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DETERMINANTS OF MANDATORY CORPORATE GOVERNANCE: EVIDENCE FROM AN EMERGING MARKET

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ABSTRACT

This study investigates whether listed companies in Jordan comply with mandatory governance rules and explores factors that affect the governance compliance level. A checklist was designed to construct a governance index for each of 128 Jordanian listed companies that disclose the necessary data to calculate the variables under study. The results indicate that on average Jordanian listed companies comply with mandatory governance rules. This compliance depends on some crucial variables. Company size, profitability, age as a listed company on the ASE, size of the auditor and type of industry significantly affect the compliance level.

JEL: G34, M43, M48

KEYWORDS: Corporate Governance, Audit, Emerging Market, Compliance, Jordanian Listed Companies

INTRODUCTION

The agency problem, as a result of the separation of ownership and management in modern organizations, drove the demand for corporate governance. Lin and Hwang (2010) note the need for corporate governance as a mechanism to align the interests of management with those of shareholders/investors. There is no consensus about the definition of corporate governance among the experts. The OECD (2004) defined corporate governance as a set of mechanisms by which organizations are directed and controlled, which means that such mechanisms may be adopted internally, like firm policies and regulations, or externally, such as governance regulations issued and implemented by governments or market regulators. In the Middle East, corporate governance procedures and regulations have been in focus for two decades. Miteva (2005) argued the OECD started to focus on the Middle East and North Africa (MENA) countries through initiatives that aim to modernize the practices and procedures of corporate governance and to improve the policies and the environment for investment.

All companies listed on the Amman Stock Exchange (ASE) work under supervision of the Jordan Securities Commission (JSC), which is considered the market regulator. In late 2008, the JSC issued a corporate governance guide as a result of the market demand for such a regulation that considers stakeholders' rights. This guide was published in early 2009 by the JSC, and 2010 was announced as the implementation year for all listed companies. This guide is considered the first powerful regulation in Jordan regarding corporate governance and is divided into four main sections: board of directors, stockholders' meetings, stockholders' rights, and disclosure and transparency, which include mandatory governance mechanisms. Black et al. (2012) stated that optimal governance always differs between emerging markets and developed countries. Furthermore, the differences between emerging countries of the MENA region in adopting and implementing governance procedures have been evidenced (Euromoney, 2007; Fawzy, 2004). Bhuiyan and Biswas (2007) mentioned that significant differences in governance practices and disclosure have been noted among developing countries. Samaha et al. (2012) stated that non-compliance with governance regulations is a phenomenon in developing countries and particularly in MENA countries, indicating the need to investigate governance practices and compliance with governance regulations in developing countries in general and in the MENA region in particular. Previous studies have found that governance practices and compliance are related to many variables, including firm characteristics such as firm value (Ammann et al., 2011; Bebchuk et al., 2009; Cremers & Nair, 2005), firm size (Black et al., 2006, 2012), firm profitability (Durnev & Kim, 2005), and firm growth (Bennedsen et al., 2012; Doidge et al., 2004), which indicates that governance level and governance practices do not differ among firms in the same country. The current study explores the level of governance compliance in Jordan (a member country of the MENA) as the growing economy is attracting new investment. Another objective of this study is to determine the level of governance in Jordanian listed companies using the firms' characteristics and auditor size. This area of research is still unexplored in the Jordanian market, which adopted and implemented the governance code (guide) less than four years ago. The results of the current study provide guidance and valuable information to investors, stockholders, and regulators regarding governance implementation and the factors that determine the compliance level with the governance code, and it will also enhance the improvements in the regulations, particularly when considering the mandatory adoption of governance regulations. The rest of the paper proceeds as follows; a review of related literature and development of the study's hypotheses is in section 2. In section 3, a description of methodology and the sample was presented, while sections 4 discuss the empirical results. The paper closes with a summary in section 5.

LITERATURE REVIEW

Corporate governance has attracted a great deal of attention in the recent literature, which has discussed its different dimensions and policy issues in relation to developed market economies. Emerging and developing countries have also benefitted from these efforts. In corporate finance, the agency problem usually refers to a conflict of interest between a company's management and its stockholders. The manager, acting as the agent for the shareholders, or principals, is supposed to protect the interests of the stockholders. In developing countries, corporate governance still needs more research in the area of implementation and its determinants (Baydoun et al., 2013). Recent research in developing countries and particularly in the MENA region has reported mixed results about governance practices and their implications. For example, Al-Saidi et al. (2014) found that board size, non-executive directors, and role duality have no impact on governance disclosure in Kuwait. Samaha et al. (2012) found a significant association between the same variables and corporate governance disclosure in Egypt. The variations of these results are also supported by a study conducted by Al-Malkawi et al. (2014). This study compared corporate governance in the five countries of the MENA region and found that the governance practices and implications are significantly different among the countries. It is observed from the above discussion that the theory of corporate governance is not as refined as in the developed world. Therefore, more efforts are required to strengthen the governance concept, governance practices, and governance determinants.

