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Corporate Governance Overview- The Saudi Arabian Context

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Abstract

Corporate governance refers to internal arrangement that encompasses procedures, practices and individuals, which aids the needs of stockholders and other investors, by guiding and monitoring organization actions with good corporate savvy, fairness and honesty. Good Corporate governance supports impartiality, honesty, and transparency in its accountabilities to investors. Good corporate governance practices simplifies economic competence by concentrating on value-enhancing actions and aids proficient distribution of scarce resources. This is accomplished when corporations proficiently employ their resources, attract low cost capital, meet societal anticipations and improve overall performance. This paper discusses different frameworks with their critical analysis. Moreover this paper sheds the light on Saudi Arabian Corporate governance arrangements and their legal context.

Keywords*: Corporate governance, capital conveyance, stockholders.*

I. INTRODUCTION

Corporate governance is presently a point of open deliberation in every meeting room, address lobbies and online networking. The corporate catastrophe in the 17th century referred to as South Sea Bubble failure; changed the laws and hones of business in England [1].

All the associations and markets which failed had one thing in common and that was appalling corporate governance [2]. It stated that great corporate governance heightens the benefit of capital conveyance in and over the association, decreases the capital issuer expense, helps to expand access to venture, reduces calamities, supports speculation procurements and diminishes abuse. The conception of "Corporate Governance" is subjected to both narrow and broad definitions, pertaining to the two viewpoints of stakeholder and shareholder orientation. If one defines narrowly, the concept is linked with associations that exists between the board of directors, corporate managers, and shareholders of the company [3]. However, it may also be defined as the relationship between corporation to society and stakeholders. Broadly, corporate governance can include combination of laws, listing rules, regulations and voluntary practices of the private sector that leads to capital gain, profit generation, effective performance, and meeting both general and legal expectations of the society [3].

It is not possible to provide one definition for corporate governance due to varying viewpoints of those who have tried to do so. The chief cause behind this is the differences in the economic, political and other socio-technical aspects of each state. This is the way we usually come across different definitions of corporate governance according to subject matter e.g. business, investment. Moreover, it also differs according to the area where it is practiced with respect to the level of a country's progress.

II. INTERNAL AND EXTERNAL GOVERNANCE

The aim of explaining the current topic in this section is to connect different parts of corporate governance components in a logical strand. Firm's performance is

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dependent on how well their monitoring procedures are operating especially to align the conflicts of interest between the owners and the managers [4, 5]. It is mostly unmanageable for principals in a corporation to be charged with responsibility for day to day corporate tasks, therefore they deploy and delegate these operations to the agents hired by them. Obviously, in this situation governance complications such as conflicts of interest happen, particularly if shareholders are dissatisfied from their returns [6]. The primary reason behind monitoring, controlling and significance of these agents are explained underneath. The monitoring is essential because managers tend to:

i. Misuse their position. They not only try to misuse the power of their position but also uses the firm's money in their own favor.

ii. Form empires. The manager tends to build huge empires since they want to control huge corporations, not minor ones.

iii. Utilize entrenchment reserves these managers uses the reserves in areas where the manager has familiarity and experience but the possible benefit is lower than the anticipated risk.

iv. Illogical conduct towards risk. Managers try to act irrationally by getting in uncertain investments if their rewards and pay is linked to performance or take no risk when their pay or reward is not linked to company's performance [7].

v. Conflicts of earning retention. The manager tries not to distribute dividends by retaining profits at firm disposal and not allocating it to shareholders [7].

vi. Differences in time horizon. Most managers need short performance since their reimbursement is subjected to it and shareholder needs long-term expansion.

vii. Offensive conduct. The managers try to manipulate the accounting facts, deficiency of transparency and may consume severance agreements options [7].

In lieu of the above-mentioned situation, it is evident that the authentic controlling mechanism is the only solution and that must be devised. Shleifer and Vishny, (1997) [8] argue that efficient controlling mechanism is must for all circumstances to encourage management/agent/manager to work for the best interest of the stockholders. The main question here is what actually comprises of a controlling and monitoring mechanism. Corporate governance systems can be separated into the internal and external governance scheme [9].

