee and Tweedie, 1975:9).

The researchers found that many of the respondents appear to skim through the annual report, the chairman's report being the most widely read section. Shareholders with no knowledge of accounting were more interested in the chairman's report than any other section, and this was confirmed when 95.7% of the respondents rated the chairman's statement the most useful part of the annual financial report for investment decision-making purposes.
Those shareholders with some form of training in accounting read the report more carefully than those without any such experience and paid particular attention to the profit and loss account. They rated the profit and loss account and balance sheet as most useful section.

Financial press reports were considered to be the most important sources of information other than the annual financial report. Shareholders rated the financial press reports as being slightly more useful in investment decision making than the published profit and loss account. Half-year interim accounts were only considered to be of moderate to slight importance, as one third of the respondents considered these reports to be of no use to them for investment decisions, although those with accounting experience rated them more highly than those without accounting experience. The economic prospects of the firm were considered to be the most important item of information contained in both the annual report and the other sources of information (Lee and Tweedie, 1975:279).

The study results also revealed that respondents appear to have a better understanding of reporting objectives, although it is clear that the general level of understanding is not as good as it could be (Lee and Tweedie, 1975:9).
The authors concluded that shareholders are very interested in information about the future of the company and those without a knowledge of accounting seem to prefer to consider an interpretation of the company's results rather than the published statements themselves (Lee and Tweedie, 1975:288).

Chenhall and Juchau conducted a survey in Australia, in the form of a mail questionnaire concerning 37 factors used in share decisions. The study took the survey rationale and questionnaire format of Baker and Haslem's US study, which they extended to provide an information base for future comparative studies. The respondents were asked to identify the relative importance of each factor on a five point scale (1 = of no importance and 5 = of maximum importance). Information was also collected to ascertain the socio-economic background of respondents, to distinguish between investors with high and low risk preferences and to indicate the main sources of information for investors (Chenhall and Juchau, 1977:113).

From a total population of 1,025 investors, 476 valid replies were received. This represents a response rate of 46.4%. Respondents considered the quality of the management, listing of the share on the stock exchange, the future economic outlook of the company, and financial strength of the company among the factors that have great
importance when making their investment decisions, while they thought that share turnover, portion of the company's annual earning paid out in dividends, the expected future growth in sales, the current and expected future percentage return from dividends (yield), and the past percentage growth of dividends per share have a moderate importance. The past percentage return from dividends (yield), the involvement of the company in active research and development, the size of the company in terms of total assets, and the ease with which the firm can liquidate its assets in case of failure, were considered by the respondents to have slight importance in their investment decisions (Chenhall and Juchau, 1977:114).

The researchers found that information, both specific and non-specific to the company, which is not disclosed in the annual corporate report bears strongly on share investment decisions, as in the top 18 rankings at least eight items had their origin outside the annual corporate report. This result suggests that information sources outside the annual corporate report have significance, and those agents who collate and disseminate information not included in the annual corporate report are important reference areas for investors. The results of this survey showed that the financial statements, which are the major elements in the annual corporate reports, do not have a
dominant place as a source of information; only 30% of the respondents rated the financial statements as their most important source of information. However, the role of the financial statements retains significance when it is realised that other information sources used by investors would resort to analysis of financial statements together with other economic and capital market information (Chenhall and Juchau, 1977:117).

The researchers concluded that investors in Australia ranked financial reports (30%), stockbrokers (27.5%), and newspapers (16.6%) in the the top three sources of information. 3.2% of them considered advice from their friends, 15.1% of the sample considered rumours from the market, and 7.6% considered the advisory services as sources of information. In addition, the study raised some important questions regarding information needs of investors and the provision of investor information from both within and outside the corporate reporting framework. It was suggested that some further empirical examination is required to establish the relative importance of information which relates to anticipatory data dealing with share price, earnings and dividend measurements and movements (Chenhall and Juchau, 1977:119).

In another Australian study, Winfield investigated the sources of information used by stock investors and their
views on the importance of the annual corporate financial reports. The results of his study indicated that 70.5% of the sample considered the financial reports as their prime source of information, 55.8% of the respondents thought that newspapers are an important source of investment information, while 34.8% of them consulted stockbrokers for investment decisions and 19.7% indicated that they consult their friends as a source of investment information. 19.1% of the survey sample mentioned other sources of information (Winfield, 1978).

56.4% of the respondents ranked the chairman's report as the most important section in the financial reports, 41% and 41.1% of the respondents rated the profit and loss account and balance sheet in the second rank, followed by the director's report which 28.5% of them considered an important section. 26.3% of the respondents considered the financial highlights as an important section of the financial reports and historical operating summary was thought to be important by 18.9% of them.

Felemban (1989), investigated the availability of the market information system to all investors in the Saudi stock market when he examined the Saudi equity security market, with special emphasis on market efficiency. The author conducted his research through two integrated approaches. The first was a basic analysis of the overall
market environment and structure, such as the share issuing bodies, the investors who demand share trade, the legal and organizational structure which legislates and controls the market activity, the political and economic environment in which the market operates and the overall activity of the market. The second approach contained two parts; firstly, an analysis of the movement of the Saudi Share Price Index in comparison with other indexes for the period from when it was published to the end of 1988; and secondly, a market efficiency test of the weak form using raw data of the weekly share price of selected Saudi joint stock companies (Felemban, 1989:7). Our attention here will be confined to those findings related to the subject of the present study.

A field survey was conducted which included a questionnaire survey on small and medium investors as well as official broker interviews. The researcher interviewed only the senior officials in the share trade department of three banks in Jeddah, namely; the National Commercial Bank (NCB), Riyadh Bank, and the Saudi Investment Bank (SIB). These banks were selected by the researcher because of their active performance in share trading for the six month period prior to the survey (Felemban, 1989:220).

The questionnaire survey was limited to Saudi investors holding less than 5000 shares. The sample was geographically limited to the Jeddah area. The
questionnaire was designed to exclude the big individual investors and institutional investors. It was divided into two parts, the first being concerned with demographic variables, in order to make sure that the sample was representative in terms of sex, age, education, marital status, annual income, and number of shares owned. The second section included 26 questions designed to cover the purpose of the questionnaire. By the end of the survey period a total of 210 questionnaires had been answered out of 600, a response rate of 35% (Felemban, 1989:199-204).

Among the results of the study, the researcher found that 40.7% of the respondents preferred share investment and 30.6% preferred real estate investment. 38% of the respondents bought shares for capital gain, while 38% did so for regular income in terms of dividend and 29% for both capital gain and dividend. The respondents were asked to indicate which of 13 criteria they would consider when evaluating a company to invest in. 73.3% of the sample considered the company performance in terms of turnover and profit, 66.2% considered the sector in which the company is classified, 55.2% the prestige of the company. 50.5% of the respondents considered the company share market price while 48.6% considered the distributed dividend and 35.2% considered the company age. 34.8% considered the reserved capital while 24.8% would consider the names of the board.
of directors and 21% considered the shareholders' equity. 19% of the sample would consider the company capital while 18.6% indicated that they would consider the historical market price trend for the company share and 14.3% considered the company account for the calendar year (Felemban, 1989:208).

According to the survey, 72.9% depended on SAMA's share price list when making investment decisions. This source of information was considered the prime source, which 42% of the investors indicated that they would trust. Newspapers were the second source of information (used by 48.6%), and 25.6% of respondents said they would trust them. 45.2% considered inquiries to bank share departments and 39% of the sample indicated that they considered the company annual report as the prime source of information for investment decisions (Felemban, 1989:209). Furthermore, 52.9% of the sample believed that the information available to the investor in the Saudi stock market was not analysed, while 37.6% believed it reflected the positive side and 35.2% indicated that it was not altogether realistic. Although 11.4%, 8.1%, and 5.7% of the respondents believed that information was comprehensive, accurate, and easy to understand, 35.2% said it was incomplete while 33.3% thought it was useless to the ordinary investor and 12.4% found it difficult to understand (Felemban, 1989:211).
In order to determine the use and understanding of the information disclosed in the company's annual report, the study revealed that of the 52.4% of the respondents who answered they were very interested in looking at the company's annual financial report, 60% indicated that they had some difficulty understanding it and 12.4% confirmed the fact that they found it difficult. 23.3% of the sample found no difficulty in it (Felemban, 1989:216).

The author concluded among the findings of his study, that investors in Saudi stock market ranked SAMA share price list (72.9%), newspapers (48.6%), inquiries to share departments in the banks (45.2%), and financial reports (39%) as the top four sources of information for investment decisions. He also found that small investors were not happy with the available information reported in the annual financial reports as they could not understand and use it and did not rely on it. This in turn, would appear to indicate to some extent, the imperfection of the market information available in the Saudi stock market and the company's annual financial reports are not that easy to understand by small investors. In addition, the study showed that more than 60% of the respondents were long term investors and the majority of small investors were not speculators. The study also found that the share trading procedure was complicated and share transaction execution
took a long time. The majority of small investors seemed unaware of the Saudi share price index, despite the fact that it has existed in the market since 1987. It has evidently not been made ready accessible and comprehensible to the lay investor, and does not appear regularly in the local media, even though it is produced weekly (Felemban, 1989:197-219).

In another Saudi study, Abdelsalam investigated the use of corporate financial reports by Saudi investors when they were making investment decisions. Basing his study on earlier studies, he conducted his survey through a questionnaire only, which he distributed to Saudi investors. He did not classify his sample by size of investment, but as will be seen from the findings reported overleaf, the sample in fact contained large, medium and small investors. The questionnaire comprised two parts. The first one was to indicate Saudi investment behaviour, such as the kind of companies in which Saudis invest, the number of shares owned, in whose name shares are registered, the reasons behind buying and selling shares, and whether the investors read the corporate financial reports and attend the annual general meetings. The second part was to indicate the sources of information used by investors and the importance of specific sections in the corporate annual reports (Abdelsalam, 1990:28).
The responses of 231 respondents to the survey showed that 68.4% of the respondents invest in the banking sector, 50.1% in the cement sector, and 54.5% invest in the industrial sector. 42% of the respondents own more than 1000 shares and only 11.7% own fewer than 100 shares. 60.2% of the sample buy shares under their families' names as well as their own and 34.2% buy shares under their names alone. Among the respondents, 61.5% buy shares for profit, while 59.7% are interested in the future of the corporations. The study also revealed that 85.3% of the respondents read the corporate annual financial reports when they decide to invest in shares, but only 45% of the sample attend the corporate general meeting to discuss the annual financial reports (Abdelsalam, 1990:29-31).

According to the survey, 67.5% of the respondents depend on the corporate financial reports when making investment decisions. This source of information was considered the prime source, followed by newspapers as a second source of information for investment decisions (51.9%). Those respondents who considered the corporate financial reports as their most important source of information ranked the profit and loss account as the most important section in the financial report (78.4%). The sections next in importance were the balance sheet and the statement of changes in the financial position of the
company (47.2%, 31.2%). The income statement was ranked fourth (30.7%). In answer to a question as to which of the information contained in the financial statements they considered most important when making investment decisions, 79.7% of respondents indicated the profit followed by the owners' equity and total revenues (59.3% and 39.4% respectively).

In addition to specific items in the financial statements, respondents indicated their need for more information about the management and directors of the company, the general economic conditions and the financial policy of the firm. Past sales and share book value were also specifically mentioned (Abdelsalam, 1990:34).

The researcher concluded that the two most important sources of information to Saudi investors when making investment decisions are the financial reports and newspapers. The information contained in the financial statements is considered to be useful for investment decisions and the profit and loss account and the balance sheet are the most important sections in corporate annual financial reports. Comparing his results with those of previous studies carried out in other countries, such as the United States, the United Kingdom, New Zealand, and Australia, Abdelsalam found many similarities, including the financial reports as important sources of information, the
reliance on the financial statements for decision making and the use of the profit figure as an important decision criterion (Abdelsalam, 1990:34).

Thus, looking at these studies overall, it was found that the most important source of information to individual investors in the United States, Australia, and Saudi Arabia are the financial reports and newspapers. Investors in the United States rely heavily on stockbrokers. Whereas in the Baker and Haslem study (1973), financial statements were ranked only fifth, stockbrokers themselves rely heavily on the financial statements. In the Felemban study (1989), SAMA share price list and inquiries to the share department in the commercial banks were ranked first and third among the most important source of information for investment decisions purposes. Rumours from the market and advice from friends were ranked low in all the studies.

The investor survey of Saudi Arabia was conducted in the light of the following two attributes which did not exist in the countries of the earlier studies:

a) Saudi Arabia has a very new market, regulated only in 1985;

b) The market is heavily influenced by the Saudi government, which owns shares in about one-third of the
corporations, and guarantees a minimum profit for about one-sixth of the rest.

The study of investor use of financial reports in Saudi Arabia was compared with those carried out in the United States and the United Kingdom because investors in new markets might have different uses for accounting and financial information than do those in long established markets. Moreover, the new market has fewer sources of information, and different knowledge may remove some of the traditional needs for financial reports. Also, when a firm has a guaranteed minimum profit, the investors are less concerned about the firm's financial condition.

9.3. The Questionnaire Survey

Field studies, comparative surveys, and experimental designs often use questionnaires to measure the variables of interest. A questionnaire is a preformulated written set of questions to which respondents record their answers. It is an efficient data collection mechanism to measure the variables of interest and it can be administered personally or mailed to the respondents. When the survey is confined to a local area, and the researcher is willing and able to assemble groups of respondents to respond to the questionnaires, personally administering the questionnaires is the best way to collect data. The main advantage to this
is that the researcher can collect all the completed responses within a short period of time. Any doubts that the respondents might have regarding any question could be clarified on the spot. The researcher also has the opportunity to introduce the research topic and motivate the respondents to give their honest answers. Administering questionnaires to large numbers of individuals simultaneously is less expensive and less time consuming than interviewing; it also requires fewer skills to administer the questionnaire than to conduct interviews (Sekaran, 1992).

The mail questionnaire can be used to cover a wide geographical area, where the questionnaires are mailed to the respondents, who can complete them at their own convenience, in their homes, and at their own pace. However, the return rates of mail questionnaires are typically not as high as might be desired; sometimes they are very low. Also, with very low return rates it is difficult to establish the representativeness of the sample, because those who responded to the survey may be totally different from the population they were intended to represent. Another disadvantage to the mail questionnaire is that any doubts the respondents might have can not be clarified. Although, some effective techniques exist for improving the rates of response to mail questionnaires,
such as sending follow-up letters, enclosing some small monetary incentives with the questionnaire, providing the respondent with self-addressed stamped return envelopes, and keeping the questionnaire as short as possible.

Because questionnaires are commonly used in surveys, it is necessary to know how to design an effective questionnaire. A good questionnaire has to be designed specifically to suit the study's aims and the nature of its respondents. It needs to have some of the same properties as a good law: to be clear, unambiguous and uniformly workable. Its design must minimize potential errors from the respondents and since people's participation in survey is voluntary, a questionnaire has to help in engaging their interest, encouraging their co-operation, and eliciting answers as close as possible to the truth (Hoinville et al, 1977).

The design of good questionnaire should focus on three main areas. First, the principles of wording of the questions, which refer to the appropriateness of the content of the questions; how questions are worded and the level of sophistication of the language used; the type and form of questions asked; the sequencing of the questions in the questionnaire; and the personal data sought from the respondents. Therefore, the questions must be designed so that they are easy for respondents to understand and to
answer accurately and clearly and the vocabulary used therefore has to be comprehensible to all respondents. Type of question refers to whether the questions will be open-ended, which allows respondents to answer them in any way they choose, or closed question which would ask the respondents to make choices among a set of alternatives given by the researcher. The last type of questions help the respondents to make quick decisions by making a choice among the several alternatives that are provided and it also help the researcher to code the information easily for subsequent analysis. Of course, care has to be taken to ensure that the alternatives are mutually exclusive and collectively exhaustive. The form of the question refers to positively and negatively worded questions (Sekaran, 1992; Hoinville et al, 1977).

Questions should not be phrased in such a way that they lead the respondents to give the responses that the researcher would like to, or may come across as wanting to, elicit. Short questions are preferable to long ones. Regarding the sequence of questions in the questionnaire, it should be such that the respondent is led from questions of a general nature to those that are more specific; and from questions that are relatively easy to answer to those that are progressively more difficult. In determining the sequence of questions, it is advisable not to place
consecutively a positively worded and a negatively worded question tapping the same element or dimension of a concept. The way questions are sequenced could introduce certain biases, frequently referred to as the ordering effects. Although randomly placing the questions in the questionnaire would reduce any systematic biases in the response, it is very rarely done, because of subsequent confusion while categorizing, coding, and analyzing the responses (Sekaran, 1992).

The demographic questions or personal information consist of such information as age, educational level, martial status, and income. Unless absolutely necessary, it is best not to ask for the name of the respondent. If, however, the questionnaire has to be identified with the respondents for any reason, then the questionnaire could be numbered and connected by the researcher to the respondent's name, in a separately maintained, private document. The reason for using the numerical system in questionnaires is to ensure the anonymity of the respondent even if the questionnaires should fall into someone else's hands. However, this procedure should be clearly explained to the respondent.

Whether questions seeking personal information should appear in the beginning or at the end of the questionnaire is a matter of choice for the researcher. Some researchers
may prefer to collect most of the personal data at the very beginning, on the grounds that respondents might have psychologically identified with the questionnaire and feel committed to responding, once they have said something about themselves at the very beginning. Other researchers advocate asking for personal data at the end rather than at the beginning of the questionnaire and their reasoning may be that by the time the respondent reaches the end of the questionnaire he would have been convinced of the genuineness of the inquiry made by the researcher (Oppenheim, 1986). Thus whether one asks this information in the beginning or at the end of the questionnaire is a matter of individual choice.

The second principle refers to issues of how the variables will be categorized, scaled, and coded after the questionnaire responses are received. There are some principles of measurement that are to be followed to ensure that the data collected are appropriate to the purpose of the survey. These principles of measurement include the scales and scaling techniques used in measuring concepts, as well as the assessment of reliability and validity of the measures used. Appropriate scales should be used depending on the type of data that needs to be obtained. Once data are collected, the goodness of data is assessed through tests of validity and reliability. Validity
establishes how well a technique, instrument, or process measures a particular concept, and reliability indicates how stably and consistently the instrument taps the variable. The data have to be obtained in a manner that lends itself to easy categorization and coding.

The third principle pertains to the general appearance of the questionnaire. Not only is it important to address issues of wording and measurement in questionnaire design, it is also necessary to pay attention to how the questionnaire looks. An attractive and neat questionnaire with appropriate introduction, instruction, and a well arrayed set of questions and response alternatives will make it easier for the respondents to answer the items in the questionnaire. A proper introduction that clearly discloses the identity of the researcher and the purpose of the survey is very important. It is also essential to establish some friendship with the respondents and motivate them to respond to the questions in the questionnaire willingly and enthusiastically. Assuring confidentiality of the information provided by respondents will help to ensure less biased answers. The introduction section should end with a courteous note thanking the respondents for taking the time to respond to the survey (Sekaran, 1992).