In Jordan, corporate governance took place for the first time through governmental regulations that forced companies to adopt specific governance practices in 2003. The first governance code was issued by the Jordanian Central Bank in 2003 and aimed to identify a general framework for governance in Jordanian banks. However, it was not mandatory for banks to adopt the content of this guide. In 2007, the Jordanian Central Bank issued a mandatory governance guide that was compulsory for all Jordanian banks to adopt. Still, other companies were not required to adopt these governance practices. In late 2008, the JSC issued a governance guide that includes mandatory governance practices for all the companies listed on the ASE and assigned 2010 as the year of implementation. The guide includes detailed practices that all the listed companies have to adopt. Those practices have been articulated based on governance best practices around the world and based on the market needs to protect stakeholders' rights (JSC, 2014). Keeping all the above in view, we aimed to investigate whether Jordanian listed companies comply with the governance guide. We also examine whether the compliance level matches the needs and expectations of Jordanian companies. Most literature has discussed determinants and policy issues related to the practices of corporate governance and its improvements, especially in the emerging market. Most of these studies found a significant correlation between voluntary governance and other variables (related to the ownership structure) that may affect the implementation and disclosure of governance (e.g. Black et al., 2012; Gazali & Weetman, 2006; Samaha & Dahawy, 2010; Samaha et al., 2012). Interestingly, these studies were not able to analyze firm characteristics as main variables.

Previous studies found a significant positive association between firm size and voluntary disclosure (Alsaeed, 2006; Firth, 1979). However, it is a well-established fact that large firms have more resources to disclose more information and also may need more governance practices to respond to their complex operations. Agency costs also increase due to the increase in financial resources and lower ownership concentration (Black et al., 2012). Ettredge et al. (2011) examined a sample of US companies and found firm size to be one of the determinants of voluntary disclosure. Al-Janadi et al. (2013) addressed the importance of firm characteristics and found a significant effect of firm size on voluntary disclosure for Saudi listed companies. Samaha et al. (2012) achieved the same results when they studied the determinants of corporate governance disclosure in Egypt.

As mentioned earlier, large firms may have more governance practices due to the complexity of their operation and tend to have more voluntary disclosure due to their large resources. It is also argued that firms with no profitability cannot disclose voluntary information like profitable firms because of the limited financial resources available. Marston and Polei (2004) argued that managers of profitable firms are more likely to disclose more information in order to increase the stakeholders' confidence in increasing their compensation, which meets the suggestion of the agency theory. Ahmed and Courtis (1999) stated that the association between profitability and voluntary disclosure is not clear due to the mixture of results. Samaha et al. (2012) found no significant relationship between firms' profitability and governance disclosure in Egypt, while Black et al. (2012) found a positive significant correlation between firms' profitability and governance practices that predicts the market value for high-profitability firms in emerging countries. Auditors perform their role as an independent agency that provides assurance about the fairness of financial statements, reducing the information asymmetry (Beatty, 1989) and lowering the effects of the agency problem between managers and stockholders (Jensen & Meckling, 1976).

Al-Ajmi (2009) clearly mentioned that audit quality plays a notable role in corporate governance. Zureigat (2010) found that auditor characteristics and audit firm size are important factors that affect the market reaction to auditor reports in Jordan. In addition, a number of studies have concluded that audit quality is a function of auditor characteristics (Carcello et al., 1992; DeAngelo, 1981; Hmedat, 2002; Zureigat, 2011), which indicates the importance of such a variable in governing firms. DeAngelo (1981) stated that big auditors tend to focus on more information disclosure in order to reduce their legal liability. These arguments were supported through empirical evidence in developed countries (Ettredge et al., 2011) as well as in developing countries (Al-Janadi et al., 2013). It is interesting to note that no evidence exists in Jordan.