According to Azim (2012) [10], Market incorporate block shareholders, the capital market and the managerial labor market. Internal monitoring mechanism incorporates insider shareholders, boards of directors, regulatory is defined as the government bodies and the external audit. In order to understand the comprehensive picture of how these mechanisms functions we need to understand the corporate governance concept.

Imam and Malik (2007) [11] stated the theoretical framework of corporate governance represents a wider control mechanism of the corporate characteristics in order to promote effective use of business resources. Sustaining proper acquiescence is also attained by the good exercise of mechanisms of corporate governance. This will be followed by shedding light on the origin of Corporate Governance which will be followed by its theoretical framework.

III. Corporate Governance Theoretical Framework

There has been numerous corporate governance theoretical frameworks because of wider range of academic investigations focusing on corporate governance and different firm's systems demanding economic opportunities. Different approaches of frameworks approaches are due to the discipline ranges, viewpoints, terms of corporate governance, and legal impacts. However, there is also framework overlapping as they face certain similar issues.

A. Agency Theory

From the start of Berle and Means (1932) [12], the partition of ownership and control was the center of corporate governance due to which issues pertaining to principle-agent emerged with the dispersed possession in the modern firms. As indicated by them, through corporate administration, the governing body can screen and determine the main principal-agent issue. The origin of agency theory goes back to the economic theory developed by Alchian and Demsetz in 1972 [13]. Furthermore, the work of Jensen and Meckling (1976) [14] is very significant in this perspective. The theory of agency is the most popular and has established greater consideration from academics and practitioners [15]. The agency theory was given out based on the principal-agent associations. The ownership estrangement from management in case of the

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corporations provides us with a working framework of the agency theory. In the current establishments, the shareholders (or principals) seems to be distributed and are not basically involved in daily administrative works; therefore, managers (agent) are recruited in order to perform these tasks for the firm [15]. This separation of ownership and rights to control ends up in the conflicts of agent and principal's interest. In order to resolve this problem between these two parties, the firm incurs controlling and monitoring cost that includes incentives for the agents.

Bowrin et al (2011) [16] states that the agency theory is referred to as a set of proposals that helps in leading a corporation in today's economic world that is basically divided by the shareholders who are large in number and allows the agents in controlling and managing their joint capital for future earnings. The agent might not have their own stocks but they can manage the firm through their professional skills and capabilities. This theory identifies monitoring mechanism's role of the corporate governance in reducing the agency cost and principal-agent conflict.

The agent attempt to accomplish his individual goals at the expense of the owner. Managers are generally interested by their own individual interests and welfares, and work to increase their own personal value instead of considering interests of shareholders. In order to decrease the problem of agency, the monitoring and controlling procedures must be superior, which aids to guarantee that managers look after shareholder's interests more than their own. The concept of corporate governance assumes a crucial tension between owners and agents [14]. A shareholders mainly aims at returning their investment along with power and status of running a large corporation, as well as other privileges offered to them relevant to their position in the firm. Fama and Jensen (1983) [17] stated that managers have the peer hand because of their effective access to inside information of that particular firm as well as to the shareholder's powerless position. Therefore, shareholders have the power to control the executives through their delegates like that of the board of directors.

Boards of directors are the natural guardians of the firm's stockholders as they check for any misconduct by the managers, thus ensuring proper management and control by the managers. Fama and Jensen (1983) [17] stated that for reducing agency problem because of separation of ownership and control, the firm needs tool for this job. This will lead to reduction in the agency costs along with the shareholder's growth through successfully power monitoring and self-biased choices of the managers. The agency theory hypothesizes a basis for the governance involving both internal and external means.

Corporate governance mechanisms are devised to bring into line the interest of owners and managers restricts the opportunistic actions of managers and defend stockholder welfares, mostly to resolve the problem of agency [15]. This sort of governance is a way in which the stockholders take the role of managers by ensuring the best interest of the firm. From an agency theory point of view, corporate governance augments the performance of corporation by solving the problem of the agency with monitoring activities of management, controlling management self-centered actions, and reviewing the financial reporting process [15]. Moreover, it enables to reduce agency costs by dissolving the conflicts of interests between the managers and shareholders by monitoring the firm's management and through various means of corporate governance.