Since 1970, individuals have been able to invest their resources in Saudi corporations in six main economic
sectors, namely: financial, industrial, agricultural, services, electricity and cement. Eventually, the Ministry of Commerce issued regulations to control and supervise Saudi corporations in order to safeguard the public interest and protect private funds. Furthermore, stock regulations were officially issued by SAMA through SCAD to control the Saudi stock market's trading activities through the Saudi commercial banks. These included the requirement that financial statements be both issued to shareholders before each annual general meeting and published in the local media. At the present time there are about 78 Saudi corporations, with 618 million shares and SR 206.06 billion invested.

The questionnaire was based on earlier studies in the United Kingdom (Lee and Tweedie, 1976), in the United States (Baker and Haslem, 1973), in Saudi Arabia (Felemban, 1989), and also on the information collected from the Saudi stock market. The questionnaire was divided into two parts.

The first section contained eight questions designed to examine the investment characteristics, the motivation and investment background of a random sample of Saudi individual investors owning shares to a value less than SR 500,000. The sample included both sexes, and various educational and occupational backgrounds and incomes; respondents varied as to the regularity of dealing in
stocks, and the number of companies, both Saudi and overseas, in which they held shares.

The second part consisted of twenty questions designed to indicate the investors' views as to the sources of information on which they most heavily relied and on the importance of specific sections in the corporate financial reports.

The final draft of the questionnaire was translated from English to Arabic, because Saudi individual investors might not be able to answer an English questionnaire. The Arabic version was sent to respondents, accompanied by an Arabic covering letter which explained the purpose of the study and assured the confidentiality of the reply, as the questionnaire did not require the respondent's identity to be revealed. A copy of the questionnaire is shown in Appendix 2.

9.4. The Interview Survey

Interviews are one method of obtaining data; they can be either unstructured or structured and can be conducted face-to-face or over the telephone. Unstructured interviews are usually conducted to obtain more definite ideas about what is and is not important and relevant to particular problem situations. Structured interviews give more in depth information about specific variables of interest. To
minimize bias in responses, the interviewer must establish rapport with the respondents and ask unbiased questions (Sekaran, 1992).

Interviews were conducted with some share investors who had previously agreed to be interviewed, as a group of users of the accounting information reported in the corporate annual financial reports. Official brokers were included in the interview survey because they carry out all the brokerage business through the Saudi commercial banks and act on behalf of their clients. Unofficial brokers were also interviewed, as they play a significant role in the Saudi stock market and their views on the trading procedures should be considered when studying the market activity.

9.5. The Sample Selection

There were three possible approaches to contact Saudi individual investors whose shares were valued at less than SR 500,000: at the joint stock companies, through the shareholders' register, by post, or by personal contact. In fact, the first two approaches were unsatisfactory because the shareholders' register is not up-to-date and is unreliable, while postal services are very costly, and delivery is uncertain in view of the non-availability of full and correct addresses for investors. Therefore, the
only practical approach to carry out this questionnaire survey was by personal contact through the commercial banks at the Central Negotiation Units (CNU) in Riyadh, the Branch Negotiation Units (BNU) in Jeddah, and the unofficial broker firms, both in Riyadh and Jeddah. Most share trading activities are conducted in Riyadh and Jeddah due to the availability of the required trading facilities.

From January to April 1993, a visit was paid to Saudi Arabia, during which time the questionnaire was distributed. The Faculty of Economics and Administration at King Abdul Aziz University in Jeddah provided the researcher with formal letters addressed to the commercial banks, to facilitate the distribution of questionnaires to the Saudi investors.

The questionnaires were left with the heads of the Share Negotiation Units as well as with the official brokers in both the CNUs and BNUs, together with full explanations as to how the investors should complete the questionnaire. The official broker was instructed to offer the questionnaire to the first client who showed cooperation and eligibility. Similar instructions were given to the unofficial brokers.

For the sample to be truly representative of individual shareholders in Saudi Arabia, female investors
were included in the sample by supplying questionnaires to two commercial bank branches, which serve female clients only.

9.6. Summary

The previous research on investors' uses of accounting information contained in the financial statements demonstrates clearly the controversial aspect of the subject. Some researchers found that investors place great importance on the financial statements for their equity investment decisions. Other place a lower value on the importance of this information source.

The studies discussed in this chapter revealed that the most important source of information to individual investors in the United States, Australia, and Saudi Arabia are the financial reports, the newspapers, SAMA share price list, and the inquiries to the share department in the commercial banks. Although investors in the United States rely heavily on stockbrokers, and in the Baker and Haslem study (1973), financial statements were ranked only fifth, stockbrokers themselves rely heavily on the financial statements. Rumours from the market and advice from friends were ranked low in all the studies.

A lot of attention was paid to questionnaire design because questionnaires are one of the most common methods
of collecting data, especially when large numbers of people are to be reached in different geographical regions. The principles of questionnaire design relate to how the questions are worded and measured, and how the entire questionnaire is organized. To minimize respondent biases and measurement errors, all the principles have to be followed carefully.

In order to obtain the views of as many shareholders as possible, it was decided to conduct the present survey in Saudi Arabia by means of a questionnaire and an interview. The study is primarily concerned with the question of the contribution of the accounting information which is used by private shareholders and investors. The sample was selected randomly in order to be truly representative of private shareholders in Saudi Arabia.

The results derived from these questionnaires and interviews will be described and discussed in detail and then compared with the results and findings of previous studies, in the next chapter.
CHAPTER TEN

The Survey Responses
10.1. Introduction

The utility and relevance to the user of reported accounting information lies not simply in how it describes the economic activity of the company but also in how clearly it presents its economic message to the user. It has been suggested that accounting is a communications system concerned with communicating measured data for the benefit of a variety of decision makers. One of these is the group of individual shareholders and private investors who may place great importance on accounting information when making investment decisions.

It is generally recognized that for the accounting information contained in the financial reports to be successful as a primary means of communication between the corporations and their shareholders, they must be both read and understood by them. If either of these two conditions is not met, then the shareholders could fail to perceive the underlying economic condition of the company. They may also, as a result, seek information from other sources.

The aim of this chapter is to describe and discuss the characteristics of Saudi investors, whether investors individually use the accounting information disclosed in the corporate annual financial reports, and on what information in those reports they most heavily rely, based
on the responses of the survey respondents. These results will also be compared with those of previous studies.

10.2. The Response to the Questionnaire Survey

Although no specific date was requested, the participants were prompt in replying, and the answered questionnaires were all received in March and April 1993. By the end of the survey period, a total of 260 questionnaires out of 300 had been received from the commercial banks CNUs, BNUs and unofficial brokers, and 40 participants had not returned the questionnaire. However, only 135 questionnaires were completed, giving an overall response rate of 45%, as shown in Table 10.1.

| TABLE 10.1 |
| NUMBER OF QUESTIONNAIRES DISTRIBUTED AND RESPONSES |

<table>
<thead>
<tr>
<th></th>
<th>NUMBER OF QUESTIONNAIRES DISTRIBUTED</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>CNUs (RIYADH)</td>
<td>150</td>
<td>60</td>
<td>40.0</td>
</tr>
<tr>
<td>BNUs (JEDDAH)</td>
<td>100</td>
<td>45</td>
<td>45.0</td>
</tr>
<tr>
<td>UNOFFICIAL BROKERS (RIYADH AND JEDDAH)</td>
<td>50</td>
<td>30</td>
<td>60.0</td>
</tr>
<tr>
<td>TOTAL</td>
<td>300</td>
<td>135</td>
<td>45.0</td>
</tr>
</tbody>
</table>

This may appear low, but it was to be expected, given
the nature of the subject being researched and the method of research. In addition, it can be argued that these respondents would tend to be the more interested, and possibly, the most informed of all those sampled. It also seems reasonable to suggest that the survey results were obtained from shareholders with more than just a passing interest in the financial reporting function.

Though there is inevitably a suspicion that the non-respondents may have widely differing views from those returning the questionnaire, the results do give insight into the use of the accounting information disclosed in the company financial reports by Saudi private shareholders.

In order to construct an aggregate profile of the 135 respondents, the following background factors were sought: level of education; sex; occupation; annual income; regularity of buying and selling shares; total number of shareholdings held; total value of shareholdings held; and sources of help in investment decision making. In other words, these were factors which described the respondents' educational level; the size of their share portfolios; whether or not they relied on expert help and advice when making investment decisions; and whether or not they buy and sell shares regularly.

The responses to the questions in the first part of
the questionnaire revealed that the sample was representative of the range of Saudi individual investors. Regarding educational level, 29.6% of the respondents had completed high school, 52.6% had a first university degree, and 17.8% were postgraduates. This result is to be expected, as respondents who were postgraduates or had completed their first university degree would be likely to have higher earnings and savings than those with less education, which would enable them to invest in shares.

74.8% were males and 25.2% females. Again, this is an expected finding given that, in Saudi Arabia, married men still take responsibility for financial matters. 38.5% of the sample were government employees, 34.8% were private sector employees, and 26.7% were self-employed.

It was found that the annual income of 22.2% of the sample was less than SR 50,000, while 34.8% had an income of SR 50,000 - 100,000, and 43% had more than SR 100,000. The investors were asked whether they buy and sell shares regularly. 60.7% of the sample said yes and 39.3% said no. 46.7% of the sample held shares in 1 - 5 companies, 28.9% held shares in 6 - 10 companies, 13.3% held shares in 11 - 20 companies, and 11.1% held shares in more than 20 companies. While only 8.1% of the respondents held shares in overseas companies, 91.9% of the sample held shares in Saudi companies. As regards the value of shares, 71.9% of
the sample held shares totalling between SR 50,000 and SR 100,00 in value, while 28.1% of the sample held shares valued at more than SR 100,000. It appears, then, that some respondents may be holding portfolios of some significant value. 90.4% of respondents made their own investment decisions. The 9.6% of them who did not, indicated that they sought assistance from market experts, such as the unofficial stockbrokers, and from relatives and friends who deal with shares and stocks in the market. Tables 10.2 and 10.3 summarize the distribution of the sample according to the characteristics discussed above.

TABLE 10.2
EDUCATIONAL LEVEL, SEX, OCCUPATIONS AND ANNUAL INCOME OF SURVEY RESPONDENTS

<table>
<thead>
<tr>
<th></th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>EDUCATION:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>HIGH SCHOOL</td>
<td>40</td>
<td>29.6</td>
<td></td>
</tr>
<tr>
<td>UNIVERSITY</td>
<td>71</td>
<td>52.6</td>
<td></td>
</tr>
<tr>
<td>POSTGRADUATE</td>
<td>24</td>
<td>17.8</td>
<td>100.00</td>
</tr>
<tr>
<td>SEX:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>MALE</td>
<td>101</td>
<td>74.8</td>
<td></td>
</tr>
<tr>
<td>FEMALE</td>
<td>34</td>
<td>25.2</td>
<td>100.00</td>
</tr>
<tr>
<td>OCCUPATION:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GOVERNMENT EMPLOYEE</td>
<td>52</td>
<td>38.5</td>
<td></td>
</tr>
<tr>
<td>PRIVATE SECTOR EMPLOYEE</td>
<td>47</td>
<td>34.8</td>
<td></td>
</tr>
<tr>
<td>SELF-EMPLOYED</td>
<td>36</td>
<td>26.7</td>
<td>100.00</td>
</tr>
<tr>
<td>ANNUAL INCOME:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LESS THAN SR 50,000</td>
<td>30</td>
<td>22.2</td>
<td></td>
</tr>
<tr>
<td>SR 50,000 - 100,000</td>
<td>47</td>
<td>34.8</td>
<td></td>
</tr>
<tr>
<td>MORE THAN SR 100,000</td>
<td>58</td>
<td>43.0</td>
<td>100.00</td>
</tr>
</tbody>
</table>
# Table 10.3

**Summary of Responses' Investment Behaviour**

<table>
<thead>
<tr>
<th>DO YOU BUY AND SELL SHARES REGULARLY?</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
<td>82</td>
<td>60.7</td>
<td>100.00</td>
</tr>
<tr>
<td>NO</td>
<td>53</td>
<td>39.3</td>
<td>100.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TOTAL NUMBER OF SHAREHOLDINGS HELD:</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 - 5</td>
<td>63</td>
<td>46.7</td>
<td>100.00</td>
</tr>
<tr>
<td>6 - 10</td>
<td>39</td>
<td>28.9</td>
<td>100.00</td>
</tr>
<tr>
<td>11 - 20</td>
<td>18</td>
<td>13.3</td>
<td>100.00</td>
</tr>
<tr>
<td>20+</td>
<td>15</td>
<td>11.1</td>
<td>100.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>TOTAL VALUE OF SHAREHOLDINGS HELD:</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>SR 50,000 - 100,000</td>
<td>97</td>
<td>71.9</td>
<td>100.00</td>
</tr>
<tr>
<td>MORE THAN SR 100,000</td>
<td>38</td>
<td>28.1</td>
<td>100.00</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>INVESTMENT DECISION MAKING:</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>DECISIONS TAKEN ON OWN INITIATIVE</td>
<td>122</td>
<td>90.4</td>
<td>100.00</td>
</tr>
<tr>
<td>DECISIONS MADE BY AN EXPERT ON</td>
<td>13</td>
<td>9.6</td>
<td>100.00</td>
</tr>
<tr>
<td>INVESTOR'S BEHALF</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

The respondents were predominantly male, largely had a first university degree, one-third of the respondents were employed by the government, and the majority buy and sell shares regularly. This result reflects the respondents' awareness of share investment in the Saudi stock market, which in turn, gives a good indication for a significant future participation in share investment.
The first question of the second section of the questionnaire asked respondents their preferred type of investment. Of the 135 investors, 25.9% were interested in real estate investment, 48.9% preferred share investment, 11.1% preferred foreign currency and 7.4% were interested in Islamic investment funds organized by the commercial banks in accordance with the Islamic Shari'ah (the principles and functions of these funds were discussed in detail in Chapter Four).

5.2% favoured gold and 1.5% favoured other, unspecified investments. Once again, these results show the investors' interest in share investment compared with other types of investment. Table 10.4 summarizes the respondents' preferred type of investment.

<table>
<thead>
<tr>
<th>PREFERRED TYPE OF INVESTMENT</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>REAL ESTATE</td>
<td>35</td>
<td>25.9</td>
<td></td>
</tr>
<tr>
<td>SHARES</td>
<td>66</td>
<td>48.9</td>
<td></td>
</tr>
<tr>
<td>FOREIGN CURRENCY</td>
<td>15</td>
<td>11.1</td>
<td></td>
</tr>
<tr>
<td>ISLAMIC INVESTMENT FUNDS</td>
<td>10</td>
<td>7.4</td>
<td></td>
</tr>
<tr>
<td>GOLD</td>
<td>7</td>
<td>5.2</td>
<td></td>
</tr>
<tr>
<td>UNSPECIFIED</td>
<td>2</td>
<td>1.5</td>
<td>100.00</td>
</tr>
</tbody>
</table>

292
Question two asked about respondents' reasons for buying shares. 66.7% indicated that they bought shares for both dividend and capital gain, 22.2% bought shares for dividend only and 9.6% bought shares for capital gain only. 1.5% of the respondents gave other reasons for buying shares, namely for speculation and for a better, more secure future.

From these results, it appears that the majority of respondents were long-term investors, which indicates that the most important investment objective for those respondents is thus determined to be a combination of dividend income and capital gain. The long-term nature of investment objectives is important in evaluating investors' information sources. Responses to this question are presented in Table 10.5.

**TABLE 10.5**

**REASON FOR BUYING SHARES**

<table>
<thead>
<tr>
<th>REASON FOR BUYING SHARES</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>DIVIDEND</td>
<td>30</td>
<td>22.2</td>
<td></td>
</tr>
<tr>
<td>CAPITAL GAIN</td>
<td>13</td>
<td>9.6</td>
<td></td>
</tr>
<tr>
<td>BOTH</td>
<td>90</td>
<td>66.7</td>
<td></td>
</tr>
<tr>
<td>OTHER</td>
<td>2</td>
<td>1.5</td>
<td>100.00</td>
</tr>
</tbody>
</table>
The third question asked the sample of Saudi investors about the important financial information they need to know as shareholders. It was found that investors considered a variety of financial and non-financial information about the companies in which they held shares.

13.3% of the respondents were concerned about the company's capital base and 11.9% of the sample considered the profit distributed by the firm, as important information. 9.6% considered the financial policy of the company and 8.9% indicated their concerns about the company's sector of activity. Respondents were aware that the government owns shares in many corporations and guarantees a minimum profit for some others.

It is quite clear that data concerning company capital base were considered to be the most vital pieces of financial information. Profit data was the next popular response, followed by information on the company's financial policy and its sector of activity and information about the company's directors. 7.4% of respondents considered share price.

Few other pieces of financial information appeared to be important to many respondents. The answers of the respondents are summarized in Table 10.6.
### TABLE 10.6

**INFORMATION CONSIDERED IMPORTANT BY THE SAMPLE OF THE SAUDI INVESTORS**

<table>
<thead>
<tr>
<th>INFORMATION</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAPITAL BASE OF THE COMPANY</td>
<td>18</td>
<td>13.3</td>
</tr>
<tr>
<td>PROFITS/EARNINGS</td>
<td>16</td>
<td>11.9</td>
</tr>
<tr>
<td>FINANCIAL POLICY OF THE COMPANY</td>
<td>13</td>
<td>9.6</td>
</tr>
<tr>
<td>THE COMPANY'S SECTOR OF ACTIVITY</td>
<td>12</td>
<td>8.9</td>
</tr>
<tr>
<td>DIRECTORS OF THE COMPANY</td>
<td>11</td>
<td>8.1</td>
</tr>
<tr>
<td>SHARE PRICE</td>
<td>10</td>
<td>7.4</td>
</tr>
<tr>
<td>DIVIDEND INFORMATION</td>
<td>11</td>
<td>8.1</td>
</tr>
<tr>
<td>DEMAND FOR THE COMPANY'S SHARES</td>
<td>8</td>
<td>6.0</td>
</tr>
<tr>
<td>THE COMPANY'S FOUNDERS</td>
<td>6</td>
<td>4.4</td>
</tr>
<tr>
<td>FUTURE PROSPECTS</td>
<td>5</td>
<td>3.7</td>
</tr>
<tr>
<td>NUMBER OF SHARES OFFERED</td>
<td>5</td>
<td>3.7</td>
</tr>
<tr>
<td>DOES THE COMPANY DEAL WITH FORBIDDEN ACTIVITIES ?</td>
<td>7</td>
<td>5.2</td>
</tr>
<tr>
<td>ASSETS</td>
<td>4</td>
<td>3.0</td>
</tr>
<tr>
<td>OTHER</td>
<td>4</td>
<td>3.0</td>
</tr>
<tr>
<td>CASH/LIQUIDITY</td>
<td>3</td>
<td>2.2</td>
</tr>
<tr>
<td>PROFITS TREND</td>
<td>2</td>
<td>1.5</td>
</tr>
<tr>
<td><strong>TOTAL</strong></td>
<td><strong>135</strong></td>
<td><strong>100.00</strong></td>
</tr>
</tbody>
</table>

The sample were asked in the fourth question, how they would select a company to invest in. None of the
respondents said they would select at random. 26.0% would select according to the recommendation of others, such as share brokers, relatives and friends who have experience in share dealings.