DATA AND METHODOLOGY

At the end of 2013, the total number of Jordanian listed companies, which were formally listed and traded during the year 2013, was 128. It is mandatory for all listed companies to adopt the governance guide that was implemented in 2010 in Jordan. The current study considered all listed companies as its population, and the sample consisted of 109 listed companies. Those that disclosed the data needed to calculate the variables at the end of 2012.

Dependent Variable: Governance Practices

The JSC, through the governance guide, requires all listed companies to disclose all governance procedures that have been adopted based on that guide in the annual reports for the year ending in 2012 and also to disclose which governance factors have not been adopted. A content analysis was undertaken for all companies listed on the ASE to identify the adopted governance practices for each company. A unified checklist was developed, based on governance practices listed in the governance guide, to capture governance practices that are implemented in each company. An unweighted compliance index was constructed for each company based on the checklist. To achieve these aims, the following hypothesis was formulated and tested during the course of the study:

H1: Jordanian listed companies do not comply with the governance guide that has been issued by the JSC.

Independent Variable: (Firm Size, Profitability, and Audit Firm Size)

The current study followed previous studies in measuring firm size based on total assets (Al-Janadi et al., 2013; Black et al., 2012; Samaha et al., 2012; Zureigta, 2011). The natural logarithm for total assets at the end of 2012 was used. Return on equity (ROE) was used as a proxy for profitability, which was calculated as net income divided by total equity (Samaha et al., 2012); the ROE was measured for companies at the end of 2012. The second and third hypothesis was developed as follows:

H2: There is no effect of company size on firms' compliance with the governance practices listed in the governance guide.

H3: There is no effect of companies' profitability on their compliance with the governance practices listed in the governance guide.

Auditor size was determined according to whether the firm is one of the Big 4 or non-Big 4 audit firms (DeAngelo, 1981; Zureigat, 2011). A classification of auditors who were hired for each company was made to identify companies that hired Big 4 or non-Big 4 auditors for the year ended 2012. The value one was assigned to Big 4 audit firms and zero otherwise. Based on that, the fourth hypothesis was formulated as follows:

H4: There is no effect of auditor size on firms' compliance with the governance practices listed in the governance guide.

Control Variables

The current study focused on firm characteristics as independent variables to be regressed to the level of governance compliance, while other factors may affect the dependent variable (level of governance compliance). Such factors may control the expected relationship between dependent and independent variables. The study used the type of industry (sector), following Samaha et al. (2012), and the age of the listed company on the ASE, following Black et al. (2012).

Model

The study examined the effect of some firm-related characteristics on the level of governance compliance in Jordanian listed companies. A multiple regression model was developed to estimate the expected relationship between dependent and independent variables as follows:

$$GC = \alpha + \beta 1 LnFZ + \beta 2 FP + \beta 3 AZ + \beta 4 S + \beta 5 A \quad (1)$$

Where:

GC: Governance compliance level, which was measured using the unweighted compliance index calculated based on the governance checklist.

Ln FZ: Natural logarithm for firm size, which was measured using the total assets.

FP: Firm profitability, which was measured using the return on equity (ROE).

AZ: Auditor size, which was determined as 1 if the hired auditor for company X is one of the Big 4 audit firms and 0 otherwise.

S: Sector, which reflects the sector (type of industry) to which the company belongs, for which the financial sector was labeled 1, the service sector was labeled 2, and the industrial sector was labeled 3.

A: Age, which reflects the length of time for which company X has been listed on the ASE. All of the above variables were calculated for each company as of the end of 2012.

RESULTS

Data were collected from the publications and website of the ASE as of the end of 2012. Table 1 shows the total number of listed companies having the relevant data. Some 63 companies out of the total are financial companies, 29 are service companies, and 36 are industrial companies. The industry classification (financial, service, and industrial) was used as published by the ASE.

Table 1: Number and Frequencies of Companies (Sector Classification)

	Frequency	Percentage	Valid Percentage	Cumulative Percentage
Financial	63	49.2	49.2	49.2
Services	29	22.7	22.7	71.9
Industry	36	28.1	28.1	100
Total	128	100	100	

This table presents number and frequencies of companies based on a sector classification. Some 63 companies out of the total are financial companies, 29 are service companies, and 36 are industrial companies

Table 2 presents descriptive statistics for the variables under study. The governance compliance index in Jordanian listed companies recorded an average of 80%, and the minimum value for this index is 58%. The highest-scoring Jordanian company has complied with 90% of the governance rules. Those companies have mixed profitability where the ROE (firm profitability) varies between -7.54 and 11.34 with a mean of 3.51. This indicates that Jordanian listed companies do not produce competitive profitability, which may be explained by the characteristics of the Jordanian economic environment as an emerging market that is still working on producing more regulations to control the freedom of the capital. This issue is evidenced when noticing the age values that represent the age of the firm as a listed firm on the ASE, which was established only 36 years ago. The average age for the sample companies is just 13.69 years. This fact indicates that the listed companies' culture is still new and not comprehensive in the Jordanian environment; it needs more time and regulation to protect the interest of the stakeholders after gaining more experience.