B. Stewardship Theory

In contrast to agency theory, stewardship theory gives a distinctive perspective of governance, where supervisors are considered great stewards who are working for the interests of owners [18]. Stewardship theory is established in social psychology, concentrating on the officials' conduct. The steward's behavior is ace hierarchical and collective, having more value than working for own self and steward's activities are adjusted to the interests of the organization as the steward lives up to expectations for the achievement of association's objectives [19].

Shareholder's wealth and steward's benefits are specifically corresponding as the relationship achievement is in expanding shareholders wealth. They further express that stewards adjust the weight between different recipients and other interest groups. Stewardship theory contends firm productivity fulfilling the intrigues of parties that result in stability of strong productivity for adjusted administration. A steward enhances performance effectively if the intrigues of stakeholders are defended and served with a growing wealth of organization [20]. If the roles of CEO and Chairman are played by a solitary individual, technique determination is additionally in the hand of a single individual. In this manner, stewardship theory concentrates on the enabling structure preferably

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than a structure that controls and monitor. Thus, stewardship theory does not stress over the differentiated position of CEO and Chairman rather designates a single individual for both of the positions and different specialist executive directors. Moreover, stewardship theory is embedded in psychology and sociology [21].

Critical Overview: As an alternative view to agency theory, according to stewardship theory, the managers will work responsibly as stewards if they left on their own. It proposes that executives and managers are good stewards whose motivations are aligned with the interests of shareholders. On the other hand, stewardship theory largely ignores economic rationality [18], and rather emphasizes the behavioral aspects of the agent [20].

C. Resource Dependence Theory

The Resource Dependency Theory deals with the dependency of the firm on the internal and external environment. Based on this theory, the company's directors are required to cooperate with the external environment to gain resources that are significant for the survival of the organization. Therefore, the observation of the significant features pertaining to environmental uncertainty remains key for the company's board of directors. Additionally, Kiel and Nicholson (2003) [19] that environmental networks can assist in reducing the cost associated with environmental interdependency suggested it.

The firm requires resources from the external environment that develops associations among the organizations. In addition to this, the unequal distribution of resources tends to create interdependence in the organizational relationship. However, the intensity of interdependency is dependent on many factors, such as the importance of resources, resource availability, as well as the concentration of resources in the environment. The company's directors might also link the organization with the resources required from the external environment so as to overcome the uncertainty. This is because coping up the uncertainty remains crucial for the survival of the firm. According to the resource dependency viewpoint, organization's resources such as information, human resource, and their skills, major elements such as buyers, suppliers, social groups, decision makers of public policy, and legal ways to minimize uncertainty are brought by the directors [22].

It recommends that the directors can support the firm in obtaining favorable access to resources. Due to their capability and influence, institutional representative directors can assist the business in avoiding costly mistakes when its actions may by error encounter with the interests of these agencies [23]. Resource dependence theory argues that the board member is being designated by the firm rather than a social class.

Critical Overview: While the resource dependence theory has become accepted and used in many studies, the resource role of the board has not been as comprehensively examined, as it could be. Fan et al. (2011) [24] suggested that resource dependence theory has been developed in the context of advanced economies, leaving little or no consideration of the unique social, political, and economic contexts presented in emerging stock markets such as Saudi Arabia. More importantly, previous research has largely neglected bundling contextual considerations of emerging markets with theory, and rather have deployed in parallel with it [25]. The lack of integration between theory and context means an accurate diagnosis of a phenomenon in emerging markets would not be achieved.

D. Stakeholder Theory

In agency theory, the arrangements and mechanisms of corporate governance are linked to the safety of the shareholders' rights as the main aim of the firm to maximize the earnings and generate more capital to the stockholders. Therefore, while agency theory focuses on the separation between the management and the ownership view, there are other perspectives that reflect other duties such as social responsibility. Thus, this view describes the relationship between the parties that have a direct association with the firm, which means the firm needs to form a positive bond with all stakeholders in order to breed sustainable economic affluence [26].