3.7% of the respondents would select according to their own evaluation. However, 70.3% of them would select on the basis of both the recommendation of others and their own evaluation. The answers of the respondents are summarized in Table 10.7.

Thus, it is quite clear that investors are aware of share investment, as they base their investment decisions on their own evaluation and on the recommendation of market experts. Unofficial brokers play a significant role in this regard, as some investors indicated that they consult them and follow their advice.

**TABLE 10.7**

**THE SAMPLE BASE OF SELECTION**

<table>
<thead>
<tr>
<th>BASIS OF SELECTION</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>AS RECOMMENDED BY OTHERS</td>
<td>35</td>
<td>26.0</td>
</tr>
<tr>
<td>ACCORDING TO THEIR OWN EVALUATION</td>
<td>5</td>
<td>3.7</td>
</tr>
<tr>
<td>ACCORDING TO THE RECOMMENDATION OF OTHERS &amp; THEIR OWN EVALUATION</td>
<td>95</td>
<td>70.3</td>
</tr>
<tr>
<td>TOTAL PERCENT</td>
<td>135</td>
<td>100.00</td>
</tr>
</tbody>
</table>
In question five the respondents were asked from which market they preferred to buy their shares. 55.6% of the respondents preferred to buy shares from the primary market, while 25.9% preferred to buy from the secondary market. 14.8% of the respondents liked to deal in both markets and 3.7% did not indicate a preference. Table 10.8 summarizes the responses with regard to preferred market.

**TABLE 10.8**

**PREFERRED MARKET FOR SHARE PURCHASE**

<table>
<thead>
<tr>
<th>THE PREFERRED MARKET</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>THE PRIMARY MARKET</td>
<td>75</td>
<td>55.6</td>
<td></td>
</tr>
<tr>
<td>THE SECONDARY MARKET</td>
<td>35</td>
<td>25.9</td>
<td></td>
</tr>
<tr>
<td>BOTH MARKETS</td>
<td>20</td>
<td>14.8</td>
<td></td>
</tr>
<tr>
<td>NOT INDICATED</td>
<td>5</td>
<td>3.7</td>
<td>100.00</td>
</tr>
</tbody>
</table>

The result shows that small investors are less likely to participate in the secondary market, which is the speculative market. However, they might participate as sellers if they are attracted by a potential profit.

Question six asked about the main and most important purpose of the financial statements contained in the company annual financial report. The respondents agreed with the purposes suggested in the question, though they
were also asked to indicate any other purposes they considered to be important. As there can be more than one purposes or objectives of the financial reports, multiple responses were to be expected, and the undernoted percentages therefore do not add up to 100%.

The responses elicited from the respondents are of a mixed nature as they contain certain favourable as well as unfavourable features. It was found that 61.5% of respondents believed that financial statements give the shareholders useful data for investment decisions, which indicates that private shareholders may be well-informed about present reporting objectives, as might be supposed. Indeed, the investment decision result was supported by many individual comments from shareholders indicating that they felt that the present types of reports are of great use for investment decision. Another 45.9% of the respondents believed that financial statements justify the dividend payments proposed by the company.

There was an agreement among the respondents regarding the ranking of the purposes of the financial statements, with the provision of information to be used for investment decisions being ranked in first place. The respondents' ideas about the purposes of financial statements are shown in Table 10.9.
TABLE 10.9
PURPOSES OF THE FINANCIAL STATEMENTS CONTAINED IN THE COMPANY'S ANNUAL FINANCIAL REPORT

<table>
<thead>
<tr>
<th>PURPOSES</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>RANKING</th>
</tr>
</thead>
<tbody>
<tr>
<td>TO MAKE COMPANY DIRECTORS ACCOUNTABLE TO SHAREHOLDERS</td>
<td>27</td>
<td>33.3</td>
<td>3</td>
</tr>
<tr>
<td>TO GIVE SHAREHOLDERS AN INDICATION OF THE VALUE OF THE COMPANY</td>
<td>19</td>
<td>27.4</td>
<td>4</td>
</tr>
<tr>
<td>TO GIVE SHAREHOLDERS DATA OF USE FOR INVESTMENT DECISIONS</td>
<td>54</td>
<td>61.5</td>
<td>1</td>
</tr>
<tr>
<td>TO JUSTIFY THE DIVIDEND PAYMENTS PROPOSED BY THE COMPANY</td>
<td>31</td>
<td>45.9</td>
<td>2</td>
</tr>
<tr>
<td>OTHER</td>
<td>4</td>
<td>9.6</td>
<td>5</td>
</tr>
</tbody>
</table>

Question seven gave the respondents some sources of information and asked them to indicate the degree of influence these sources have on their investment decisions, by ranking them on a five point scale as follows: 1) maximum influence; 2) considerable influence; 3) moderate influence; 4) slight influence; and 5) no influence.

The profit and loss account and balance sheet were considered to be of maximum to considerable influence on the investment decisions of 52% of the respondents, while the chairman's report and auditors' report were considered...
to be of considerable to moderate influence on the investment decisions of 29% of the respondents.

Directors' report and notes to accounts were considered to be of moderate to slight influence on investment decisions of 33% of the respondents and 17% of them consider statistical data might have slight influence on their investment decisions. The data evidenced that, while more respondents considered other sources of information, the profit and loss account and balance sheet were rated as the most important sources of information and considered to be of marginally more influence on their investment decisions.

Chairman's report was the third most widely used source of information considered by respondents, who rely heavily upon it to obtain information for decision-making purposes. There could be two main reasons for this. Firstly, the less numerate shareholders, and those with little knowledge of accounting practice, may look to the chairman's report to avoid the difficulty of understanding the figures presented in the accounting statements. Secondly, these shareholders may be looking for information not revealed in the profit and loss account and balance sheet, but which they perceive as being useful to them for decision-making purposes. Table 10.10 shows the degree of
influence indicated by respondents and the ranking of those sources.

**TABLE 10.10**

RESPONDENTS' VIEWS ON THE DEGREE OF INFLUENCE OF SOURCES OF INFORMATION ON THEIR INVESTMENT DECISIONS

<table>
<thead>
<tr>
<th>SOURCES AND THEIR DEGREE OF INFLUENCE</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>RANKING</th>
</tr>
</thead>
<tbody>
<tr>
<td>PROFIT AND LOSS ACCOUNT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BALANCE SHEET OF MAXIMUM TO CONSIDERABLE INFLUENCE</td>
<td>69</td>
<td>52</td>
<td>1</td>
</tr>
<tr>
<td>CHAIRMAN'S REPORT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>AUDITORS REPORT OF CONSIDERABLE TO MODERATE INFLUENCE</td>
<td>36</td>
<td>29</td>
<td>3</td>
</tr>
<tr>
<td>DIRECTORS' REPORT</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>NOTES TO ACCOUNTS OF MODERATE TO SLIGHT INFLUENCE</td>
<td>20</td>
<td>33</td>
<td>5</td>
</tr>
<tr>
<td>STATISTICAL DATA OF SLIGHT TO NO INFLUENCE</td>
<td>10</td>
<td>17</td>
<td>7</td>
</tr>
</tbody>
</table>

* The total adds up to more than 100% because respondents were allowed to give more than one answer.

Question eight asked the respondents about their understanding of the meaning of three terms: Profit (the excess of revenues over expenses for a particular accounting period); Dividend yield (latest dividend per share to current share price); and Dividend cover (number of times dividends covered by available profits). Profit, being a word in everyday use, was the term most widely
understood by respondents, almost all of whom gave a reasonable definition of it. 80% of the respondents had a reasonable understanding of the term, 15% had a vague understanding and only 5% had no understanding.

Dividend yield was less well understood, with 70% of the respondents having a reasonable understanding, 18% a vague understanding and 12% no understanding. There was little understanding of dividend cover; only 14% of respondents had a reasonable understanding, 19% had a vague understanding and the majority, 67% of respondents, had no understanding. Thus, it appears that respondents' understanding of these terms was, on the whole, poor. Table 10.11 summarizes the responses.

TABLE 10.11
ACTUAL UNDERSTANDING OF FINANCIAL TERMS

<table>
<thead>
<tr>
<th>LEVEL OF UNDERSTANDING</th>
<th>PROFIT %</th>
<th>DIVIDEND YIELD %</th>
<th>DIVIDEND COVER %</th>
</tr>
</thead>
<tbody>
<tr>
<td>REASONABLE</td>
<td>80</td>
<td>70</td>
<td>14</td>
</tr>
<tr>
<td>VAGUE</td>
<td>15</td>
<td>18</td>
<td>19</td>
</tr>
<tr>
<td>NONE</td>
<td>5</td>
<td>12</td>
<td>67</td>
</tr>
<tr>
<td>TOTAL PERCENT</td>
<td>100.00</td>
<td>100.00</td>
<td>100.00</td>
</tr>
</tbody>
</table>

Respondents were asked in question nine to indicate their understanding of the following four accounting terms
commonly used in companies' annual financial reports: Depreciation (the diminution in value of a tangible asset, however arising); Current assets (assets which are reasonably expected to be realised in cash, or sold, or otherwise consumed during the normal operating cycle of the business or within one accounting year, if longer); Reserves (the amount of net worth of a company which is in excess of the nominal value of the issued share capital); and Accrued charges.

Briston (1977), argued that respondents may correctly understand these terms and yet not be able to express themselves in the exact words required because it is understandable that unique definitions of accounting terms are rarely available.

Depreciation is a word in common usage and the concept was reasonably well understood by the majority (70%) of the respondents. 20% had a slight or vague understanding and 10% had no understanding of it. Current assets were less well understood, with 53% having a reasonable understanding, 33% a vague understanding and 14% no understanding.

Reserves, once again, is a word familiar to respondents and in common usage. 66% of respondents gave a reasonable definition of reserves, 23% of them had some
slight understanding, and 11% had no understanding of the term.

Accrued charges is essentially an accounting term, which is not in common usage outside the financial world. More than two-thirds the respondents (69%) had a weak understanding of this term, while 18% of them gave either no answer or an incorrect answer. Only 13% of respondents defined accrued charges reasonably correctly.

Apart from specific items in the corporate financial reports, respondents in question ten were asked which of eight given criteria they would consider when evaluating a company for possible investment. Although 7.4% of the total respondents did not answer this question, 54.8% considered the age of the company, and 58.5% considered the sector in which the company is classified.

62.2% of respondents considered the company capital and 65.9% of the sample considered the company's performance in terms of profit and turnover, while 60.7% considered the distributed dividend.

Share market price was considered by 63.7% of respondents and 57.7% considered the historical market price trend. 30.4% of the respondents indicated that they also consider other criteria, such as the share book price.
Table 10.12 summarizes the percentage responses to these eight criteria and the respondents' ranking of them.

Although respondents considered a variety of criteria when they evaluate a company for investment, they indicated that the first criterion, again, is the company's performance, which is related to the ability to earn profits and, therefore, comes as no surprise.

**Table 10.12**

**CRITERIA CONSIDERED BY RESPONDENTS WHEN EVALUATING COMPANIES FOR INVESTMENT**

<table>
<thead>
<tr>
<th>CRITERIA</th>
<th>PERCENTAGE</th>
<th>RANKING</th>
</tr>
</thead>
<tbody>
<tr>
<td>COMPANY AGE</td>
<td>54.8</td>
<td>7</td>
</tr>
<tr>
<td>COMPANY SECTOR</td>
<td>58.5</td>
<td>5</td>
</tr>
<tr>
<td>COMPANY CAPITAL</td>
<td>62.2</td>
<td>3</td>
</tr>
<tr>
<td>COMPANY PERFORMANCE (PROFIT)</td>
<td>65.9</td>
<td>1</td>
</tr>
<tr>
<td>DISTRIBUTED DIVIDEND</td>
<td>60.7</td>
<td>4</td>
</tr>
<tr>
<td>SHARE MARKET PRICE</td>
<td>63.7</td>
<td>2</td>
</tr>
<tr>
<td>HISTORICAL MARKET PRICE TREND</td>
<td>57.8</td>
<td>6</td>
</tr>
<tr>
<td>OTHER</td>
<td>30.4</td>
<td>8</td>
</tr>
</tbody>
</table>

Question eleven asked respondents to state whether they believed that they could assess five financial aspects of a company's operations, namely, profitability, potential bankruptcy, capacity to survive, managerial efficiency and
investment policy. Few respondents were prepared to state that they could assess any aspect of a company's performance and financial stability, and only 10.4% of them answered this question.

Profitability was felt by those who answered the question, to be the easiest feature to assess, as they all interpreted profitability simply in terms of profit or sales figures taken directly from the profit and loss account, the balance sheet, and the auditor's report.

The respondents believed that they could assess potential bankruptcy and capacity to survive by looking at the balance sheet, mainly for data about creditors, assets, borrowing and liabilities. Others tended to rely on the profit and loss account and information about the share market price, the company's management and the distributed profit.

The profit and loss account was also used by respondents to assess managerial efficiency, as most respondents equated managerial efficiency with profit. The statistical data appearing in the company's annual financial statements and the company chairman's reports were also used. One respondent tended to rely on the company's board committee and company's directors to assess managerial efficiency. The respondents who stated that they
were able to judge investment policy tended to rely on the balance sheet, the profit and loss account, the liquidity that the company has in the banks, the company's participation in the formation of other companies, and the growth of reserves.

In question twelve, respondents were given six sources of information and asked which of them they considered to be valuable and useful in making investment decisions. 2.2% of the respondents did not answer this question. Table 10.13 summarizes the responses to the question concerned.

<table>
<thead>
<tr>
<th>SOURCES OF INFORMATION</th>
<th>PERCENTAGE</th>
<th>RANKING</th>
</tr>
</thead>
<tbody>
<tr>
<td>NEWS IN DAILY PRESS</td>
<td>56.3</td>
<td>4</td>
</tr>
<tr>
<td>NEWS IN FINANCIAL PRESS</td>
<td>57.0</td>
<td>3</td>
</tr>
<tr>
<td>INQUIRIES TO SHARE DEPARTMENT IN BANKS</td>
<td>47.4</td>
<td>6</td>
</tr>
<tr>
<td>SAMA SHARE PRICE</td>
<td>60.7</td>
<td>2</td>
</tr>
<tr>
<td>COMPANY ANNUAL REPORT</td>
<td>65.2</td>
<td>1</td>
</tr>
<tr>
<td>PERSONAL CONTACTS</td>
<td>54.1</td>
<td>5</td>
</tr>
<tr>
<td>OTHERS</td>
<td>20.0</td>
<td>7</td>
</tr>
</tbody>
</table>

Although the respondents chose four sources on average, the company's annual report seems to be the main
source of information at which they would look. The responses show that the secondary source of information is the SAMA share price. Two respondents indicated that unofficial brokers and professional investors were among the useful sources of information for investment purposes.

Question thirteen asked respondents whether they were interested in looking at the company's annual financial reports. 46.7% of respondents were very interested, while 42.2% were quite interested and 8.9% were not interested. These results show that Saudi private investors rely heavily on the corporate financial reports when making investment decisions, and a relationship existed between reading the corporate annual report and perceiving it to be of importance to the shareholder for decision-making purposes. 2.2% of respondents did not answer this question, as shown in Table 10.14.

**TABLE 10.14**

<table>
<thead>
<tr>
<th>DEGREE OF INTEREST</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>VERY INTERESTED</td>
<td>63</td>
<td>46.7</td>
<td></td>
</tr>
<tr>
<td>QUITE INTERESTED</td>
<td>57</td>
<td>42.2</td>
<td></td>
</tr>
<tr>
<td>NOT INTERESTED</td>
<td>12</td>
<td>8.9</td>
<td></td>
</tr>
<tr>
<td>NO ANSWER</td>
<td>3</td>
<td>2.2</td>
<td>100.00</td>
</tr>
</tbody>
</table>
As a further check to ascertain whether reading of the corporate annual reports was related to their perceived importance for investment decision making, question fourteen asked those respondents who were interested in looking at the company's annual report, whether they found it difficult to understand its contents.

It was found that the company's annual reports are considered not very easy to understand by the majority of small investors, as 32.6% of the respondents indicated that they found them difficult while 34.1% faced some difficulty. Among those, only six respondents indicated that they found some difficulty in understanding the classification of both assets and liabilities, the operational costs, the accounting terminology which appeared in the financial annual reports, and the method of calculating the company's profit. 8.9% of the respondents had no difficulty at all and 4.4% gave no answer to this question, as shown in Table 10.15.

Despite the fact that few respondents did not either read the company's annual reports or did not understand their contents, again the results reflect the respondents' awareness of the importance of the corporate annual financial reports and their needs for more simple and understandable accounting and financial information which will help them in making rational investment decisions.
### TABLE 10.15

RESPONDENTS' UNDERSTANDING OF THE CONTENTS OF COMPANY'S ANNUAL REPORTS

<table>
<thead>
<tr>
<th></th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>YES</td>
<td>44</td>
<td>32.6</td>
<td></td>
</tr>
<tr>
<td>SOME DIFFICULTY</td>
<td>46</td>
<td>34.1</td>
<td></td>
</tr>
<tr>
<td>NO</td>
<td>39</td>
<td>28.9</td>
<td></td>
</tr>
<tr>
<td>NO ANSWER</td>
<td>6</td>
<td>4.4</td>
<td>100.00</td>
</tr>
</tbody>
</table>

The same respondents were asked in question fifteen whether they experienced particular problems, stated in the question, when reading the company's annual reports.

13.3% of the respondents indicated that they had problems with the variation in account classification, while 36.3% had problems with accounting terminology and 30.4% had problems with the variation in format and layout of reports. Only 3% of respondents had no problems when reading the company's annual reports. 17% of respondents gave no answer to the question.