The reflection of the above results can also be seen in Table 3, which presents the frequencies of the auditor size variable. This variable presents the size of the audit firms that were hired by Jordanian listed companies as of the end of 2012. Table 3 shows that only 53% of the Jordanian listed companies hire Big 4 auditors.

Table 2: Descriptive Statistics

	N	Minimum	Maximum	Mean	Std Deviation
Governance Compliance	128	0.58	0.9	0.8	0.07
Ln. Firm Size	128	11.58	20.45	15.68	2.02
Firm Profitability	128	-7.54	11.34	3.51	2.54
Age	128	1	36	13.69	8.96

This table presents the descriptive statistics for dependent (Governance Compliance) and independent variables that are related to firm's characteristics (Firm Size and Firm Profitability). Also Firm Age is described.

Testing of the Hypotheses

The first hypothesis explores whether Jordanian listed companies comply with the governance rules issued by the JSC in its governance guide. This hypothesis cannot be tested using a T test, such as the one-sample T test, because there is no valid test value for the calculated compliance index. The compliance index produces values that present a percentage of the company's compliance. Those values, as presented in Table 2, are between 58% and 90% in the sampled companies. To this end, we notice that all the Jordanian listed companies comply with the governance rules as the minimum value for the compliance index is 58% and the mean value for the compliance index is 80%, indicating that Jordanian listed companies comply with the governance guide issued by the JSC. To investigate the rest of the study hypotheses, a multiple regression analysis was conducted based on the study model.

Table 3: Descriptive Statistics for Auditor Size

	Frequency	Percentage %	Valid Percentage %	Cumulative Percentage %
Non Big 4	60	46.9	46.9	46.9
Big 4	68	53.1	53.1	100
Total	128	100	100	

This table provides descriptive statistics for Auditor's Size. The table provide descriptive about how auditors that provides the audit service to the Jordanian listed companies and shows that Big 4 auditors are having the biggest market share.

To run the regression, a multi-collinearity test was performed to determine whether a high correlation between independent variables exists or not; the results indicate that the collinearity problem does not exist because the tolerance values are above 0.20 and the VIF values are less than 5. The results of the ANOVA test and values of the adjusted R square are presented in Table 4, which indicates that the independent variables explain only 40% of the changes in the dependent variable, but the F value, which is 18.147 at the significance level equal to 0, clearly shows that the model is acceptable and well designed. The results of the multiple regression are presented in Table 4, which explains the directions of the relationship between the dependent variable (governance compliance) and the other independent and control variables.

Table 4: ANOVA and Multiple Regression Results

Multiple Regression	B	Std Error	T	Sig.
(Constant)	0.811	0.044	18.377	0.00
Ln. Firm Size	0.00	0.003	-0.169	0.866
Firm Profitability	0.005	0.002	2.483**	0.014
Auditor Size	0.067	0.011	6.143***	0.00
Sector	-0.031	0.006	-4.921***	0.00
Age	0	0.001	-0.256	0.798
F	**Sig.**	**Adjusted R Square**		
18.147***	0.00	0.403		

*This table provides the results of ANOVA and multiple regression model, which explains the directions of the relationship between the dependent variable (governance compliance) and the other independent and control variables. ***, ** and * indicate significance at the 1, 5 and 10 percent levels respectively.*

The second hypothesis explores the effect of company size on governance compliance in Jordanian listed companies. The regression results indicate that company size does not affect governance compliance, where the T value is -0.169 at the significance level of 0.888. Such a result shows that there are no differences between big and small companies in the governance compliance level in the Jordanian context. This result opposes that of Black et al. (2012) and Samaha et al. (2012), but it can be rational in the Jordanian context when considering ASE characteristics especially in a new stock market. The third hypothesis investigates the effect of Jordanian listed companies' profitability on their governance level. The regression results show the t value for this variable is 2.483 at the 0.014 significance level, which indicates a significant effect of companies' profitability on governance compliance. The result of this hypothesis is supported by Samaha et al.'s (2012) results. Such a result means that profitability is considered an incentive for Jordanian companies to comply more with the governance rules as listed in the governance guide in Jordan, and it can also be explained by the characteristics of the ASE which still an emerging market that considers profits as driver for investor's decisions.