This theory is an extension of the agency theory, where the theory of agency presumes board of directors to safeguard only the interests of stockholders. But, stakeholder theory broadens the narrow emphasis of agency theory on shareholders' welfare to stakeholders to take into account the welfares of many diverse groups and individuals, incorporating social groups, and environmental and ethical concerns. Stakeholder means anyone whose objectives have direct or indirect connections with the firm and influenced by a firm or who exert influence on the firm's goal achievement. These comprise of management,

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employees, customers, dealers, government, civil parties, and resident community [15].

According to stakeholder theory, the aim of the corporation is to aid and harmonize the welfares of its various stakeholders such as shareholders, employees, creditors, customers, suppliers, government, and the community. The stakeholder theory starts with the supposition that principles are essentially and clearly a part of doing the trade. It asks managers to express the combined awareness of the value they create moreover It also drives managers to be well-defined about how they desire to do business, precisely, what types of dealings they want and need to generate with their stakeholders. According to this theory, the stakeholders in corporate governance can produce a promising external environment which incorporates the understanding of corporate social responsibility in it. The organization collects capital from shareholders, they depend upon workers/agents to achieve the objective of the corporation.

External stakeholders such as customers, suppliers, and the community are equivalently significant and inhibited by formal and informal procedures that a corporation must regard. According to stakeholder theory, the superlative corporations are ones with dedicated suppliers, customers, and employees and stakeholders to deliver on their commitment. The benefit of the stakeholder model stress on overcoming problems of underinvestment associated with opportunistic behavior and encouraging active collaboration between stakeholders to assure the long-term productivity of the corporation.

CEOs play a dominant part in the management of the associations between all the stakeholders; the aim is to maximize wealth through these associations. However, this will be accomplished through a firm's social commitment, and social and environmental concern, which shows the difference to agency theory, where the dominant role is that of the stockholders. Carroll has explained the social responsibilities of the company and believes that the company must work in accordance with legal, ethical, philanthropic and economic responsibilities. Corporate governance in this setting is the mechanism that safeguards the responsibility of the organization to direct its actions in the way of a just system for all parties involved [26].

Critical Overview: The stakeholder theory has not been exposed to much practical and empirical investigation. The usual criticisms for stakeholder theory are that how to bring into line the stakeholder's contradictory welfares since the problems result from how to manage different stakeholders with diverse requirements and demands. It is impossible to handle all stakeholders likewise [15]. Furthermore, it is impractical for all stakeholders to be actually represented in corporate governance suggestions as this may challenge the welfare of the corporation. The other criticism of the current model is that executives or board may utilize "stakeholder "explanations to defend poor corporation performance [15].

IV. ISLAMIC CORPORATE GOVERNANCE MODEL (ICG)

In spite of non-recognition of the idea of the corporation at an early phase of the Islamic era, an effort to develop Islamic corporate governance has been made by different researchers. Wolfensohn was a former president of World Bank described corporate governance as an entity supporting corporate fairness, transparency, and accountability [27]. Kasri (2009) [28] states that the main difference between conventional corporate governance and Islamic corporate governance is based on the philosophical characteristic.

In the Islamic perspective, corporate governance practice is a Muslim's responsibility, obligation, and duty to Allah. Therefore, this leads to an implied promise with God and an open agreement with individuals. Ultimately, God and Islam are the main players in corporate governance practice. This differences to the conventional view that stresses the physical and considerable structures of governance [28].

Islamic corporate governance is steady with Sharia philosophies, it has a wide prospect, with duties covering and ranging to all the stakeholders, taking on the spiritual as well as the time-based necessities of the community. This clearly states that the Islamic perspective of corporate governance is an obligation and duty not only on a corporate level but also on the level of individual and extending beyond the interests of shareholder value [27], as assumed in the conventional view, to reach the community and the environment [27]. ICG (Islamic corporate governance) is about fairness to all investors, an opinion that most of the conventional contributors would hardly agree as they constraint the aim of governance to the administration of the firm and control in order to acquire the long-term value of the company [29]. In practice,

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mostly companies integrate western corporate governance ideologies, which might not be in accord with Islamic standards. Though the governance tools and measures are alike for both and the variances are minor and irrelevant [28].

