CORPORATE GOVERNANCE FROM THE PERSPECTIVE OF THE PAST AND THE PRESENT AND THE NEED TO FILL AN INTERNATIONAL GAP

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Abstract

Corporate governance (CG) emerged many centuries ago, despite the debate on this subject and the widely-held view that it commenced in the 2000s. Thus, CG is not a new practice and over time it has become a precise system. In this study, the origins of CG are examined by the author in order to shed light on the underlying facts concerning the roots of this discipline and its history. By introducing such facts, it provides the background of the emergence of CG as clear principles and mechanisms. In the organizational sense, this study is considered important for both investors and organizations in applying the principles of CG and its mechanisms in all countries worldwide. The objective of this paper is to provide useful information to both researchers and practitioners in relation to CG including the fundamental principles and its history. This paper will present a solution to fill the gap in the literature concerning the relationship between CG and a firm's performance in such instances when the results of examining such a relationship are found to be inconsistent. A number of factors have contributed to this author's desire to research the relationship between a firm's performance and CG and that includes the author's experience and understanding of accounting over the years especially in the CG discipline, and also further to an in-depth literature review.

Keywords: History; Agency Theory, Corporate Governance, a Firm's Performance, Non-Financial Measurements, Jordan

1. INTRODUCTION

The practice of corporate governance (CG) in organizations has developed rapidly in recent times, and worldwide its significance has been increasingly highlighted. It has even been noted by countries which have yet to adopt CG in their organizations, and where possible CG is adopted and implemented in those countries. The rationale for the worldwide interest in CG is that CG underpins a firm's operating framework. Therefore, adoption and implementation of the practice of CG is expected to the benefit the owners. With the owners being committed to using CG principles and mechanisms, in the widest sense this can equate to an effective monitoring of a firm's activities particularly when disclosure and transparency principles are adopted. Accordingly, by adopting and implementing CG in firms, this decision can positively impact on the current and potential investors' investment-related decisions, on the one hand, and on the value of the firm on the other (Brennan & Solomon, 2008; Hebble & Ramaswamy, 2005).

The bankruptcy and subsequent collapse of large corporations in the United States of America (U.S.), such as Worldcom, Enron and Adolphia and the public awareness of these financial disasters has led investors to become increasingly aware of organizations that are characterized as having reputable CG systems in place; in other words there is an orientation for investors to gravitate to companies which adhere to the best practice of CG. Furthermore, as information is readily available, decisions can be accessed and assessed on a daily basis by shareholders and owners, in addition to the assessment made by investors and analysts (Alabdullah, 2014).

A clear and important role is revealed regarding the effect of CG mechanisms on performance(Alabdullah, 2016). Nonetheless, several previous studies tested the relationship between CG and firm performance but the results were inconsistent; some of which led to positive results, and others were mixed: negative and positive on firm performance (Alabdullah et al., 2016). This research fills an international gap regarding what has been done in the previous studies, through suggesting a solution that lies in investigating the relationship between CG and the firm performance from a new perspective. In that, there should be studies testing this relationship by taking into account both financial and non-financial measurements to measure a firm's performance rather than just focusing on financial ones as the majority of previous studies have done.

The remainder of this study is prepared in the following way. Section 2 reviews the literature review. This is followed by Section 3 which discusses corporate governance and agency theory. Section 4 deals with corporate governance and firm's

performance. Finally, Section 5 is the conclusion of the study.

2. LITERATURE REVIEW

2.1. The Development of Corporate Governance

In general, worldwide in the current business environment and in particular in the discipline of accounting there is a widely held view and a clear understanding of the principles and mechanisms of CG. Accordingly, there has been much debate on the topic of CG amongst a range of parties and this includes academicians, regulators, and members of the business community worldwide. However, currently there is no distinctive definition which describes specifically the meaning of CG by taking into consideration the CG system's comprehensive characteristics. Therefore, there is some contention and confusion concerning the definition of CG (Windsor, 2009). Notwithstanding this, the general and traditional definition of CG is that held by the Organization of Economic Cooperation and Development (OECD, April 1999) which has provided the following definition: *"corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs"* (Hebble & Ramaswamy, 2005).

Furthermore, other definitions of CG can be found in the body of existing literature. For example CG is a system which aims to provide control and direction for organizations as described by Cadbury (1992). Shleifer & Vishny (1997) gave another definition in that CG is a process in which a corporation's financiers expect to get a return on their investment.

2.2. History and Origin of Corporate Governance

Historically, the first big debate regarding CG came about in the Netherlands in 1602. By way of background the Netherlands is known as having the oldest stock market in the world. At that period of time managers persisted in the view that a firm's work should be continual and as a result a profit should ensue. In France, it was the failure of the Mississippi Company in 1720 that provided the momentum to go down the path of CG (Morck & Steier, 2005). In the U.S. CG appeared in Canal Companies which was one of the early enterprises. A stockholder review committee influenced the development of CG and the processing of financial reporting in the instance of the Canal Companies (Russ *et al.*, 2006). However, there is a different school of thought (Bai *et al.*, 2004; Giroud & Mueller, 2010) in that the concept of CG might have been derived from Adam Smith's thesis written well over three hundred years ago as part of his book entitled *The Wealth of Nations.* Smith made reference to possible problems relating to the absence of corporate ownership when he raised the issue in joint-stock corporations of the separation of power between stewardship and ownership. He claimed that a manager of someone else's money cannot be expected to oversee the operations with as much care and consideration as an owner may, therefore, there is a need for an efficient mechanism control to oversee the operations which will resolve any conflict between the managers and the owners. Economists have long held the belief that ineffective management is predominantly an issue for companies in those industries which are deemed to be non-competitive.