The result shows that accounting terminology presents the main problem to small investors, which is consistent with the relatively poor understanding of accounting terminology revealed by the investors in their answers to
some previous questions. The result also suggests that less interested readers of annual reports tend to shy away from using formal accounting-based reports, relying instead on interpretative reports from sources such as the financial press. Table 10.16 summarizes the responses to the mentioned problems.

<table>
<thead>
<tr>
<th>PROBLEMS</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>VARIATION IN ACCOUNT CLASSIFICATION</td>
<td>18</td>
<td>13.3</td>
<td></td>
</tr>
<tr>
<td>PROBLEMS WITH ACCOUNTING TERMINOLOGY</td>
<td>49</td>
<td>36.3</td>
<td></td>
</tr>
<tr>
<td>VARIATION OF FORMAT AND LAYOUT OF REPORT</td>
<td>41</td>
<td>30.4</td>
<td></td>
</tr>
<tr>
<td>NO PROBLEM</td>
<td>4</td>
<td>3.0</td>
<td></td>
</tr>
<tr>
<td>NO ANSWER</td>
<td>23</td>
<td>17.0</td>
<td>100.00</td>
</tr>
</tbody>
</table>

In question sixteen, respondents were asked to indicate their understanding of the reporting process by the examination of their comprehension of the fundamental nature of reported accounting information that is, whether it accurately, approximately or inaccurately reflects company financial progress and position. This was done as
it was felt that investors and shareholders may be misled into believing that accounting information can accurately describe company activity due to the seeming preciseness of the figures reported.

They were asked to evaluate the financial results which appear in companies' annual reports in accordance with three definitions, as follows:

1) An accurate reflection of their financial progress and position;

2) A reasonable approximation of their financial progress and position;

3) An inaccurate reflection of their financial progress and position.

60.7% of the respondents considered the second of these to reflect their views of company reports, while 18.5% chose the first and 16.4% felt the third reflected their views. 4.4% of the respondents did not answer this question, as shown in Table 10.17.

Apart from a small number of "no answer", beliefs on this matter appear to be that reported accounting information can be regarded in approximate terms appears to be understood by more than half of those respondents.
TABLE 10.17
SURVEY RESPONDENTS' VIEWS ON THE ACCURACY OF THE COMPANY'S ANNUAL REPORTS

<table>
<thead>
<tr>
<th>COMPANIES' ANNUAL REPORTS ARE:</th>
<th>NUMBER OF RESPONSE</th>
<th>PERCENTAGE</th>
</tr>
</thead>
<tbody>
<tr>
<td>AN ACCURATE REFLECTION OF THEIR FINANCIAL PROGRESS AND POSITION</td>
<td>25</td>
<td>18.5</td>
</tr>
<tr>
<td>AN REASONABLE APPROXIMATION OF THEIR FINANCIAL PROGRESS AND POSITION</td>
<td>82</td>
<td>60.7</td>
</tr>
<tr>
<td>AN INACCURATE REFLECTION OF THEIR FINANCIAL PROGRESS AND POSITION</td>
<td>22</td>
<td>16.4</td>
</tr>
<tr>
<td>NO ANSWER</td>
<td>6</td>
<td>4.4</td>
</tr>
<tr>
<td>TOTAL</td>
<td>135</td>
<td>100.00</td>
</tr>
</tbody>
</table>

In question seventeen, respondents were given the following two investment concepts: There is a risk involved in share investment; Share market price might go down as well as up. Then, they were asked their views about them.

2.2% of the respondents did not express any comment. 68.9% of them believed that there is a risk involved in share investment, while 28.9% did not. The vast majority of the respondents (97.8%) were aware that share market price might go down as well as up. Table 10.18 summarizes the respondents' beliefs with regard to these investment concepts.
Question eighteen was concerned with the quality of investment information available to small investors in the Saudi stock market. Respondents were asked to rate such information in terms of a choice of six descriptions.

13.3% of the respondents did not answer the question. 28.1% considered the available information to be accurate while 34.1% described it as comprehensive and 37.0% believed that it is easy to understand. 45.2% of them felt that the information is incomplete, while 29.6% of respondents thought it is useless to ordinary investors and 22.2% believed that it is not entirely realistic.

Question nineteen asked the respondents whether there
was anything in particular in the annual financial report of Saudi corporations in its present form which they did not fully understand. 24.4% of the respondents said there was nothing; the present annual financial report is perfectly understandable. A further 31.1% could not or did not answer the question.

The remainder (44.5%) indicated their need for more information about the profit and loss account, the balance sheet, and the figures and terminology used in annual financial reports, as shown in Table 10.19.

<table>
<thead>
<tr>
<th>ASPECT OF THE ANNUAL REPORT</th>
<th>NUMBER OF RESPONSES</th>
<th>PERCENTAGE</th>
<th>TOTAL PERCENT</th>
</tr>
</thead>
<tbody>
<tr>
<td>NOTHING</td>
<td>33</td>
<td>24.2</td>
<td></td>
</tr>
<tr>
<td>NO ANSWER/DO NOT KNOW</td>
<td>42</td>
<td>31.1</td>
<td></td>
</tr>
<tr>
<td>PROFIT AND LOSS ACCOUNT</td>
<td>10</td>
<td>7.4</td>
<td></td>
</tr>
<tr>
<td>BALANCE SHEET</td>
<td>6</td>
<td>4.4</td>
<td></td>
</tr>
<tr>
<td>TERMINOLOGY</td>
<td>15</td>
<td>11.1</td>
<td></td>
</tr>
<tr>
<td>OTHERS</td>
<td>29</td>
<td>21.8</td>
<td>100.00</td>
</tr>
</tbody>
</table>

The respondents believed that the language used at present in financial statements is too technical in nature,
and felt that such statements should be presented in terms comprehensible to ordinary investors. Others stated that summarized versions or simple explanations of the key features of the annual financial report would help to increase their understanding and use of financial information supplied by companies.

This result is confirmed by the responses to question number twenty, which asked about any additional financial information which should be reported to investors or shareholders through the company's annual financial reports.

55.6% of the respondents stated that the financial information disclosed at present is insufficient and indicated that additional information is necessary. 51.9% of respondents asked for more information about the budgets, while 67.4% asked for more information about profit forecasts and 46.7% asked for more information about current value accounts.

45.9% of respondents felt that they need more information about funds flow statements. 40.7% stated that more information about cash flow statements is required, while 38.5% asked for more information about the human resource statements. A further 11.1% could not or did not
answer the question. These responses are summarized in Table 10.20.

<table>
<thead>
<tr>
<th>ADDITIONAL FINANCIAL INFORMATION</th>
<th>PERCENTAGE</th>
<th>RANKING</th>
</tr>
</thead>
<tbody>
<tr>
<td>BUDGET</td>
<td>51.9</td>
<td>3</td>
</tr>
<tr>
<td>PROFIT FORECASTS</td>
<td>67.4</td>
<td>1</td>
</tr>
<tr>
<td>CURRENT VALUE ACCOUNTS</td>
<td>46.7</td>
<td>4</td>
</tr>
<tr>
<td>FUNDS FLOW STATEMENTS</td>
<td>45.9</td>
<td>5</td>
</tr>
<tr>
<td>CASH FLOW STATEMENTS</td>
<td>40.7</td>
<td>6</td>
</tr>
<tr>
<td>HUMAN RESOURCE STATEMENTS</td>
<td>38.5</td>
<td>7</td>
</tr>
<tr>
<td>INCREASED DISCLOSURE OF EXISTING FINANCIAL INFORMATION</td>
<td>55.6</td>
<td>2</td>
</tr>
</tbody>
</table>

10.3. The Interview Survey

In this survey, interviews were conducted with three groups involved in the share investment business. They were: share investors; official brokers in commercial banks; and unofficial brokers.

Interviews with share investors either in the CNUs or in the BNU's, revealed that there are many problems existing in the trading system of the Saudi stock market. The majority of investors complained of the delay of the
negociation process which takes a long time to be completed through the CNUs under the control of SAMA. They were agreed that the information reported to them through the system is inadequate in terms of accuracy, reliability and comprehensiveness, which adversely affects their investment decisions. Many investors indicated that they required more information about the members of the board of directors of the company and their remuneration.

They also mentioned that the market is dominated, in terms of the volume of trading and the number of shares bought and sold, by big investors who have access to more useful investment information through the corporations, whereby company's directors disclose such information about the company to investors outside the general meeting. The Companies Act does not allow such disclosure, ostensibly for the safeguard of small investors and the stability of the market.

Although SAMA regulates the registration and transfer of share ownership through the SSRC, the share transaction process is still very slow, so that buyers might lose the chance to resell their shares at a profit should the price rise, because they have not received the share certificates. Sometimes these certificates get lost during the transaction process, as they have to pass through many
channels. This creates another problem for both the
investors and the banks.

Official brokers in the CNUs and BNUs mentioned that
some small investors do not follow the share investment
procedures implemented by SAMA, due to their lack of
awareness of share investment. This results in delays in
completing the transaction process. However, there are no
penalties enforced against any violations of share trade
regulations. Another problem mentioned by the brokers was
that many investors do not call in to pay the next
installments of the new issue, or to collect the dividend
on their shares.

Although there is still considerable ignorance of
share investment procedures, one broker suggested that
small investors have begun to be aware of this type of
investment, making inquiries within the CNUs and BNUs about
the corporations and looking at companies' quarterly and
annual financial reports in order to evaluate their
performance before making investment decisions. Such
investors also expressed their views about companies'
performance and its effect on the market share price.

They also indicated their desire for more simple
accounting and financial information to be displayed in a
way which would be understandable to the majority of
investors and shareholders. Brokers were satisfied with share trading activities, despite the large number of investors who participate and deal with share business. They indicated that the market will improve with the introduction of more rules and regulations to control its activities and also through the increase of investors' experience of share investment.

Unofficial brokers, as shown in an earlier chapter, play an important role in the market activity. The majority of them are former real estate brokers who use their experience in the share investment business. They play the role of market makers, employ many financial analysts, and use the financial information publicly reported either by corporations or by SAMA, for their interests and on behalf of their clients. Some of them also carry out comprehensive studies about specified companies and about the performance of the market as a whole.

In an interview with one big broker, he indicated that their business is focused on buying and selling shares of specified companies in which they are interested and providing investors with advice about share investment on a consultancy basis.

One broker pointed out that investors who wish to sell their shares quickly often do so through unofficial brokers
because they do not charge commission or use a lot of paper work and they make an immediate payment upon the receipt of share certificates. Another unofficial broker complained that although they cooperate with official brokers in the trading activities of the Saudi stock market, they are still not officially recognized by the government. Although the Ministry of Finance and National Economy and SAMA control and appreciate their role in the market, the Ministry of Commerce is still in doubt of their ability to undertake the brokerage business. Therefore, they are asking the government, through the Ministry of Commerce, to legalize their business as stockbrokers and market makers. However, their demand is still under investigation by the concerned authority.

10.4. Results and Comparison with Earlier Studies

In Saudi Arabia, the base of individual shareholders comprises two groups. The first is the very big investors, which are relatively small in number but hold the larger number of shares in the market. They tend to be company founders or directors, and to retain their shares permanently. However, some of them tend to create a speculative trend by continually buying-up shares of the company with which they are connected, from small investors. The second investor group is the small investors, which are relatively large in number but hold a

321
small proportion of shares in the market. These small individual investors play a significant role in the market activity, although they do not have access to other sources of information available to the big investors such as the company's founders and directors. Government agencies represent the institutional investors in the Saudi stock market.

The private investors and shareholders interviewed in this study were predominantly male, held relatively few shares, and had little experience of accounting and related matters. Most of them made their own investment decisions without assistance from experts. The majority of the small investors are most likely to hold their shares for a long term, although there is a clear section keen to sell their shares for a quick profit.

Few investors believed that they understood the accounting information contained in the corporate annual report. Therefore, the initial impression was of the reporting accountant largely failing in communicating to those particular private investors. Tests of actual understanding in seven key reporting areas provided evidence that respondents' comprehension of financial reporting practice was consistently low, with the nature of financial statements being best understood and financial ratios being least understood by the sample as a whole.
Responses of the private investors revealed that those who believed they did not understand accounting information had a low level of comprehension relative to the interview sample as a whole, while those who claimed they did understand tended to have a higher level of comprehension relative to the group as a whole. The latter result was found to be relevant to investment decisions of those who stated they understood accounting information.

Thus, the annual report, if it is to succeed as a communications link between company management and investors and shareholders, should be relevant to the needs of the latter group and it must be read thoroughly by all concerned. Fortunately, the survey results indicate that most of the responding investors tended to read the annual report, with thorough attention usually being given mainly to both the profit and loss account and balance sheet. The chairman's report and auditors report were read thoroughly by a small number of investors.

On the basis of their interest in looking at the annual financial report respondents were divided into three reading groups: very interested readers, quite interested readers, and not interested readers. It was thought that those respondents who were not interested in looking at the annual report might well look elsewhere for accounting and financial information relevant to their needs. This,
however, was not the case. The other groups of investors who were very or quite interested in looking at the annual financial report were more inclined than the first group to use other sources of accounting and financial information.

Saudi investors, according to the survey results, rely heavily on the corporate financial reports when making investment decisions. They indicated that financial reports represent information more useful and of more influence on their investment decisions than any other source of information. The profit and loss account and the balance sheet were the most important sections of the corporate financial statements, which indicates the importance of earnings and financial position for the investors. Investors ranked SAMA share price list second behind the company annual reports; it appears that they rely on this source of information for investment decisions because they have confidence in it as being prepared by a government authority.

Some Saudi investors considered the financial information published in the local media when making investment decisions, to obtain information which is not legally required to be disclosed in the corporate annual report, such as general information relating to a company's activities, its share price, its management and directors, the general economic conditions, and the financial policies
of the firms, which emphasizes the investors' interest in income and earnings potential.

The investor survey reveals that the greatest problems facing the majority of Saudi investors appear to be the complexity of the reporting system and the language and terminology used in the corporate financial reports. These were not unexpected results. It is the profit and loss account and balance sheet which appear to have caused most problems for respondents in this survey. In particular, the terminology employed in them is a mixture of technical terms and everyday words, frequently used in a specialised context, and often removed from their normal meaning, such as reserves, accrued charges and current assets.

Respondents expressed their difficulties in understanding the corporate financial report, because it is too technical in nature; they want it to be presented in terms comprehensible to the lay shareholder. These findings again emphasize the investors' need to understand the accounting and financial terms presently in use in corporate financial statements. This will affect their investment decisions related to buying, holding, or selling stocks, which in turn will affect the trading activities of the stock market.

With all this information from the questionnaires and
interviews now collected, the results of this study can be compared with the results of previous studies in Saudi Arabia and other countries, which we discussed in the preceding chapter. The relative importance of the accounting information for investment decision-making for the Saudi private investors is compared with two American studies (Baker and Haslem, 1973; Chang and Most, 1981), two Australian surveys (Chenhall and Juchau, 1977; Winfield, 1978), one U.K. survey (Lee and Tweedie, 1977), and two Saudi studies (Felemban, 1989; Abdelsalam, 1990).

According to the findings of this survey, the Saudi private investors considered the accounting information disclosed in the corporate financial reports very useful and of more influence on their investment decisions, which indicates that the corporate financial reports are considered to be the most important source of information for those investors. This is consistent with the findings of Chang and Most in the United States and Chenhall and Juchau and Winfield in Australia. Similarly, the third place ascertained to information published in newspapers by Saudi investors, is consistent with the Baker and Haslem study in the United States and Chenhall and Juchau study in Australia. Table 10.21 summarizes the comparison of the different sources of accounting and financial information by Saudi investors with other studies in the United States.
and Australia. Although in the Baker and Haslem study, the respondents indicated that their primary source of information for investment decision purpose is the stockbrokers, it is obvious that those brokers rely heavily on the corporate financial reports.

Furthermore, the Saudi investors in the Abdelsalam study, considered the corporate financial reports as their most important source of information and they ranked it first in the list of the sources of information, which matches the views of the respondents in the present survey. In the Felemban study, however, the respondents ranked SAMA share price list as their prime source of information for investment decision purpose, and this list also ranked high in the present survey, coming in second place. It seems that the respondents rely heavily on the SAMA share price list which is prepared by a government authority due to the fact that the list is more readily understandable than some other sources. It does not contain any difficult accounting terminology, which presents a significant problem for such investors. Rather, it contains simple information such as the maximum price of the share, the minimum price, the volume of shares traded, the value of shares traded, the number of deals, and the average price. In addition, Felemban in his study found that investors indicated that they experience problems when reading the company reports,
**TABLE 10.21**

**COMPARISON OF SAUDI INVESTORS' SOURCES OF ACCOUNTING AND FINANCIAL INFORMATION WITH OTHER STUDIES**

<table>
<thead>
<tr>
<th>SOURCES OF INFORMATION</th>
<th>SAUDI INVESTORS</th>
<th>CHENHALL &amp; JUCHAU AUST.</th>
<th>WINFIELD AUST.</th>
<th>BAKER &amp; HASLEM USA</th>
<th>CHANG &amp; MOST USA</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>(in brackets)</td>
<td>(in brackets)</td>
<td>(in brackets)</td>
<td>(in brackets)</td>
<td>(in brackets)</td>
</tr>
<tr>
<td>Financial Reports</td>
<td>1 (65.2)</td>
<td>1 (30.0)</td>
<td>1 (70.5)</td>
<td>5 (7.9)</td>
<td>1 (46.8)</td>
</tr>
<tr>
<td>News in Daily Press</td>
<td>4 (56.3)</td>
<td>3 (16.6)</td>
<td>2 (55.8)</td>
<td>3 (14.8)</td>
<td>2 (38.0)</td>
</tr>
<tr>
<td>News in Financial Press</td>
<td>3 (57.0)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Advice from Friends</td>
<td>-</td>
<td>6 (3.2)</td>
<td>4 (19.7)</td>
<td>4 (9.7)</td>
<td>6 (13.1)</td>
</tr>
<tr>
<td>Rumors from the Market</td>
<td>-</td>
<td>4 (15.1)</td>
<td>-</td>
<td>6 (5.2)</td>
<td>7 (7.8)</td>
</tr>
<tr>
<td>Advice from the Bank</td>
<td>6 (47.4)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Advisory Services</td>
<td>-</td>
<td>5 (7.6)</td>
<td>-</td>
<td>2 (15.6)</td>
<td>4 (32.1)</td>
</tr>
<tr>
<td>Stockbrokers</td>
<td>-</td>
<td>2 (27.5)</td>
<td>3 (34.8)</td>
<td>1 (46.8)</td>
<td>3 (33.3)</td>
</tr>
<tr>
<td>Personal Contacts</td>
<td>5 (54.1)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Sama Share Price</td>
<td>2 (60.7)</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Proxy Statements</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>5 (16.6)</td>
</tr>
<tr>
<td>Others</td>
<td>7 (20.0)</td>
<td>-</td>
<td>5 (19.1)</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

* Figures in brackets refer to the percentage of respondents.
such as problems with the understanding of accounting terminology and the variation of format and layout of the report. This is consistent with the findings of the present survey.