The main distinctive characteristic of Islamic corporate governance is the obligatory existence of a Sharia Supervisory Board (SSB) as all industry dealings have to be Sharia compliant [28, 29]. The Organization for Economic Co-operation and Development (OECD) states that corporate governance is the association between firms to its stockholders in short or related to the public at large. The idea of Islamic Corporate Governance (ICG) is no dissimilar with that of OECD, apart from that ICG used the principle of Islamic socio-scientific epistemology based on the divine, the oneness of GOD. Islamic corporate governance is a novel concept if compare with western type, however, it played a vital part in influencing the thoughts of Muslim researchers, economics and experts alike, the goal of ICG is Maqasid Shariah, which was established by a well-known Muslim researcher called Al-Ghazali, it mention to the fortification of the wellbeing of the individuals, comprising their trust, life, intelligence, posterity & capital.

Theory of business enterprise is an economic book written by Thorstein Veblen, issued in 1904. This theory is about social and economic objectives that stress GOD, in all its arrangement, it is established into what is now called S.E.T., Shariah Enterprise Theory, which is all about God, individuals, and environment. The theory went into a lot of alterations. Joseph Schacht, (1950) spoke more on the theory in his books, (Origin of Mohammadeen Jurisprudence, and Institution to Islamic Law). The S.E.T. theory has as its central aims; the whole thing belongs to ALLAH, and individuals are Jamaat (God trustees on earth), social, environment has to be protected from the pollution of all types. It focuses on spiritual values, justice, honesty, accountability (Amanah, Istiqamah). Thus it can be said that the governance principles (Accountability, transparency, fairness, & responsibility) published by Cadbury Report which was released in the UK in 1991 is in the same alignment with S.E.T. The S.E.T. theory is now being extensively adopted in most Islamic countries in banks, and other corporations. The regulatory and legal context will be discussed in the later part of the current chapter but the pivotal role of sharia has been presented above to get a smooth flow of the argument.

V. The Saudi-Arabia Corporate Governance Regulatory and Legal Framework

Since the thesis will be studying the variables in the context of Saudi Arabia it is mandatory to learn about the basic structure of the governance system in the legal context. The previous section has shed the light on main sharia principle that encircles the governance system of the country, moreover, the literature also stated that there is not much of the difference between the model that is currently in practice in the country and one in the west (Anglo Saxon). However, there certainly is a difference in the legal and regulatory framework of the country, which is discussed below:

There are dissimilar levels of legalization and institutional contexts that are linked to corporate governance in the Saudi Arabian situation, and the corporate governance code has been embraced from other jurisdiction after a series of provisions to make it suitable and applicable in Saudi society [26]. Thus, the acceptance of a new idea in a challenging and different legal and cultural environment needs to be examined. Starting with Sharia, the capability to accept and absorb a new idea such as corporate governance, with the unlike structure of institutional and legal frameworks, could present a challenge [26]. Starting with Sharia, that has supremacy over all aspects of life, ethical and social it is vital in this situation to look at the main features of Sharia as the Supreme law of Saudi Arabia to study the harmonization of such a novel concept as corporate governance with other laws and regulations with regard to Sharia. Examining the new regulations and laws to check their compatibility with Sharia principles is an ongoing issue in Saudi Arabia, for example, there is a recent example with Companies law 2015, which has been adjusted- to some extent- to be more in tune with Sharia principles.

Sharia's literally means in Arabic, the way to the source of life. However, Shari'a is now used to signify a legal structure in line with the behavior called for by Qur'an and Sunna. In Islamic jurisprudence, the religion Islam (sharia's), is well-defined as displaying the conditions and direct commands of God as prescribed for worship through the Prophet Mohammad [30]. Undoubtedly the corporate governance in many parts of the world has been influenced from the UK legal system, including the GCC countries

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such as Saudi Arabia, and some scholars think that the economic independence of the GCC is more of British influence. Saudi Arabia as a developing country and emerging market has more reasons to examine corporate governance as a tool, as it could be a solution to some problems. The importance of corporate governance in the context of family businesses in Saudi Arabia is very strong. Additionally, the family business makes up to 80% of the business sector and the contribution of family businesses to the GDP- without the oil industry is more than 90%.