The second and third hypotheses investigate the effect of internal variables (size and profitability) on governance compliance, whereas the fourth hypothesis aims to investigate the effect of auditor size (Big 4 or non-Big 4) on the governance level. The regression results show a T value of 6.143 at the 0.00 significance level, which indicates that auditor size positively affects the level of companies' compliance with the governance rules listed in the Jordanian governance guide. This result is in line with the author's prediction and aligned with Al-Janadi et al.'s (2013) results. Such results mean that auditors in Jordan play a governance role and that Big 4 auditors are more effective in this role. Furthermore, this result presents new evidence on the quality of Big 4 auditors.

Regarding the control variables, Table 4 shows that the industry type (sector) positively affects the compliance level in Jordanian listed companies. The T value is -4.921 at the 0.00 significance level, which indicates that the financial sector complies more than the other sectors with the governance rules. However, the age of the company as a listed company on the ASE does not affect the compliance level.

To add clarity about the results presented in Table 4, a simple linear regression has been run to determine the robustness of the results. For each independent variable (Firm Size, Firm Profitability, and Auditor Size) a simple regression was run. The results of those regressions are presented in Table 5 which asserts that company size doesn't affect governance compliance at Jordanian listed companies. The T value is 1.17 but is not significant. At the same time, profitability is found to have a positive effect on governance compliance in Jordanian listed companies where big companies have more compliance to governance guidelines. This effect is significant at the 10% level as mentioned in Table 5. Also, the result of the simple regression regarding the effect of auditor size is the same result that has been indicated through the multiple regression where T value is 6.86 at zero significance level which indicates that auditor size significantly affect the governance compliance where big 4 audit firms are associated with more compliance to governance guidelines in Jordan.

Table 5: Results of Simple Regression

	B	Std. Error	T	Sig
Ln. Firm Size	0.004	0.003	1.170	0.244
Firm Profitability	0.005	0.003	1.811*	0.073
Auditor Size	0.078	0.011	6.860***	0.000

*This table presents the results of simple regression models. Those regressions were run to capture the relation between the dependent variable (Governance Compliance), and each independent variable separately. ***, ** and * indicate significance at the 1, 5 and 10 percent levels respectively.*

CONCLUDING COMMENTS

Corporate governance has become the norm during the past two decades due to its importance in controlling companies' actions toward their stakeholders. Governmental agencies and regulators have devoted more attention to governance practices and started initiating governance rules and guides to push companies to adopt governance practices. In Jordan, one of the emerging markets in the MENA region, the JSC issued a governance guide that lists the mandatory governance practices that all listed companies have to adopt. This guide was first implemented in 2010. The guide was adopted due to the shortage of governance culture in the region Al-Ajmi (2009). The current study aimed to investigate whether Jordanian listed companies are complying with the governance rules listed in the governance guide and to explore factors that may affect the compliance level. A checklist was developed based on the governance guide components to construct an unweighted governance index for Jordanian listed companies. Both multiple and simple regression models were tested to capture the relation between dependent variable (governance Compliance) and independent variables (firm size, profitability, and auditor size). The results indicate that Jordanian companies comply with this guide and are implementing its components. The results of the multiple and simple regressions indicate that companies' size and age as a listed company on the ASE do not affect the governance compliance level, whereas auditor size, profitability, and industry type positively affect the governance level.

Such results show no effect of companies' related variables (size and age as a listed company) on the governance level can be explained by the nature of the ASE as a new stock market in an emerging country. The fact that both auditor size (Big 4) and the industry (sector) positively affect the governance level can be explained by considering both as external factors. This means that Jordanian listed companies consider external factors more than internal ones, which indicates the power of the rules and regulations in Jordan as an emerging market. In addition, these results indicate that Big 4 auditors perform the governance role more than non-Big 4 auditors as quality auditors. Future research in this area to have more comprehensive results is needed when considering that this paper focused on mandatory governance practices. Further analysis for both mandatory and non-mandatory governance practices will be valuable to provide a clear view for governance compliance especially in emerging markets.

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