Although the Saudi investors ranked the information published in newspapers in the second place in the above two Saudi studies, it is obvious that such information originally derived from both the published corporate financial reports and SAMA share price list, the latter of which was ranked second by the respondents in the present survey. In the previous two studies, news in the financial press was not indicated as a source of information by respondents, due to the fact that the financial press in Saudi Arabia was not found until 1992. It is now considered a useful source of information for investment purposes by Saudi investors.

The investor survey shows that personal contacts with share departments in the commercial banks, which represent the official brokers, were considered to be in the fifth place among the important sources of information, which again is consistent with the views of other respondents in the Abdelsalam study, though it was ranked third in that study. It seems that during the early days of the organized share trading activity through the commercial banks, investors were unaware of the share investment game and its
rules, and preferred to seek advice from the official brokers, even though the brokers in the banks are not allowed to play the role of market makers.

Similarly, the company annual report was rated fourth by respondents in the Felemban Study, because in Saudi Arabia corporations used to report and publish their financial statements on an annual basis only, which may have affected the investors' use of those statements for making investment decision. However, since full implementation of the new trading system, at the beginning of March 1991, as we mentioned in an earlier chapter, SCAD requires companies to report and publish their financial statements quarterly within two months from the end of each quarter, in order to provide the investors with comprehensive information to rely on for investment decision purposes. Since then, the majority of Saudi investors have paid more attention to the corporate annual reports and regarded them as the most important source of information for their share investment decisions, despite the difficulty some experience in understanding them.

The Saudi investors indicated that the most important sections in the corporate financial statements were the profit and loss account and the balance sheet, which again matches the views of other respondents in the Abdelsalam study in Saudi Arabia, the Lee and Tweedie study in the
United Kingdom, and in the Winfield study in Australia; even though the profit and loss account was ranked second behind the chairman's report, it is considered the most important section of the financial statements. Table 10.22 presents a comparison of these views in the United Kingdom and Australia.

Finally, there are many similarities between the results of the Saudi small investor survey and surveys previously conducted in Saudi Arabia and other countries such as the United States, the United Kingdom, and Australia. These include the reliance on corporate financial reports for decision making and the use of the profit figure as an important decision criterion. Although individual investors in general do find the financial reports a useful source of investment information, they look only to the simple bottom line to make their investment decisions and they do not care about the complex and detailed sections such as the notes to accounts or the income statement (Abdelsalam, 1990:38).

Interpretation of the results suggests several conclusions, and gives rise to recommendations which may be developed for improving the efficiency of the stock market information system in Saudi Arabia. All these will be presented in the following chapter.
## Table 10.22

**Comparison of Saudi Investors' Views on the Important Sections in the Corporate Annual Financial Reports with Other Studies**

<table>
<thead>
<tr>
<th>Sections in the Corporate Financial Reports</th>
<th>Saudi Investors</th>
<th>Lee &amp; Tweedie (The U.K.)</th>
<th>Winfield (Australia)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit and Loss Account</td>
<td>1 (52.0%)</td>
<td>1 (52.8%)</td>
<td>2 (41.0%)</td>
</tr>
<tr>
<td>Balance Sheet</td>
<td>2 (52.1%)</td>
<td>3 (42.0%)</td>
<td>2 (41.1%)</td>
</tr>
<tr>
<td>Chairman's Report</td>
<td>3 (29.0%)</td>
<td>2 (44.3%)</td>
<td>1 (56.4%)</td>
</tr>
<tr>
<td>Auditor's Report</td>
<td>4 (29.1%)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Director's Report</td>
<td>5 (33.0%)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Notes to Accounts</td>
<td>6 (33.1%)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Statistical Data</td>
<td>7 (17.0%)</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Statement of Sources and Application of Funds</td>
<td>-</td>
<td>-</td>
<td>3 (28.5%)</td>
</tr>
<tr>
<td>Financial Highlights</td>
<td>-</td>
<td>-</td>
<td>4 (26.3%)</td>
</tr>
<tr>
<td>Historical Operating Summary</td>
<td>-</td>
<td>-</td>
<td>5 (18.9%)</td>
</tr>
</tbody>
</table>

*Figures in brackets refer to the percentage of respondents.*
CHAPTER ELEVEN

CONCLUSIONS AND RECOMMENDATIONS
11.1. Conclusions

This study set out to investigate the contribution of accounting information to investor decisions in the Saudi stock market (SSM). Financial markets perform an economic function as they facilitate the transfer of real economic resources from surplus units to deficit units. When deficit units use the borrowed fund productively they will produce a larger income, thereby raising their own real standard of living and that of others in the economy. Financial markets also perform a financial function, whereby they provide deficit units with funds that they need to carry out their plans. They also provide surplus units with earning assets, so that the wealth of these units may be held in a productive form without the necessity of direct ownership of real assets.

The objective of capital markets is to improve efficiency of resource allocation and, consequently, the growth rates in the economy. Capital markets provide competitive means by which funds are transferred between investors (savers) and borrowers (producers). Financial assets separate individual acts of saving from acts of investment over both time and place, due to marketability, liquidity and divisibility in savings. The mobilization of savings into their most productive uses increases the propensity to invest and hence the level of national income.
and the propensity to consume. These favourable allocative
effects impact on economic growth rates.

The role of capital markets in economic development is
mainly viewed as a catalyst in the efficient mobilization
of savings to their most productive uses. However,
allocational efficiency will not develop unless an
environment exists which supports economic and financial
development. It does not make sense to rely on capital
markets for resource mobilization and allocation in an
economy with low per capita income and weak financial
institutions. The Saudi Arabian economy is well developed,
with high per capita income and a sophisticated economic
infrastructure built during the years of surplus oil
revenues. Thus, a well developed capital market can play a
significant role in the continuing economic development.

Because of the nature of the study, it is not possible
to make general statements about the information needs of
all small individual investors. Nor it is appropriate to
make absolute claims about the major sources of investment
information for individual investors (Baker and Haslem,
1973). However, certain indications did emerge, which we
can highlight here.

The overall impression gained from this research is
that a considerable communications gap exists between joint
stock companies and their private investors and shareholders. The results presented in this study suggest that the main cause of the lack of communication relates to the valuation procedures and accounting terminology used in the annual report, which may lead to many investment decisions being based on inaccurate interpretations of the information disclosed in the financial reports. In addition, corporations may not be effective enough in reporting the result of their activities to investors and shareholders.

On the basis of the study findings, we can draw the following possible conclusions:

1) Private investors use many different sources of information when making investment decisions in stocks, but the corporate annual financial reports and SAMA share price list predominate.

2) Meaningful information additional to that provided by forecast of sales and earnings is considered by investors in their investment decisions.

3) User information requirements for investment decisions may very well differ. Comparison with results of other studies suggests that the needs of private investors may differ from those of professional analysts.
4) The majority of the respondents experience difficulties in understanding accounting information and related matters. This lack of such knowledge affects their use and understanding of information contained in the corporate financial reports, which will in turn affect their investment decisions.

5) Disclosure requirements do not promote conditions leading to informational efficiency. The accounting disclosure on corporate annual reports of Saudi joint stock companies was studied by Bahjatt (1986), who found that the index of disclosure in Saudi corporations is significantly lower than that for United States corporations.

6) Trading procedures are time consuming and expensive due to the absence of a centralized market.

7) A significant proportion of transactions are executed directly through individual companies or through individual unofficial brokers (market makers). The latter process these transactions through the commercial banks or through the firm's share registration offices. These transactions are difficult to estimate because they are difficult to track. The only paper trail is when the orders are processed through the SSRC.

8) There are no official market makers, as banks are not allowed to take positions in stocks which reduces
liquidity in the market. At the present time, some active investors provide the market with liquidity and play the role of market makers. Their profits are determined by their bid and ask prices and by profit or losses they earn by holding shares.

11.2. Recommendations

Accounting terms used mainly within the profit and loss account and balance sheet terminology represented a major problem for private investors to understand and to use. As a result, it is unlikely that they could possibly come to any reasoned conclusions regarding the financial progress of a company and they were obviously lacking in confidence as to their ability to make judgement of these matters and, in turn, to make a rational investment decision.

To improve communications between corporations and the private investors and shareholders, it is most strongly recommended that attention be paid to simplifying the present system of financial reporting based on measures of profitability and financial position. This should be done, irrespective of the valuation bases adopted and should also incorporate, whenever possible, interpretive statements outlining the main features of the financial results being reported. The following remedial suggestions could be
practically undertaken to achieve the simplification of the present system of financial reporting:

a) A general simplified outline of both the profit and loss account and balance sheet could be presented to private investors, separately from those disclosed in the annual financial report. Indeed, this was also a suggestion of a majority of respondents. This could be coupled with providing private investors with a reasonable understanding of the balance sheet in particular. They should be aware that the balance sheet is used as a statement of balances appearing in the accounting records. As a result, the effects of the matching principle would require explanation and this would apply whether the basic data were accounted for on a historic cost or current cost basis. Additionally, for the benefit of investors, a simple and general explanation of the balance sheet identity, such as assets being equal to liabilities and shareholders' equity, should be provided.

b) Investors could be provided with a reasonable understanding and interpretation of the main features of financial statements by giving explanations of the terms actually used in the financial reports within the reports themselves. In addition, everyday words used in a technical sense, such as reserves, or technical terms used in an everyday context, such as depreciation, should either be
replaced in financial reporting or the attention of the investors as report users should be drawn to their specific meaning within a financial statement context.

The explanation and simplification of accounting terminology used in corporate financial reports should not be the sole responsibility of the market regulation authorities (SCAD in this case), but should involve various parties including the quoted companies, universities, management consultancy firms, stockbroking firms, shares department of the commercial banks, financial analysts, and chambers of commerce and industry. In the long run, this will improve the investors' understanding and use of these terms, which will affect their investment decisions and in turn will affect the market trade activities. Boards of directors and external auditors of the company are responsible for explaining the main features of the financial reports and for discussing the company's financial stability, liquidity and profitability through the use of prescribed and clearly explained financial ratios.

c) Investors could be provided with financial information required by them which at present is not legally required to be disclosed, such as future prospects, the corporation's financial policy, and general economic conditions. Such information, which respondents indicated
would be of use to them, could usefully be introduced into the annual reports in a simple and understandable manner.

As private investors require more disclosure of existing information, we suggest the following recommendations to improve and promote the present disclosure system:

a) A full disclosure system should be developed by which companies are required to provide quarterly financial statements. A corporate audit of the quarterly statements is sufficient and corporations should be required to report within two months maximum, or be subject to legal penalties. All major corporate events should be reported to the SCAD and local media. These include changes in key management of a corporation and agreements reached on large contracts for or by the corporation. Then, SCAD should report such information to investors and shareholders and decide whether any violations were meant to monopolize or abuse information. Corporations should provide the SCAD with any details or information requested and corporations should appoint a key person, such as the public relations officer, to be responsible for answering such requests.

b) Shareholdings of all corporate staff and the board of directors should be periodically reported, as should any shares traded by corporate insiders.

c) Penalties for violations of the information disclosure regulations should be designed by the SCAD and enforced against abuses of information. Inaccurate or misleading information which might defraud investors should be investigated with penalties for the persons responsible. Regulations should incorporate effective enforcement measures without applying lengthy legal procedures. These measures could include delisting until regulations are complied with, releasing reports on local media on repetitive violators to increase public awareness, and a penalty structure according to the level of information disclosure violations.

d) Due to the scarcity of professional financial analysts and periodic financial publications, SCAD should play this role and information reported to investors and shareholders should include the last trade of the day and the closing bid/ask prices quoted on each share if not traded. The current dividend yield and P/E ratio might be included as useful information. SCAD could perform the financial analysis of corporate financial reports, but if the current staffing conditions in the SCAD do not allow such professional analysis, this job could be temporarily sub-contracted to outside professionals and staff should be employed and trained for financial analysis. Also, summaries of financial positions and financial ratios
should be reported to the commercial banks and active stockbroker firms in the form of booklets on a quarterly basis.

e) Financial publications should be encouraged, as should current newspapers' coverage of trade activity and financial information. Major accounting and financial information should be periodically supplied to local media in the form of summary reports. A daily bulletin board of all major information and news (economic, financial, and corporate) should eventually be produced through the ESIS which should ultimately allow access to the data bank. These recommendations will increase the public interest in accounting and financial information and will promote the market trading activity.

To compliment the operational efficiency of the ESIS, the waiting time for receipt of the purchase and sale notifications for the SSRC should be reduced from three days to one day, which would greatly reduce transaction costs (documentation and delivery costs) and increase the rhythm of trading procedures. It would also give share traders the opportunity to trade their shares when they wish to do so. This procedure could be implemented through the establishment of a computerized clearing system under the control of the SCAD, which would give the regulatory authority immediate information on major shareholders'
activities. Such information would also be valuable in detecting and prosecuting insider information violations and cases of market fraud.

The role of market makers in providing liquidity and enhancing market stability is well established. Market makers hold inventories of stocks and provide liquidity to the market. Their profit margins compensate them for their costs of inventory and the business risks involved. The current brokerage firms have some active investors considered to act as market makers because they hold inventories of stocks and provide liquidity to the market. Therefore, licensing these market makers would ensure that active market makers have at least a minimal level of professional knowledge and conduct themselves according to professional standards. There is no reason to restrict the number of licensed professional market makers, as more market makers will increase the level of competition in bid/offer and price efficiency in the existing trading system.

The function of the market makers is to buy and sell shares on their own account. The licensing of market makers would make more information on their activities available to regulators. They should still be required to deal through the bank trading system by having direct access to the SSRC and the current trading system by regularly
providing bid/offer quotations. This procedure would enable them to have an unrestricted view of market activity, as the nature of their business requires, and they could play the role of maintaining the balance in the market. It also would reduce the pressure on the CNUs at commercial banks. Only licensed traders should be allowed to provide banks with bid/offer quotations. Regulation of active market makers (traders) would develop an extra channel of communication and allow the trading system to develop under close supervision and control.

These suggestions are tentative ones. They are, however, very seriously recommended in the light of the research findings obtained.

11.3. Limitations of the Study and Recommendations for Further Research

Although the study has analyzed aspects of the understanding and use of accounting information contained in the corporate annual financial report and its contribution to the trading activities of the Saudi stock market, the limited time and resources which were available to the researcher made it very difficult for him to investigate in great detail certain issues: the accounting environment in the Saudi private sector; the need to standardize the corporate annual statements and other
financial information which affect the investment potential in joint stock companies shares; the institutional investors' needs for accounting and financial information and their important role in developing the stock market in Saudi Arabia; and the integration between the stock markets in the Gulf Cooperation Council (GCC) countries, as part of a wider economic integration within those countries, which increasingly affects Saudi Arabia. More research on these issues would be of great importance in providing a more comprehensive assessment of the impact of accounting information system.
Appendix 1

REGULATIONS FOR COMPANIES

COMPANIES ACT

As updatey amended

PART V

CORPORATIONS (JOINT STOCK COMPANIES)
PART V
CORPORATIONS
CHAPTER I
GENERAL PROVISIONS

Article 48: the capital of a corporation shall be divided into negotiable shares of equal value. The members thereof shall be responsible only to the extent of the value of their shares, and their number shall not be less than five.

Article 49: "The capital of a corporation that offers its stock for public subscription shall not be less than ten million Saudi riyals. In all other cases, the capital of a corporation shall not be less than two million Saudi riyals. The paid-in capital upon the incorporation of the company shall not be less than one half of the prescribed minimum, with due regard to the provision of Article 58. The (par) value of each share shall not be less than fifty Saudi riyals”.

Article 50: The name of a corporation may not include the name of a natural person, unless the company’s object is the utilization of a patent or an invention registered in the name of such person, or unless the company acquires a commercial firm and adopts the name of the latter as its own name.

Article 51: The Minister of Commerce shall issue a decision incorporating standard bylaws for corporations, from which no departure shall be allowed except for reasons satisfactory to the said minister.
CHAPTER II
INCORPORATION AND PUBLICATION
OF A CORPORATION

Article 52: "The following corporations may be incorporated only by virtue of an authorization issued in a royal decree based on the approval of the Council of Ministers and the recommendation of the Minister of Commerce, with due regard to the provisions of the Regulations:
(a) Concessionary companies.
(b) Companies managing a public utility.
(c) Companies receiving subsidy from the Government.
(d) Companies in which the Government or any other public juristic person participates.
(e) Companies engaged in banking activities.
Other corporations may be incorporated only by authorization to be issued by the Minister of Commerce and published in the Official Gazette. The Minister of Commerce shall issue said authorization only after he has reviewed a study proving the economic feasibility of the company's objectives, unless the company has submitted such study to another competent government agency that has authorized the establishment of the enterprise".

The application for such authorization shall be signed by at least five members (of the company) and submitted in the manner to be prescribed by a decision of the Minister of Commerce.

The application shall state the manner of subscription for the company's capital, the number of shares reserved by the founders to themselves and the amount subscribed by each founder. Annexed thereto shall be a copy of the company's memorandum of association and bylaws both signed by the incorporators and other founders.

The said application shall be recorded in the register kept for the purpose by the General Department of Companies.

The said General Department may request that alterations be made in the company's bylaws so as to be consistent with the provisions of these Regulations or conformable to the standard from referred to in Article 51.

Article 53: A founder of a corporation shall be any person who has signed its memorandum of association, or applied for an authorization to incorporate it, or offered a contribution in kind upon its organization, or actually participated in its organization.

Article 54: "If the founders do not limit subscription for all stock to themselves they must, within thirty days of the date of publication in the official Gazette of the Royal Decree or the Minister of Commerce's decision authorizing the incorporation of the company, offer for public subscription the shares of stock for which they did not subscribe. The Minister of Commerce may, if necessary, authorize the extension of such period by not more than ninety days."
Article 55: If an invitation for subscription is made to the public, subscription must be effected through the banks designated by the Minister of Commerce.

The founders shall place a sufficient (number of) copies of the company's bylaws at the said banks.

Any interested party may, during the period of subscription, obtain a copy thereof at a reasonable price.