Inessential to say, there is a significant role for corporate governance in the context of family business in the country. History of corporate governance in the Kingdom of Saudi Arabia started in the year 1965 when the company's laws were founded that focused on the creation of both private and public organizations. The company's law identifies that the development of organizations, insolvency as well as administration. Under the company's law management and possession of local organizations in the Kingdom of Saudi Arabia by non-Saudi is prohibited. In the year 1930, the first stock firm in the Kingdom of Saudi Arabia, Arab Automobile was listed in tadawul (Saudi stock exchange). After the firm was listed, it amplified slowly.

In the year 2009, there existed a total of 145 organizations that were listed in tadawul. Saudi Arabian context, there are several institutional bodies that participate in the supervisory task of the Saudi stock exchange including the Ministry of Commerce, Saudi Arabian Monetary Agency and Capital Market Authority where listed companies are registered, bearing in mind that listed companies are the main target of corporate governance regulations.

A. Capital market Law (CML) and Capital Market Authority (CMA)

The Capital Market Law was issued in 2003, by the Royal Decree No. M/30 and the Council of Ministers Resolution No. 91. CML consists of 67 Articles, which are further divided into 10 Section. The impacts that were caused by the dramatic collapse of Enron, WorldCom and others have extended many parts of the world, including GCC and Saudi Arabia, in particular, played a crucial role concerning legislative and regulatory reforms such as the Sarbanes-Oxley Act of 2002 in the USA. Moreover, in Saudi Arabia, there was a call for the acceleration of the formation of an authority to supervise and manage the capital market, which preceded the establishment of the Capital Market Authority in 2003. This governing body is an independent government body connected directly to the Prime Minister, the King, and it has its own administrative, legal and financial liberation. The importance of this governing body in this thesis is the critical role that is played by the capital market authority in corporate governance due to its legal powers as a government instrument that aims to guard the stockholders, augment the efficacy and transparency of the market, as well as achieve justice.

B. Ministry of Commerce and Industry

The Ministry of Commerce and Industry could be described as a key player in the context of corporate governance and Saudi stock market, In terms of publicly listed companies, and through a Royal decree, the Ministry of Commerce and Industry has the judicial, executive and legislative power. This body had the supervisory lead and the responsibility for business and commerce even when in the past, the stock market was simple and the companies were fewer, which made the control and the governance much easier.

Later, the market witnessed growth, which added more complexity to the market, as noted in 1984. Therefore a group of structural reforms were introduced, containing shifting some of the responsibilities to 'SAMA' the Saudi Arabian Monetary Agency after the formulation of a new committee by the government for the sake of developing and regulating the market. This committee comprised the Ministry of Commerce, the Ministry of Finance and National Economy and the Saudi Arabian Monetary Agency.

C. Saudi Arabian Monetary Agency

Saudi Arabian Monetary Agency' SAMA, was established in 1952. There are many functions played by SAMA, containing the Government's banking matters; matters of the national currency, the 'Saudi Riyal'; foreign exchange reserves administration; the regulation of commercial banks in the country, and encouraging the financial system's growth. One can say that SAMA is the central bank of the Kingdom of Saudi Arabia. SAMA the as a significant role in the context of corporate governance's regulatory framework. It has introduced a draft of corporate governance insurance regulations in 2014. In fact, there is a collaboration between SAMA and CMA in

order to improve the conditions of related issues, including regulating corporate governance [31, 32].

VI. Summary

The issues of governance can be resolved by introducing better governance mechanisms. The better understanding of corporate mechanisms can facilitate a corporation to act responsibly and proactively in today's dynamic and unpredictable environment.

To be effective, a governance mechanism must slender the gap between the benefits of agents and principals, and have a substantial and positive impact on corporate productivity.

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