Furthermore, economists Berle and Means (1932) explicitly claimed there is a necessity for requiring there to be control on any potential gap between the managers and the shareholders to safeguard against a manager's negative or inappropriate practices such as the improper use of the company's resources for the purposes of taking full advantage at the expense of the interest of the shareholders (Brennan & Solomon, 2008). The work by Berle and Means confirms the above argument by perceiving that the firms' managers may not take into consideration the interests of the shareholders in the first instance and instead may look after their own interests (Bai *et al.*, 2004). A study undertaken by Yuka (2010) indicated that in the six years since the study of Berle and Means much debate has been had and there is a call for central governance in firms along with the separation of control and ownership which will be of benefit to the shareholders Furthermore, the pioneers of the management theory perceived that it is the responsibility of the management of firms to not only look after the shareholders, but to look after the interest at all other stakeholders (Jensen & Meckling, 1976). It is the concern held by a firm's stakeholders that is a driving force for the introduction and implementation of CG to account for the strong influence of the senior-level of management and a lack of a strategic direction. Without effective CG there is the potential for administrative corruption, which is likely to damage a firm's reputation, such as the case of corporations such as account auditing company Arthur Andersen and Enron, the 7th largest corporation in the U.S. which before its downfall won an award six times for being the most innovative company by Fortune Magazine (Nelson *et al.*, 2008; Alabdullah *et al.*, 2014). However, conflict can arise between shareholders and managers due to the separation between control and ownership causing agency problems. Accordingly, the collapse of corporations such as Enron was the catalyst for the introduction, implementation and transformation of CG, which included reforms such as the Sarbanes–Oxley Act of 2002 (SOX) (Stigliano 2011).

3. CORPORATE GOVERNANCE AND THE AGENCY THEORY

The agency theory makes reference to an existing relationship that arises between two parties: on the one hand there is the management-level comprising the firm's executives; and the owners as principals and shareholders on the other hand in accordance with the study of Jensen and Meckling (1976) and with the agreement of later studies (Tate *et al.*, 2010). They contend that this relationship is founded on contractual conditions which are implicit and explicit for the purpose ensuring all parties can operate as efficiently as possible in order

for the owners to maximize their wealth by the delegation of authority and the allocation of certain activities to a firm's management-level as the owners are not sufficiently skilled to manage and undertake the tasks required.

Therefore, the agency theory and its hypotheses have an effect on CG. Tirole (2010) supported this stance by showing that the widespread academic thinking on CG is due to the prevalence of research which is based on the premise of the underlying principle that the agency theory focuses on the problem of the issue of separation between a firm's management and its ownership. As referred to in the early study undertaken by Berle and Means in 1932 in the U.S., there is a wide deviation in the interest of managers and owners and hence their motivations differ. It is a widely held view that effective CG mechanisms can reduce the agency costs and thereby benefit the shareholders.

4. CORPORATE GOVERNANCE AND A FIRM'S PERFORMANCE

According to Chen *et al.* (2009), recent empirical evidence in the literature demonstrates the ability of CG to limit the agency cost, and this aligns with the opinion that with improved levels of CG, a firm's performance is improved as is the value of the firm. A substantial body of literature published over the last few decades has examined the performance of firms and their value. This literature provides empirical evidence as Table 1 below indicates. What is prominent in the literature is the existence of relationships which are linked to the mechanisms of the CG system and the multiplicity of views leading to different results observed from these relationships. Despite the fact that studies have been undertaken in different parts of the world the literature supports the notion that CG is crucial, and positive, and has significant relationship with a firm's performance.

Table 1. Summary of the previous literature's findings show the relationship between Corporate Governance (CG) mechanisms and a Firm's Performance