The invitation for public subscription shall be set out in a prospectus, specifically containing the following particulars:

1. The founders’ names, residence addresses, occupations, and nationalities.
2. The company's name, object, and head office.
3. The amount of paid-in capital; the classes of stock, their value, number, the amount offered for public subscription, and the amount subscribed for by the founders; and the restrictions imposed on the negotiability of shares.
4. The particulars concerning the contributions in kind and the rights attached thereto.
5. The special privileges granted to the founders or others.
6. The method of distribution of profits.
7. The estimated amount of the company’s preliminary expenses.
8. The dates set for opening and closing the subscription and the place and terms thereof.
9. The method (to be adopted) for the allotment of shares to subscribers, if the number of the shares subscribed for exceeds the number offered for subscription.
10. The date of issue of the royal decree authorizing the incorporation of the company and the number of the Official Gazette in which it was published. This prospectus shall be signed by the founders who have signed the application for authorization.

These shall be jointly responsible for the correctness of the particulars contained in it, and for setting forth (in the prospectus) all the particulars referred to in the third paragraph of this Article.

The prospectus shall be published in a daily newspaper distributed in the locality of the company's head office, at least five days prior to the date set for opening the subscription.

Article 56: Subscription (lists) shall be open for a period of not less than ten but not more than ninety days. The company shall not be duly incorporated unless all the capital (stock) has been subscribed for.

If the entire capital has not been subscribed for within the said period, the period of subscription may, with permission from the Minister of Commerce and Industry, be extended for a period not exceeding ninety days.

Article 57: The subscriber, or his representative, shall sign a document setting forth specifically the company's name, object, and capital; the conditions of subscription; the subscriber's name, address, occupation, and nationality; the number of shares subscribed by him; and a covenant to accept the company's bylaws as established by the constituent general meeting.

The subscription shall be final and unconditional. Any condition laid down by the subscriber shall be considered nonexistent.
Article 58: The amount payable per cash share upon subscription shall not be less than one quarter of its par value; a notation of the amount paid from such value shall be made on each share.

The proceeds of the subscription shall be deposited in the name of the company under incorporation in one of the banks designated by the Minister of Commerce. They may be surrendered only to the board of directors, after publication of the company's incorporation in accordance with Article 63.

Article 59: If the number of shares subscribed for exceeds the (total) number offered for subscription, shares shall be allotted to subscribers in proportion to their individual subscriptions.

"With due regard to what the Minister of Commerce may decide in each case in respect of minor subscribers"

Article 60: If the capital includes contributions in kind or special privileges for the founders or others, the Department of Companies shall, at the request of the founders, appoint one or more experts to ascertain the correctness of the evaluation of contributions in kind, to appraise the justifications (for the granting) of the special privileges, and to set forth the evaluation factors thereof.

The expert shall submit a report to the General Department of Companies within thirty days of the date of his assignment to perform the work. The Department may, however, upon the request of the expert, grant him a delay not exceeding thirty days.

The General Department (of Companies) shall send a copy of the report of the expert to the founders who must communicate it to the subscribers at least fifteen days prior to the holding of the constituent general meeting. The said report shall also be filed at the company's head office and every interested party shall be entitled to review it.

The report shall be laid before the constituent general meeting for deliberation. If the meeting resolves to reduce the value fixed for the contributions in kind, or to decrease the special privileges (granted), such reduction must be approved during the meeting by the contributors in kind or by the beneficiaries of such special privileges. If they refuse to approve the reduction, the company's memorandum of association shall be considered null and void with regard to all its members.

Shares of stock representing contributions in kind shall be delivered to their holders only after the title to such contributions has been fully transferred to the company.

Article 61: The founders shall summon subscribers to a constituent general meeting, to be held in the manner set forth in the company's bylaws, provided that the interval between the date of the summons and date of the meeting shall not be less than fifteen days, and provided further that in case there are any contributions in kind or privileges, the meeting shall not be held before the lapse of at least fifteen days from the date on which the report referred to in the preceding Article was filed at the company's head office. Any subscriber, regardless of the number of his shares, shall have
the right to attend the constituent general meeting. The meeting shall be valid only if attended by a number of subscribers representing at least one half of the company's capital. If such majority does not obtain, a single summons shall be sent for a second meeting to be held at least fifteen days after the date of the summons. Such meeting shall be valid regardless of the number of subscribers represented thereat.

Resolutions at the constituent general meeting shall be adopted by absolute majority vote of the shares represented thereat. However, if such resolutions relate to the assessment of contributions in kind or special privileges, they must be adopted by two thirds' majority of the subscribers for cash shares, to the exclusion of the subscriptions made by the contributors in kind or the beneficiaries of special privileges. These shall have no vote on these resolutions, even if they are holders of cash shares.

The minutes of the meeting shall be signed by the chairman of the meeting, the secretary, and the teller, and the founders shall send a copy thereof to the Department of Companies.

Article 62: With due regard to the provisions of Article 60, the constituent general meeting shall specifically be competent to do the following:
1. Ascertain that the capital has been subscribed for in full and that the minimum capital has been paid up in full in accordance with these Regulations and to the extent of the amount payable on the value of each share.
2. Draw up the final provisions of the company's bylaws. However, the (constituent general) meeting may not introduce fundamental alterations to the bylaws submitted to it, except with the approval of all the subscribers represented thereat.
3. To appoint the members of the first board of directors for a period not exceeding five years and the first auditor, if these have not been appointed in the memorandum of association or in the bylaws of the company.
4. To deliberate on the founders' report on the acts and expenses necessitated by the organization of the company.

Article 63: The founders shall, within fifteen days of the date of conclusion of the constituent general meeting, submit to the Minister of Commerce and Industry an application (requesting him) to announce the incorporation of the company. The following documents shall be attached to the said application:
1. A statement that the (authorized) capital has been subscribed for in full, showing the amount paid up by subscribers on the value of shares, the names of such subscribers, and the number of shares subscribed for by each.
2. The minutes of the (constituent) general meeting.
3. The bylaws of the company as approved by the (constituent) general meeting.
4. The resolutions adopted by the (constituent) general meeting in respect of the founders' report, the evaluation of the contributions in kind and the special privileges, and the appointment of the members of the board of directors and the auditor, if such appointment was not made in the memorandum of association or bylaws of the company.
Article 64: The company shall be considered duly incorporated from the date of issue of the decision of the Minister (of Commerce and Industry) announcing its incorporation. Thereafter, any action to invalidate the company by reason of any violation of the provisions of these Regulations or of its memorandum of association or bylaws shall be barred.

As a consequence of the decision announcing the incorporation of the company, liability for all the acts performed by the founders for the account of the company shall transfer to the latter and the company shall bear all the (preliminary) expenses incurred by the founders during the period of organization.

If the company is not incorporated in the manner prescribed in these Regulations, the subscribers may recover the amounts paid up or contributions in kind made by them; and the founders shall be jointly responsible for fulfillment of this obligation and for damages, if necessary. The responsible (founders) shall also bear all the (preliminary) expenses incurred for the organization of the company, and shall be jointly responsible to third parties for all acts performed by them during the period of organization.

Article 65: The decision of the Minister of Commerce and Industry announcing the incorporation of the company shall, together with a copy of its memorandum of association and bylaws, be published in the Official Gazette at the expense of the company.

The directors must, within fifteen days of the date (of issue) of the above decision, apply for the registration of the company in the Register of Companies at the General Department of Companies. Such registration shall specifically contain the following particulars:

1. The company's name, object, head office, and term.
2. The founders' names, residence addresses, occupations, and nationalities.
3. The classes, value, and number of (capital) shares; the amount offered for public subscription; the amount subscribed by the founders; the amount of paid-in capital; and the restrictions imposed on the negotiability of shares.
4. Method of the division of profits and losses.
5. The particulars concerning contributions in kind and the rights attached thereto, and special privileges granted to the founders or others.
6. The date of the Royal Decree authorizing the incorporation of the company, and the number of the Official Gazette issue in which it was published.
7. The date of the decision issued by the Minister of Commerce announcing the incorporation of the company, and the number of the Official Gazette issue in which it was published.

The directors must also register the company in the Commercial Register in accordance with the provisions of the Regulations for the Commercial Register.
CHAPTER III
ADMINISTRATION OF A CORPORATION
SECTION I
THE BOARD OF DIRECTORS

Article 66: A corporation shall be administered by a board of directors whose number shall be specified by the bylaws of the company, provided it is not less than three.

The regular general meeting shall appoint the directors for the term specified in the company bylaws, which shall not exceed three years.

“The Council of Ministers may determine the number of boards of directors on which a director may serve”

Directors, however, shall always be eligible for re-appointment, unless the company bylaws provide otherwise.

The company bylaws shall specify the manner of retirement of directors; but the regular general meeting may, at any time, remove all or any of the directors even if the company’s bylaws provide otherwise, without prejudice to the right of a removed director to hold the company liable if the removal is made without acceptable justification or at an improper time.

A director may resign, provided that such resignation is made at a proper time; otherwise, he shall be responsible to the company (for damages).

Article 67: Unless the company bylaws provide otherwise, if the office of a director becomes vacant, the board may appoint a temporary director to fill the vacancy, provided that such appointment shall be laid before the first regular general meeting. The new director shall complete the unexpired term of his predecessor.

If the number of directors falls below the minimum prescribed in these Regulations or in the company’s bylaws, the regular general meeting must be convened as soon as possible to appoint the required number of directors.

Article 68: A director must own “whose value shall not be less than ten thousand riyals”

Shares of the company’s stock shall, within thirty days of the date of appointment of a director, be deposited in one of the banks designated by the Minister of Commerce. They shall be set aside as a guarantee for directors’ liability, and shall remain non-negotiable until the lapse of the period specified for hearing the action in liability provided for in Article 77, or until a decision has been rendered on such action.

If a director fails to submit such guarantee shares within the period specified therefor, he shall forfeit his directorship.

The auditor must ascertain compliance with the provisions of this Article, and must incorporate in his report to the general meeting any violation in this respect.
Article 69: A director may not have any interest whether or indirectly, in the transactions or contracts made for the account of the company, except with an authorization from the regular general meeting, to be renewed annually. Transactions made by way of public bidding shall, however, be excluded from this (restraint) if the director has submitted the best offer.

The director must declare to the board (of directors) any personal interest he may have in the transactions or contracts made for the account of the company. Such declaration must be recorded in the minutes of the (board) meeting, and the interested director shall not participate in voting on the resolution to be adopted in this respect.

The chairman of the board (of directors) shall communicate to the regular general meeting when it convenes the transactions and contracts in which any director has a personal interest. Such communication shall be accompanied by a special report from the auditor.

Article 70: A director may not, without authorization from the regular general meeting, to be renewed annually, participate in any business (enterprise) competitive with that of the company, or engage in any of the commercial activities carried on by the company; otherwise, the company shall have the right either to claim damages from him or to consider the operations he has conducted for his own account as having been conducted for the account of the company.

Article 71: A corporation may not grant any cash loan whatsoever to any of its directors; nor may it guarantee any loan contracted by a director with a third party. Banks and other credit companies shall be excepted from this provision, for these may, within the limits of their objects and under the same terms and conditions as they apply to their transactions with the public, grant loans to or open credits for their directors or guarantee loans contracted by them with third parties.

Any contract concluded in violation of the provisions of this Article shall be considered null and void.

Article 72: Directors may not disclose to the stockholders outside a general meeting, or to third parties, such secrets of the company as may have come to their knowledge by reason of their directorship; otherwise, they must be removed and held liable for damages.

Article 73: With due regard to the prerogatives vested in the general meeting, the board of directors shall enjoy full powers in the administration of the company. It shall be entitled, within the scope of its competence, to delegate one or more of its members or others to perform an act or certain acts.

Nevertheless, the board of directors may not contract loans for terms exceeding three years, or sell or mortgage the real property or the place of business of the company, or release the debtors of the company from their liabilities, unless so authorized in the bylaws of the company and subject to the terms set forth therein.
If the company's bylaws do not contain any provisions in this connection, the board may perform the above acts with an authorisation form the regular general meeting, unless such acts fall by virtue of their nature within the scope of the company's objects.

Article 74 : The company's bylaws shall specify the manner of remunerating directors. Such remuneration may consist of a specified salary, or of an attendance fee for the meetings, or of material benefits, or of a certain percentage of the profits, or of a combination of two or more of these benefits.

If, however, such remuneration represents a certain percentage of the company's profits, it must not exceed 10% of the net profits after deduction of expenses, depreciations, and such reserves as are determined by the general meeting pursuant to the provisions of these Regulations or of the company's bylaws, and after distribution of a dividend of not less than 5% of the company's capital to stockholders. Any determination (of remuneration) made in violation of this (provision) shall be null and void.

The board of directors' report to the regular general meeting must include a comprehensive statement of all the amounts received by directors during the financial year in the way of emoluments, share in the profits, attendance fees, expenses, and other benefits, as well as of all the amounts received by the directors in their capacity as officers or executives of the company, or in consideration of technical, administrative, or advisory services.

Article 75 : The company shall be bound by (all) the acts performed by the board of directors within the limits of its competence, and shall also be responsible for damages arising from the unlawful acts committed by directors in the administration of the company.

Article 76 : Directors shall be jointly responsible for damages to the company, or the stockholders, or third parties, arising from their maladministration of the affairs of the company, or their violation of the provisions of these Regulations or of the company's bylaws. Any stipulation contrary to this provision shall be considered nonexistent.

(Joint) liability shall be assumed by all directors if the wrongful act arises from a resolution adopted by unanimous vote. But with respect to resolutions adopted by majority vote, dissenting directors shall not be liable if they have expressly recorded their objection in the minutes of the meeting. Absence from the meeting at which such resolution is adopted shall not constitute cause for relief from liability, unless it is established that the absentee was not aware of the resolution, or, on becoming aware of it, was unable to object to it.
Article 77: The company may institute an action in liability against (its) directors for wrongful acts that cause prejudice to the body of stockholders. The resolution to institute this action shall be made by the regular general meeting, which shall appoint a person (or persons) to pursue the case on behalf of the company. If the company is adjudged bankrupt, the institution of this action shall rest with the receiver, and upon the dissolution of the company, the liquidator shall (institute and) pursue the case after obtaining the approval of the regular general meeting.

Except in cases of fraud and forgery, (the right of) instituting the action in liability vested in the company shall be extinguished by the regular general meeting’s exonerating the board of directors from responsibility for its administration. In all cases, such action shall be barred after the lapse of one year from the date of such exoneration.

Article 78: Every stockholder shall have the right to institute the action in liability against directors on behalf of the company if the wrongful act committed by them is of a nature to cause him personal prejudice. However, the stockholder may institute such action only if the company’s right to institute it is still valid and after notifying the company of his intention to do so. If a stockholder institutes such action, he shall be adjudged (compensation) only to the extent of the prejudice caused to him.

Article 79: “With due regard to the provisions of the company’s bylaws, the board of directors shall appoint from among its members a chairman and a managing director. A single director may hold the offices of chairman and managing director. The company’s bylaws shall specify the duties and powers of the chairman and of the managing director as well as the special emoluments to be received by each of them in addition to the remuneration prescribed for board members. In the absence of any provisions in this respect in the company’s bylaws, the board of directors shall divide the duties and powers among them and specify their special emoluments. The board of directors shall also appoint a secretary from among its members or others, and shall determine his duties and powers and fix his remuneration, if the company’s bylaws do not contain any provisions in this respect. The term of office of the chairman, the managing director, and the secretary who is a director shall not exceed the term of their respective directorships. The managing director and the secretary who is a board director may always be re-appointed, unless the company’s bylaws provide otherwise. However, the chairman’s term of office may be renewed to another term. The board may, at all times, remove all or any of them, without prejudice to their right to damages if the removal is made without acceptable justification or at an improper time”.
Article 80: The board of directors shall meet at the summons of its chairman in the manner prescribed in the company's bylaws. Nevertheless, and notwithstanding any provision to the contrary in the company's bylaws, the chairman must convene the board if requested to do so by two directors.

A meeting of the board shall be valid only if attended by at least one half of the directors, provided that the number of those present shall not be less than three, unless the company's bylaws provide for a larger proportion or number.

A director may not give proxy to any other director to attend the meeting on his behalf, unless this is authorized by the company's bylaws.

Resolutions of the board shall be adopted by majority vote of the directors present or represented. In case of a tie the chairman's vote shall carry, unless the company's bylaws provide otherwise.

Article 81: The board (of directors) may adopt resolutions by putting them to the directors individually, unless a director requests in writing that the board be convened to deliberate on such resolutions, in which case they shall be laid before the board at the first following meeting.

Article 82: Deliberations and resolutions of the board shall be recorded in minutes to be signed by the chairman and the secretary. Such minutes shall be entered in a special register, which shall be signed by the chairman and the secretary.
SECTION II
STOCKHOLDERS MEETINGS

Article 83: The bylaws of the company shall specify the (classes of) stockholders entitled to attend general meetings. Nevertheless, every stockholder who holds twenty shares shall have the right to attend, even if the bylaws of the company provide otherwise.

A stockholder may, in writing, give proxy to another stockholder other than a director to attend the general meeting on his behalf.

"The ministry of Commerce may delegate one or more representatives to attend the general meetings as observers."

Article 84: Except for matters falling within the jurisdiction of the extraordinary general meeting, the regular meeting shall be competent in all matters related to the company and shall be convened at least once a year within six months of the end of the company's financial year.

Other regular general meetings may be convened whenever the need arises.

Article 85: The extraordinary general meeting shall be competent to alter the bylaws of the company except in respect of:
1. Alterations of a nature to deprive a stockholder of his fundamental rights in his capacity as a member of the company, derived from the provisions of these Regulations or from the bylaws of the company, which rights are set forth in Articles 107 and 108.
2. Alterations of a nature to increase the financial liabilities of stockholders.
3. Alteration of the object of the company.
4. Transferring to a foreign country the head office of a company incorporated in the Kingdom.
5. Changing the nationality of the company.

Any provision to the contrary shall be considered nonexistent.

In addition to the prerogatives vested in it, an extraordinary general meeting may adopt resolutions on matters falling primarily within the jurisdiction of the regular general meeting, subject to the same conditions and in the same manner as prescribed for the latter.

Article 86: If a resolution adopted by a general meeting entails the alteration of the rights of a certain class of stockholders, such resolution shall not be valid unless it is approved by those entitled to vote from among the stockholders of that class, at a special meeting of such stockholders convened in accordance with the rules prescribed for extraordinary general meetings.

Article 87: Stockholders general or special meetings shall be convened at the summons of the board of directors in the manner prescribed in the bylaws of the company.
The board of directors must call a regular general meeting, if so requested by the auditor or by a number of stockholders representing at least 5% of the capital. The General Department of Companies may, at the request of a number of stockholders representing at least 2% of the capital, "or pursuant to a decision by the Minister of Commerce" call a general meeting if such meeting is not called within one month from the date set therefor.

Article 88: "Notices of general meetings shall be published in the Official Gazette and in a daily newspaper distributed in the locality of the head office of the company, at least twenty-five days prior to the date set for the meeting. Nevertheless, if all the stock of the company is registered (nominative), a notice sent by registered mail at least twenty-five days before the date of the meeting shall suffice. The notice shall contain an agenda (of the meeting). A copy of both the notice and the agenda shall be sent to the General Administration for Companies at the Ministry of Commerce within the period specified for publication."

Article 89: "The board of directors shall, at least sixty days prior to the date set for the holding of the annual general meeting, prepare for every financial year of the company a balance sheet, a profit and loss statement, and a report on the company's operations and financial position and on the method which it proposes for the distribution of net profits. The said documents shall be signed by the chairman of the board of directors, and copies thereof shall be placed at the disposal of stockholders the head office of the company at least twenty-five days prior to the date set for such general meeting. The chairman of the board of directors must publish, in a newspaper distributed in the locality, in a newspaper distributed in the locality of the head office of the company, the balance sheet, the profit and loss statement, a comprehensive summary of the board of directors report, and the full text of the auditor's report, and must send a copy of each of these documents to the General Administration for Companies at least twenty-five days prior to the date set for the general meeting."

Article 90: Stockholders wishing to attend a general or special meeting shall register their names at the head office of the company (and may do so) up to the time fixed for such meeting, unless the bylaws of the company provide otherwise. When the meeting convenes, a list shall be prepared of the names and residence addresses of the stockholders present or represented thereat, showing the number of shares held by each, whether personally or by proxy, and the number of votes allotted thereto. Any interested party shall be entitled to review this list.
Article 91: The regular general meeting shall be valid only if attended by stockholders representing at least one half of the company's capital, unless the bylaws of the company provide for a higher proportion. If this quorum does not obtain at a first meeting, a notice shall be sent for a second meeting to be held within thirty days of the previous meeting. This notice shall be published in the manner prescribed in Article 88. The second meeting shall be considered valid, regardless of the number of shares represented thereat.

Resolutions of the regular general meeting shall be adopted by absolute majority vote of the shares represented thereat, unless the bylaws of the company provide for a higher proportion.

Article 92: An extraordinary general meeting shall be valid only if attended by stockholders representing at least one half of the company's capital, unless the company's bylaws provide for a higher proportion. If this quorum does not obtain at the first meeting, a notice shall be sent for a second meeting in the manner prescribed in Article 91. The second meeting shall be valid if attended by a number of stockholders representing at least one quarter of the company's capital.

Resolutions of an extraordinary general meeting shall be adopted by a two-thirds majority vote of the shares represented thereat. But if a resolution pertains to an increase or a decrease in capital, or to extension of the term of the company, or to dissolution of the company prior to expiry of the term specified in its bylaws or to merger of the company into another company or firm, it shall be valid only if adopted by a three-fourths majority vote of the shares represented at the meeting.

The board of directors must publish, in accordance with the provisions of Article 65, the resolutions adopted by an extraordinary general meeting if these provide for alteration of the company's bylaws.

Article 93: The company's bylaws shall prescribe the manner of voting at stockholders meetings. Nevertheless, directors may not participate in voting on resolutions of a meeting pertaining to their relief from liability for their administration.

Article 94: Every stockholder shall have the right to discuss the matters listed in the agenda of a (general) meeting, and to address questions to the directors and the auditor in respect thereof. Any provision in the company's bylaws depriving a stockholder of this right shall be considered null and void. The directors or the auditor shall answer stockholders' questions to such an extent as would not jeopardize the company's interests. If a stockholder feels that the answer to a question put by him is unsatisfactory, he may appeal to the (general) meeting whose decision shall be final in this respect.
Article 95: Minutes shall be kept for every (general) meeting, showing the names of stockholders present or represented (thereat), the number of shares held by (each of) them, whether personally or by proxy, the number of votes allotted thereto, the resolutions adopted, the number of consenting and dissenting votes, and a comprehensive summary of the debate conducted at the meeting.

Following every meeting, the minutes shall be regularly entered in a special book, which shall be signed by the chairman, the secretary, and the teller of the meeting.

Article 96: Subscription for or ownership of stock shall imply that the (subscriber or) stockholder accepts the company's bylaws and will abide by the resolutions adopted by stockholders meetings in conformity with the provisions of these Regulations and the company's bylaws, whether in his presence or absence, and whether he has voted for or against them.

Article 97: "Without prejudice to the rights of any bona fide third party, all resolutions adopted by stockholders' meetings contrary to the provisions of these Regulations or of the company's bylaws shall be considered null and void. The General Administration for Companies and any stockholder who has recorded his objection to the resolution in the minutes of the meeting or who was absent from the meeting for acceptable reason, may request to invalidate a resolution. A resolution adjudged invalid shall be considered nonexistent as far as all stockholders are concerned. Nevertheless an action invalidation (of a resolution) shall be barred after the lapse of one year from the date of such resolution"
CHAPTER IV
WARRANTS ISSUED BY CORPORATIONS
SECTION I - STOCK

Article 98: Shares of stock of companies shall be indivisible as far as the company is concerned. If a share is jointly owned by several persons, these must elect one of their number to exercise the rights attached to such share on their behalf, but they shall be jointly liable for (all) the obligations arising from such ownership. Shares may not be issued at less than par value. But they may be issued at a premium if the company's bylaws so provide or if this is approved by a general meeting, in which case the differential shall be added to the statutory reserve, even if it has reached the maximum limit prescribed in these Regulations.

The preceding provisions shall apply to interim certificates given stockholders before the issue of share warrants.

Article 99: (The shares of) the company may be (issued) either for cash or for contributions in kind. The class of the share shall be stated on the face of the relative warrant.

A share may be (issued) to a registered holder or to "bearer". (In the former case) it must remain registered to a holder until its value has been paid up in full.

Share warrants shall state the amount paid up on the shares they comprise. Interim certificates shall remain registered in the holder's name until they are exchanged for share warrants.

Article 100: Cash shares subscribed for by the founders and shares for contributions in kind, as well as founders' shares shall not be negotiable before the publication of the balance sheet and the profit and loss statement for two complete financial years, each consisting of at least twelve months as from the date of incorporation of the company. A notation shall be made on the respective share warrants, indicating their class, the date of incorporation of the company, and the period during which their negotiability shall be suspended.

Nevertheless, during the period of suspension title to shares issued for cash may, in accordance with the legal provisions for the sale of rights, be transferred from one founder to another, or to a director who will submit them as qualification shares, or from the heirs of a deceased founder to a third party.

The provisions of this Article shall also apply to such shares as the founders may subscribe for in case of an increase of capital before the expiry of the period of suspension.

Article 101: The Company's bylaws any Provide for (The imposition of) restrictions on the negotiability of shares provided these do not (Permanently) prohibit such negotiability.
Article 102: Registered shares shall be transferred by means of an entry in the stockholders' register kept by the company, which contains the stockholders' names, nationalities, residence addresses, and occupations; the (serial) numbers of the shares (held by them); and the amounts paid up on such shares. An annotation shall be made on the share warrant to the effect that such entry was made. A transfer of title to any registered share shall be effective as far as the company or third parties are concerned only from the date of its entry in the said register. Shares to bearer are transferable by mere delivery.

Article 103: Shares shall carry equal rights and obligations. Nevertheless, a general meeting may, in the absence of any restraining provision in the company's bylaws, resolve to issue preferred shares of stock or to convert common shares to preferred shares of stock.

Preferred shares may vest their holders with priority in receiving a certain dividend and/or in recovering their paid-in capital upon liquidation, or with any other benefit, but no multiple-vote shares may be issued.

If the capital includes preferred shares, no new shares with prior preference to these may be issued except with the consent of a special meeting, formed in accordance with Article 86, of the holders of the preferred shares who would be injured by such issue, and with the consent of a general meeting representing all classes of stockholders, unless the company's bylaws provide otherwise. This rule shall also apply upon alteration or cancellation of the priorities established in favor of preferred stock in the bylaws of the company.

Article 104: The company's bylaws may provide for the redemption of shares while the company is a going concern, if the enterprise is (of the) gradually exhaustible (type) or is based on temporary rights.

Shares shall be redeemed only out of profits or of a disposable reserve fund. Redemption shall be effected successively, either by way of an annual draw, or by any other method insuring equality among stockholders. Redemption may be effected by the company's purchasing its own shares either at a discount or at par value. The company shall destroy the shares so obtained.

The company's bylaws may also provide for granting actions de jouyssance (reimbursed shares) to the holders of the shares redeemed by lot. The company's bylaws shall determine the rights which such shares vest in their holders.

Nevertheless, a certain percentage of the annual net profits must be set aside for distribution to (the holders of) unredeemed shares by priority over (the holders of) actions de jonissance. Upon the dissolution of the company, the holders of unredeemed shares shall have priority in receiving the par value of their shares out of the company assets.
Article 105: The company may purchase its own shares only in the following cases:

TRANSLATOR’S NOTE: A share on which the original capital contribution has been repaid. Normally, it differs from a capital share in that its holder has no further claim, upon liquidation, to a return of the capital contribution.

1. If the object of the purchase is to redeem the shares in accordance with the terms set forth in the preceding Article.
2. If the object of the purchase is to reduce the capital.
3. If the shares are part of an estate whose assets and liabilities are to be purchased (as a whole) by the company.

With the exception of the shares submitted as a pledge against directors' liability (i.e. the directors' qualification shares), the company may not accept its own stock as security, and the shares held by the company shall not have any votes in the deliberation of stockholders meetings.

Article 106: The company's bylaws may provide for the distribution to stockholders of a fixed rate (of dividend) not exceeding 5% of the capital for a period of not more than five years from the date of incorporation of the company. In the absence of net profits sufficient for payment of the said rate, any such dividends received by stockholders shall be considered part of the company's preliminary expenses and shall be deducted in the manner prescribed by the company's bylaws from the first profits (realized).

Article 107: A stockholder shall exercise the right of voting at general or special meetings in accordance with the provisions of the company's bylaws. Any stockholder entitled to attend stockholders meetings shall have at least one vote. The company's bylaws may prescribe a maximum for the number of votes vested in the holder of several shares.

Article 108: A stockholder shall be vested with all the rights attached to shares, specifically the right to obtain a share in the profits declared for distribution, the right to obtain an equity in the company's assets upon liquidation, the right to attend stockholders meetings and participate in the deliberations and vote on the resolutions (proposed) thereat, the right to dispose of his shares the right of access to the company's books and documents, and the right to control the acts of the board of directors, to institute the action in liability against the directors, and to contest the validity of the resolutions adopted at stockholders meetings, in accordance with the terms and restrictions set forth in these Regulations or in the company's bylaws.

Article 109: Stockholders representing at least 5% of the company's capital may request the Commission for the Settlement of Commercial Companies' Disputes to
investigate (the affairs of) the company if the acts performed by directors or auditors (in the conduct) of the company's affairs have aroused their suspicion. After hearing the directors and the auditors in camera, the said Commission may order an investigation of the company's management at the expense of the complainants, whom it may, if necessary require to submit aguarantec if it is proven that the complaint is valid, the Commission may order such precautionary measures as it deems fit and call a general meeting to adopt the necessary resolutions. In cases of extreme necessity, it may remove the directors and auditors, appoint a temporary manager, and specify his powers and the term of his commission.

Article 110 : A stockholder is obligated to pay the value of (his) share on the dates set for such payment. Successive owners of a share shall be jointly liable for the payment of the value of such share. With the exception of the last holder, all of them shall be relieved of this liability after the lapse of one year from the date of registration of the transfer (transaction) in the stock register.

If a stockholder defaults in payment (of a call) when it becomes due the board of directors may, after giving him notice, by registered letter, sell the share at a public auction. Nevertheless, a defaulting stockholder may, up to the date fixed for the (public) auction, pay the amount due from him plus(all) the expenses incurred by the company.

The company shall recover from the proceeds of the sale such amounts as are due to it and shall refund the balance to the stockholder.

If the proceeds of the sale fall short of the amounts (due), the company shall have a claim on the entire fortune of the stockholder for the unpaid balance. The company shall cancel the share so sold issue the purchaser a new share (certificate) bearing the serial number of the cancelled share, and make a notation to this effect in the stock register.

Article 111 : The company shall not require any stockholder to pay sums in excess of the amount to which he has committed himself upon the issue of his share, even if the company's bylaws provide otherwise.

Nor may a stockholder recover his interest in the capital of the company.

The company may not release any stockholder from his liability for the unpaid balance of the value of his share. Nor may this liability be offset against any rights due to the stockholder from the company.

366
SECTION II - FOUNDERS' SHARES

Article 112: A corporation may, on the basis of a provision in its bylaws, issue founders' shares to any person who, upon or after its incorporation, provides it with a patent right on an invention or with a franchise secured from a public juristic person. These shares may be (issued) to a registered holder or to bearer, and shall be negotiated in accordance with the provisions of Articles 100, 101, and 102. The shall not be divisible in the sense contemplated in Article 98.

Article 113: Founders' shares shall not enter in the formation of the company's capital. Nor may their holders participate in the administration of the company, or in the preparation of accounts, or in stockholders meetings. They shall be subject to such resolutions as may be adopted by stockholders meetings in accordance with the provisions of these Regulations or of the company's bylaws, including those concerning depreciation and reserve funds, of whatever type and amount, extension of the company's term, dissolution of the company before the expiry of its specified term, increase or reduction of capital, redemption of capital stock, purchase of company stock, or the issue of shares with priority over profits.

Nevertheless, if the resolutions adopted by stockholder meetings entail alteration or cancellation of the rights attached to founders' shares, such resolutions shall be valid only if approved by the holders of such shares at a meeting convened in accordance with the provisions governing stockholders special meetings.

The holders of founders' shares may, in accordance with the provisions of Article 97, contest the validity of resolutions of stockholders general or special meetings, if adopted in violation of the provisions of these Regulations or of the company's bylaws.

Article 114: With due regard to the provisions of the preceding Article, the company's bylaws or the general meeting's resolution creating founders' shares shall specify the rights attached thereto. Such shares may be granted a proportion of the net profits not exceeding 10% after distribution of a dividend of not less than 5% of the paid-in capital to stock holders. Upon liquidation, they may also be granted priority at the said percentage over the stockholder's equity in the company assets after payment of its debts.

Article 115: A stockholders general meeting may, by resolution and after the lapse of ten years from the date of their issue, cancel founders' shares in consideration of fair compensation.

The company may also at all times and out of its net profits purchase founders' shares, either at market price or at such price as may be agreed upon with the holders of this class of shares at a special meeting convened in accordance with the provisions of Article 86.
SECTION THREE - BONDS

Article 116: A corporation may issue against the loans contracted by it indivisible negotiable bonds of equal value. These bonds may be (issued) to a registered holder or to bearer. But a bond must remain registere to a holder until its value has been paid up in full.

Bonds issued (in respect of) a single loan shall confer equal rights (upon the holder thereof). Any provision to the contrary shall be considered nonexistent.

Article 117: Bonds may be issued only in accordance with the following conditions:
1. That the issuance of bonds be authorized in the company's bylaws.
2. That a regular general meeting adopts a resolution for their issuance.
3. That the company's capital be paid up in full.
4. That the value of the bond issue not exceed the value of the paid-in capital.

No new (series of) bonds may be issued unless the subscribers for the old bond issue have paid up the value of such bonds in full, and provided the value of the new bond issue plus the amount still due from the company under a previous bond issue shall not exceed the paid-in capital.

The provisions of the preceding paragraph shall not apply to real estate credit companies, to agricultural or industrial credit banks, or to companies so authorized by the Minister of Commerce.

Article 118: The general meeting may authorize the board of directors to specify the amount and terms of the loan (to be secured by a bond issue). But a resolution of the (general) meeting authorizing a bond issue shall be valid only after it has been registered in the Commercial Register and published in the Official Gazette.

Article 119: Bonds offered for public subscription must be so offered through one of the banks to be designated by the Minister of Commerce. The invitation to the public for subscription shall be effected by means of a prospectus signed by the directors, specifically containing the following particulars:
1. The resolution adopted by the general meeting authorizing the bond issue, and the date of its publication.
2. The number of bonds authorized and their value.
3. The dates set for opening and closing the subscription.
4. The date of maturity of the bond series and the terms and securities for its payment.
5. The value of any bond series previously issued, the relative securities therefor, and the value of its bonds (remaining) outstanding at the time of issue of the new bond series.

TRANSLATOR'S NOTE: Articles 118 and 119 were published in Umm al-Qura No. 2083 as a single long article numbered 118. An announcement in Umm al-Qura No. 2084 drew attention to this error and indicated where two Articles were to be separated.
6. The (authorized) and the paid-in capital of the company.
7. The head office of the company, the date of its incorporation, and its term.
8. The value of the contributions in kind.

The prospectus shall be published in a daily newspaper distributed in the locality of the head office of the company, at least five days prior to the date set for opening the subscription.

The bond subscription document, (the bond warrants), and (all) the advertisements and notices related to the bond issue shall set out all the particulars stated in the prospectus and mention the newspaper in which it was published.

Article 120: The directors must, within thirty days of the subscription closing date, submit to the General department of Companies a statement containing the number of bonds subscribed for, their value, and the amount paid up on them, and accompanied by a list of the names of subscribers and the number of bonds subscribed for by each.

Article 121: Violation of Articles 116, 117, and 119 shall entail invalidity (of the bond issue), in which case the company shall be obligated to refund the value of the invalid bonds and to pay damages to the holders thereof for the harm sustained.

Article 122: Resolutions of stockholders meetings shall apply to bondholders. Nevertheless, such meetings may not alter the rights established in favor of bondholders, except with their consent by a resolution adopted at a special meeting of such bondholders, held in accordance with the provisions of article 86. The provisions of Article 110 shall apply in case of any default in payment of the value of a bond.
CHAPTER V
FINANCES OF A CORPORATION
SECTION I - COMPANY ACCOUNTS

Article 123: At the end of every financial year the board of directors shall make an inventory of the value of the company assets and liabilities as of that date and shall prepare a balance sheet of the company, a profit and loss statement, and a report on its operations and financial position for the expired financial year, setting out the proposed method for the allocation of net profits. The board shall put the said documents at the disposal of the auditor at least fifty-five days prior to the date set for the general meeting.

Article 124: In classifying the accounts in the balance sheet and the profit and loss statement in every (financial) year, the classification used in the previous years shall be observed, and the bases of evaluation of assets and liabilities shall remain unchanged, unless the general meeting resolves at the recommendation of the auditor to alter such classification or evaluation bases.

Article 125: The board of directors shall in each up a set aside 10% of the net profits to build up a reserve fund to be called the statutory reserve. The regular general meeting may resolve to stop such deduction when the said reserve amounts to one half of the capital.

The company's bylaws may also provide for the setting aside of a certain percentage of the net profits to build up a reserve fund to be called the contractual reserve, which shall be used solely for such purposes as may be specified in the said bylaws.