Corporate Governance Mechanisms	Previous Studies	Relationship with Performance
Size of the Board of Directors	Abor & Biekpe, 2007b; Adams & Mehran, 2003, 2005; Alnaif, 2014; Belkhir, 2009; Berger et al., 1997; Bhagat & Black, 2001; Dwivedi & Jain, 2005; Fauzi & Locke, 2012; Grove et al., 2011; Jackling & Johl, 2009; Kajola, 2008; Tirole, 2010; Tornyeva & Wereko, 2012, Alabdullah, 2016.	Positive
	Adnan et al., 2011; Eisenberg et al., 1998; Grove et al., 2011; Haniffa & Hudaib, 2006; Jensen, 1993; Klein, 1998; Kumar & Singh, 2013; Mak & Kusnadi, 2005; O'Connell & Cramer, 2010; Yermack, 1996.	Negative
	Andres & Vallelado, 2008.	Inverted U-Shaped
	Al-Hawary, 2011; Bhagat & Black, 2002; Chaghadari, 2011; Ehikioya, 2009; Vo & Nguyen, 2014; Yoshikawa & Phan, 2003.	No Relationship
Independence of the Board	Abor & Biekpe, 2007b; Al-Hawary, 2011; Balasubramanian et al., 2009; Bhagat & Black, 2001; Fama & Jensen, 1983; Jackling & Johl, 2009; Kumar & Singh, 2013; O'Connell & Cramer, 2010; Tornyeva & Wereko, 2012; Vo & Nguyen, 2014; Zheka, 2006.	Positive
	(Agrawal & Knoeber, 1996; Bhagat & Black, 2001; Klein, 1998; Vo & Nguyen, 2014; Yermack, 1996.	Negative
	Andres & Vallelado, 2008.	Inverted U-Shaped
	Adams & Mehran, 2005; Adnan et al., 2011; Bhagat & Black, 2002; Chaghadari, 2011; Ehikioya, 2009; Heracleous, 2001; Hermalin & Weisbach, 1991; Mehran, 1995; Yermack, 1996; Yoshikawa & Phan, 2003.	No Relationship
CEO Duality	Abor & Biekpe, 2007b; Al-Hawary, 2011; Balasubramanian et al., 2009; Fama & Jensen, 1983; Grove et al., 2011; Kajola, 2008; Tornyeva & Wereko, 2012.	Positive
	Bai et al., 2004; Chaghadari, 2011; Jackling & Johl, 2009; Rechner & Dalton, 1991; Yermack, 1996; Zheka, 2006.	Negative
	(Adnan et al., 2011; Al-Amarneh, 2014; Chaganti et al., 1985; Fosberg, 2004; Heracleous, 2001; Rechner & Dalton, 1989; Yoshikawa & Phan, 2003.	No Relationship
Managerial Ownership	Abor & Biekpe, 2007b; Al-Khouri, 2005; Bai et al., 2004; Berger et al., 1997; Fauzi & Locke, 2012; Fosberg, 2004; Friend & Lang, 1988; Gedajlovic & Shapiro, 2002; Hiraki et al., 2003; Klein, 1998; Kumar & Singh, 2013; Vafeas & Theodorou, 1998.	Positive
	Acharya & Bisin, 2009; Al-Khouri, 2005.	Negative
	Benson & Davidson, 2009; McConnell & Servaes, 1995.	Inverted U-Shaped
	Adnan et al., 2011; Al-Khouri, 2005; Chaghadari, 2011; Demsetz & Villalonga, 2001; Ehikioya, 2009; Grove et al., 2011; Mak & Kusnadi, 2005.	No Relationship
Foreign Ownership	Abor & Biekpe, 2007b; Bai et al., 2004; Balasubramanian et al., 2009; Chhibber & Majumdar, 1997; Gedajlovic & Shapiro, 2002; Gurunlu & Gursoy, 2010; Kang & Shivdasani, 1995; Tornyeva & Wereko, 2012; Yoshikawa & Phan, 2003.	Positive
	Konings, 2001.	No Relationship

All such efforts by the previous studies resulted in inconsistent results thus the current study suggests a solution rests in investigating the relationship between CG and the performance of firms from a new perspective. In other words, there should be studies testing this relationship by taking into consideration both financial and non-financial measurements to measure a firm's performance rather than just focusing on financial ones as the majority of previous studies have done as mentioned in the table above and also for other studies in the literature review.

CONCLUSION

In spite of an increased awareness and interest in corporate governance (CG) from the beginning of the 2000s, use of the principles of CG has be traced back to hundreds of years ago to the 1600s though there was no direct application at that time nor had it been given a specific name or law or legislative requirement that led to an application of the concept in the businesses. Further to the examination of the agency theory, significant importance has been placed on the application of the mechanisms and principles of CG as one of the main objectives of CG is an extension of the agency theory's purpose which lies in providing a solution to the eternal problem of conflict between the shareholders and a firm's management-level. Applying CG has been brought about by pressure from an awareness and a real desire from internal stakeholders such as shareholders and from external stakeholders such as members of society including customers, consumers and suppliers. CG is a source of much interest worldwide as it is a useful tool to reduce or mitigate any business crises on the one hand, and on the other CG can be utilized as a building block for the firms to maximize their value by creating a competitive advantage, enabling their performance to be enhanced and thereby leading to an overall improvement in a country's economy.

This paper also contributes to the existing body of literature by analyzing the effects of the CG mechanisms on the performance and the value of firms by discussing and comparing the results of the previous studies. This paper acknowledges that the findings of the previous studies were diversified due to shortcomings of using traditional methods to measure financial performance such as ROA, ROE, etc in most of the previous studies, whilst the modern contemporary trends ought to focus on both financial and non-financial performance measurements. Also the current paper shows that the empirical findings of previous studies confirm that theories related to CG such as the agency theory provides some support to illustrate the relationship between the mechanisms of CG and a firm's performance and its value.

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