The regular general meeting may, in determining the dividend (payable to stockholders) out of the net profits, resolve to create other reserves in such an amount as to insure continued prosperity for the company or the payment of as steady dividends as possible to stockholders.

The said (general) meeting may also withhold certain amounts from the net profits for the creation of social (service) organizations for the company's employees and workmen, or for supporting such organizations as may already be in existence.

If there are any such organizations financed (partly) by company contributions and (partly) by withholdings from the salaries and wages of employees and workmen, the latter may upon termination of their employment contracts recover the amounts so withheld from their pay, to the extent of such benefits provided for in the bylaws of the social organizations as they may be deprived of (as a result of such termination).
Article 126: The statutory reserve shall be used for meeting the company's losses or for increasing its capital. If the said reserve exceeds one half of the company's capital, the regular general meeting may resolve to distribute such excess (as dividends) among the stockholders in the years during which the company fails to realize sufficient net profits for distribution of the dividends prescribed in the company's bylaws.

The contractual reserve may be used only by resolution of an extraordinary general meeting. If such reserve is not earmarked for a specific purpose, the regular general meeting may upon the recommendation of the board of directors resolve to spend it in any way beneficial to the company.

Article 127: The company's bylaws shall specify the percentage to be distributed among stockholders out of the net profits, after deduction of the statutory and the contractual reserves provided this percentage is not less than 5% of the capital.

A stockholder shall be entitled to his share in the profits (i.e. dividends) as soon as the general meeting adopts a resolution on the allocation (of profits).

Article 128: The directors must, within thirty days of the date of approval by the general meeting of the balance sheet, the profit and loss statement, the board of directors' report and the auditor's report file copies of the said documents with the Commercial Register office and with the General Department of Companies.

SECTION II
THE AUDITOR

Article 129: Stockholders shall exercise control over the company's accounts, in accordance with the provisions of the company's bylaws and subject to the following provisions:

Article 130: The regular general meeting shall appoint one or more auditors from among those licensed to operate in the Kingdom and shall specify their remuneration and term of office. It may re-appoint auditors or at any time remove them, without prejudice to their right to compensation if the removal is made at an improper time or without acceptable justification.

No person may hold the office of auditor and (at the same time) take part in organizing the company, be a director thereof, or perform any technical or administrative work for the company, even in an advisory capacity. Nor may an auditor be a partner or an employee of, or be related within four degrees of consanguinity to any founder or director of the company. Any act violating the provisions of this paragraph shall be null and void, and the violator shall be obligated to remit to the Ministry of Finance and National Economy whatever he may have received from the company.
Article 131: The auditor shall at any time have access to the company's books, records and other documents. He shall be entitled to request such particulars and clarifications as he may deem it necessary to obtain, and to verify the assets and liabilities of the company.

The chairman of the board of directors must enable the auditor to perform his duty as specified in the preceding paragraph. If the auditor encounters any difficulty in this respect, he shall state that fact in a report to be submitted to the board of directors. If the board fails to facilitate his task, the auditor must call a regular general meeting to look into the matter.

Article 132: The auditor must submit a report to the annual regular general meeting, setting forth the attitude of the company's management in enabling him to obtain the particulars and clarifications requested by him, any violations of the provisions of these Regulations or of the company's bylaws he may have discovered, and the extent in his opinion to which the company's accounts are in conformity with reality.

The auditor's report shall be read at the general meeting. If the (general) meeting resolves to approve the board of directors' report without hearing the auditor's report, its resolution shall be considered null and void.

Article 133: The auditor may not disclose to stockholders outside a general meeting, or to third parties, such secrets of the company as may have come to his knowledge by reason of the performance of his work; otherwise, he must be removed and shall be held liable for damages.

The auditor shall be liable for damages sustained by the company, the stockholders, or third parties as a result of mistakes he makes in the performance of his duties. If a mistake is attributable to more than one auditor, they shall (all) be jointly responsible (therefor).
CHAPTER VI
ALTERATION OF THE COMPANY'S CAPITAL
SECTION I - INCREASE OF CAPITAL

Article 134: An extraordinary general meeting may resolve
to increase the company's capital one or more times,
provided the initial capital has been paid up in full.

Article 135: Capital shall be increased in one of the following
ways:
1. Issue of new shares payable in cash.
2. Issue of new shares against contributions in kind.
3. Issue of new shares (as fully paid up) against debts of a
   specific amount due and payable by the company.
4. Issue of new shares in the amount of the surplus reserve
   which an extraordinary general meeting resolves to
capitalize, or increase of the par value of the outstanding
   shares by the amount of such surplus (reserve).
5. Issue of new shares in lieu of founders' shares or
   outstanding bonds.

Article 136: "Stockholders shall have a pre-emptive right to
subscribe for new cash shares, unless the company's bylaws
provide for their waiver of this right or for its restriction. The
Council of Ministers, on the recommendation of the Minister
of Commerce, after agreement with the Minister of finance
and National Economy, may cancel or restrict the pre-
emptive right in respect of the following companies:

(a) Concessionary companies
(b) Companies that manage a public utility.
(c) Companies that receive subsidy from the Government
participates.
(e) Companies that are engaged in banking activities.

The provision of this paragraph shall apply to
companies even though they may have been established
before its effective date.

This article shall not apply to petroleum and mineral
companies which operate under special agreements issued by
Royal Decrees".

The stockholders shall be advised of their preemptive
right to subscribe. (This advice shall be given) by (means of)
a notice (to be published) in a daily newspaper reporting the
resolution to increase the capital and setting forth the
conditions of subscription. But if all the company stock is
registered, the notice may be served on the stockholders by
registered letters.

Every stockholders wishing to exercise his preemptive
right shall express his desire (to do so) in writing within
fifteen days of the date of publication or service of the notice
referred to in the preceding paragraph.
The (new) shares shall be allotted to the subscribing original stockholders in proportion to the original shares held by each, provided that the number of shares allotted to (any of) them shall not exceed the number of new shares or which he has subscribed. The balance of the new share (issue) shall be allotted to the original stockholders who have subscribed for more than their share in proportion to the number of original shares held by each, provided that their total allotment shall not exceed the number of new shares for which they have subscribed.

The remainder of the new shares shall be offered for public subscription, in accordance with the provisions governing subscription for the capital of a company under formation.

When new shares are offered for public subscription, the chairman of the board of directors and the auditor shall sign the prospectus, which shall specifically include the following particulars:
1. The (text) and the date of the resolution of the extraordinary general meeting to increase the capital.
2. The company’s capital on the date of issue of the new shares, the amount of the proposed increase, the number of new shares, and the issue premium, if any.
3. A description of the contributions in kind.
4. A statement of the average dividends distributed by the company during the two years preceding the resolution to increase the capital.

Article 137: Shares representing contributions in kind that are issued on the occasion of a capital increase shall be governed by the provisions for the evaluation of contributions in kind made at the time of organization of the company (except that) the regular general meeting shall act in place of the constituent general meeting.

Article 138: If the new cash shares are issued in satisfaction of debts of a specific amount due and payable by the company, the board of directors and the auditor must prepare a statement on the origin and amount of such debts. The statements shall be signed and certified by the directors and the auditor.

Article 139: If the capital increase is effected by the capitalization of surplus reserves, the new shares must be issued in the same form and under the same terms as the outstanding shares. They shall be distributed free to stockholders in proportion to the number of the original shares owned by each.

If the said surplus reserve includes amounts withheld from the dividends allocated to holders of founders’ shares, the latter must be called to a special meeting, in accordance with the provisions of Article 86, to approve the capitalization of their share in the surplus reserve and to determine the number of new shares to be allotted to them. If such approval is withheld, the capital increase shall include only that part of the surplus reserve belonging to the holders of (common) stock.
Article 140: Capital may not be increased by the conversion of founders' shares to (common) stock, except after the lapse of the period prescribed in Article 100, and provided such conversion is approved by the holders of such shares in accordance with the provisions of Article 86.

The stock issued in lieu of such cancelled (founders') shares shall be negotiable as of the date of its issue.

Article 141: Bonds may not be converted to shares, unless such conversion is provided for in the terms of their issue. Nevertheless, in such case, the bondholder shall have the option of either accepting the conversion or receiving the par value of the bond.

SECTION II
REDUCTION OF CAPITAL

Article 142: An extraordinary general meeting may resolve to reduce the company's capital if it exceeds the company's needs or if the company incurs losses. In the latter case only, the capital may be reduced below the minimum specified in Article 49.

The resolution for reduction shall be adopted only after a reading of the auditor's report setting forth the reasons necessitating the reduction, the liabilities of the company, and the effect of the reduction on these liabilities.

Article 143: If the reduction of capital is due to an excess in capital over the company's need, the creditors must be invited to express their objections within sixty days from the date of publication of the resolution for reduction in a daily newspaper distributed in the locality of the head office of the company. If any creditor objects (to the reduction) and submits to the company, within the said period, the documents substantiating his claim, the company must pay off his debt of it is due and payable or submit adequate security for its payment if it is payable at a future date.

Article 144: Reduction of capital may be effected in one of the following ways:
1. Refunding a part of the par value per share to the stockholder, or releasing him from liability for all or part of the unpaid amount on such value.
2. Reducing the par value per share by the equivalent of the amount of the loss incurred by the company.
3. Cancelling a number of shares equivalent to the amount of the proposed reduction.
4. Purchasing a number of shares equivalent to the amount of the proposed reduction.

Article 145: If reduction of capital is effected by the cancellation of a number of shares, equality must be observed among stockholders. Holders of the shares to be cancelled must surrender them to the company within the period specified by it; otherwise, the company shall have the right to consider them cancelled.
Article 146: If the reduction of capital is to be effected by way of purchase and cancellation of a number of the company's shares, the stockholders must be requested to offer their shares for sale. The request shall be published in a daily newspaper distributed in the locality of the company's head office. However, if all the company's shares are registered, the stockholders may be notified by registered letter of the company's desire to purchase the shares.

If the number of shares offered for sale exceeds that which the company has resolved to purchase, the offers for sale must be reduced proportionately to such excess.

The purchase price of shares shall be determined in accordance with the provisions of the company's bylaws. In the absence of any provisions in this respect in the bylaws, the company must pay a fair price.

CHAPTER VII
DISSOLUTION OF A CORPORATION

Article 147: If a corporation is dissolved as a result of the transfer of all its stock to a single stockholders, the latter shall be responsible for the company's debts to the extent of its assets.

Upon the lapse of one complete year from the date on which the number of stockholders falls below the minimum specified in Article 48, any interested party may request the dissolution of the company.

Article 148: If the losses of a corporation total three quarters of its capital, the directors must call an extraordinary general meeting to consider whether the company shall continue (to operate) or be dissolved before the expiry of the term specified in its bylaws. In all cases, the resolution shall be published in the manner prescribed in Article 65.

If the directors fail to call an extraordinary general meeting, or if such meeting is unable to adopt a resolution on the subject, any interested party may request the dissolution of the company.
APPENDIX 2

'INTERVIEW QUESTIONNAIRE FOR PRIVATE SHAREHOLDERS'

SECTION A:

A1. EDUCATION :

[ ] High School (1)
[ ] University (2)
[ ] Postgraduate (3)

A2. SEX :

[ ] Male (1)
[ ] Female (2)

A3. OCCUPATION :

[ ] Government employee (1)
[ ] Private Sector employee (2)
[ ] Self employed (3)

A4. ANNUAL INCOME :

[ ] Less than SR. 50,000 (1)
[ ] SR. 50,000 - SR 100,000 (2)
[ ] More than SR. 100,000 (3)

A5. DO YOU BUY AND SELL SHARES REGULARLY?

[ ] Yes (1)
[ ] No (2)
**A6. HOW MANY COMPANIES DO YOU HOLD SHARES IN?**

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<td>[ ]</td>
<td>11 - 20</td>
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<td>[ ]</td>
<td>20+</td>
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[ ] How many Saudi's and Overseas?

**A7. WHAT IS THE TOTAL VALUE OF SHARES THAT YOU OWN?**

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<td>SR. 50,000 - SR 100,000</td>
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<td>SR. More than 100,000</td>
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**A8. DO YOU MAKE YOUR OWN INVESTMENT DECISIONS?**

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<td>[ ]</td>
<td>No</td>
<td>[please specify who does]</td>
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**SECTION B:**

**B1. WHICH OF THE FOLLOWING IS YOUR MOST PREFERRED TYPE OF INVESTMENT?**

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<tr>
<td>[ ]</td>
<td>Real estate</td>
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<td>Shares</td>
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<td>Other investments</td>
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**B2. WHEN BUYING SHARES WOULD IT BE FOR:**

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<td>Dividend</td>
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<td>Capital gain</td>
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<td>[ ]</td>
<td>Both 1 &amp; 2</td>
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<td>[ ]</td>
<td>Other</td>
<td>[please specify]</td>
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B3. WHAT PIECES OF FINANCIAL INFORMATION ABOUT COMPANIES DO YOU CONSIDER TO BE IMPORTANT TO YOU AS A SHAREHOLDER? [please give details]

B4. WHEN SELECTING A COMPANY TO INVEST IN WOULD YOU SELECT:

[ ] Randomly (1)
[ ] As recommended by others [please specify] (2)
[ ] According to your own evaluation (3)
[ ] 2 & 3 (4)
[ ] Other [please specify] (5)

B5. WHEN BUYING SHARES WOULD YOU PREFER TO BUY YOUR SHARES FROM:

[ ] The primary market (1)
[ ] The secondary market (2)
[ ] Both markets (3)

B6. WHAT IS (OR ARE) THE MAIN PURPOSE(S) OF THE FINANCIAL STATEMENTS CONTAINED IN THE COMPANY ANNUAL FINANCIAL REPORT AND WHICH IS THE MOST IMPORTANT ONE? [Give ranking if more than one].

[ ] To make company directors accountable to shareholders (1)
[ ] To give shareholders an indication of the value of the company (2)
[ ] To give shareholders data of use for investment decisions (3)
[ ] To justify the dividend payments proposed by the company (4)
[ ] Any other ............[please specify] (5)

The most important one is.............................

[ ] Chairman's report (1)
[ ] Report of directors (2)
[ ] Profit and loss account (3)
[ ] Balance sheet (4)
[ ] Auditors report (5)
[ ] Notes to accounts (6)
[ ] Statistical data (7)

B8. WHAT DO THE FOLLOWING TERMS MEAN TO YOU?

[ ] Profit (1)
[ ] Dividend yield (2)
[ ] Dividend cover (3)

B9. CAN YOU DESCRIBE BRIEFLY WHAT YOU WOULD UNDERSTAND BY THE FOLLOWING TERMS COMMONLY USED IN COMPANY ANNUAL FINANCIAL REPORTS?

[ ] Depreciation (1)
[ ] Current assets (2)
[ ] Reserves (3)
[ ] Accrued charges (4)

B10. WHEN EVALUATING A COMPANY TO INVEST IN, WHICH OF THE FOLLOWING DO YOU CONSIDER? PLEASE GIVE RANKING:

[ ] Company age (1)
[ ] Company sector (2)
[ ] Company capital (3)
[ ] Company performance [profit] (4)
[ ] Distributed dividend (5)
[ ] Share market price (6)
[ ] Historical market price trend (7)
[ ] Other ......................... (8)
B11. WHAT FINANCIAL DATA DO YOU USE TO ASSESS THESE FACTORS?

- [ ] Profitability
- [ ] Potential bankruptcy
- [ ] Capacity to survive
- [ ] Managerial efficiency
- [ ] Investment policy of the company

B12. WHEN MAKING AN INVESTMENT DECISION, WHICH SORT OF INFORMATION DO YOU CONSIDER VALUABLE AND USEFUL TO LOOK FOR FROM THE FOLLOWING SOURCES AND IN WHAT RANKING?

- [ ] News in daily press (1)
- [ ] News in financial press (2)
- [ ] Inquiries to share department in banks (3)
- [ ] SAMA share price (4)
- [ ] Company annual report (5)
- [ ] Personal contacts (6)
- [ ] Others (7)

B13. ARE YOU INTERESTED IN LOOKING AT COMPANY'S ANNUAL FINANCIAL REPORTS?

- [ ] Very interested (1)
- [ ] Quite interested (2)
- [ ] Not interested (3)

B14. WHEN LOOKING AT THE COMPANY'S ANNUAL REPORT DO YOU FIND THE CONTENTS DIFFICULT TO UNDERSTAND?

- [ ] Yes (1)
- [ ] Some difficulty [which item do you find difficult?] (2)
- [ ] No (3)
B15. HAVE YOU EXPERIENCED ANY OF THE FOLLOWING WHEN READING COMPANY REPORTS?

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<td>Variation in account classification</td>
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<td></td>
<td>Problems with accounting terminology</td>
<td>(2)</td>
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<td></td>
<td>Variations of format and layout of report</td>
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B16. DO YOU CONSIDER THE FINANCIAL RESULTS WHICH ARE ANNUALLY REPORTED TO YOU BY COMPANIES TO BE:

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<td>An accurate reflection of their financial progress and position</td>
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<td>A reasonable approximation of their financial progress and position</td>
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<td>An inaccurate reflection of their financial progress and position</td>
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B17. DO YOU BELIEVE THE FOLLOWING CONCEPTS:

*There is risk involved in share investment

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*Share market price might go down as well as up

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B18. WHICH OF THE FOLLOWING BEST DESCRIBE THE INVESTMENT INFORMATION AVAILABLE TO INVESTORS IN SAUDI MARKET PLEASE RANK THEM IN ORDER.

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<td>Comprehensive</td>
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<td>Easy to understand</td>
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<td>Incomplete</td>
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<td>Useless to ordinary investor</td>
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<td>Not realistic to some extent</td>
<td>(6)</td>
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</table>
B19. IS THERE ANYTHING IN PARTICULAR IN THE PRESENT FORM OF COMPANY ANNUAL FINANCIAL REPORT WHICH YOU DO NOT FULLY UNDERSTAND?

B20. IS THERE ANY ADDITIONAL FINANCIAL INFORMATION WHICH YOU THINK INVESTORS OR SHAREHOLDERS SHOULD BE GIVEN IN COMPANY ANNUAL FINANCIAL REPORTS? IF SO, PLEASE RANK THEM IN ORDER OF IMPORTANCE.

[ ] Budgets (1)
[ ] Profit forecasts (2)
[ ] Current value accounts (3)
[ ] Funds flow statements (4)
[ ] Cash flow statements (5)
[ ] Human resource statements (6)
[ ] Increased disclosure of existing financial informations (7)
[ ] Other [please specify] (8)
Bibliography


Boursat Al-Aorag Al-Malah Al-Mosahimah, Riyadh: Research Department at Riyadh Chamber of Commerce and Industry. (Published in Arabic).


