CORPORATE GOVERNANCE: INSTRUMENT OF RECOVERYAND DEVELOPMENT OF PERFORMANCE

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Abstract: The performance of an entity varies by those charged with governance attitude towards events that occur both inside and outside of it. International standards recognize that tone provided by senior managers is an important factor in establishing a positive control environment, contributing to the implementation of an effective internal control system. If those charged with governance do not comply with legislation regulating their actions, their subordinate employees' compliance is unlikely. Conversely, an administration which sets clear objectives, pay attention to risk prevention activities and shows personal interest in monitoring and developing effective internal control systems will promote a culture where it is more likely that the controls work properly .

Key-words: ***history of corporate governance, theories and responsibilities of corporate governance, hierarchy of governance, governance mechanisms of corporate control, corporate performance.***

Introduction

Speaking about governance research area we are focusing on the difficulties that the persons responsible for governance face within an organization. Arguing about corporate governance creates a number of difficulties, as it is discussed so much lately, within various national and international conferences, as well as within the scientific research institutions worldwide. The most difficult problem refers to the fact that a big number of researchers do not correctly interpret the essence of corporate governance, which is its role within the enterprise.

Although entities draw up Regulations or Codes on corporate governance, our question is whether they are applied, or how properly they are applied and what are the results of their introduction. Don't the corporate governance regulations have a formal character?

Another issue related to corporate governance refers to the fact that many peolpe confound internal control with corporate governance. Eventualy we would like to argue that the control system is an attribute of corporate governance and derives from the Anglo-Saxon system. In this sense, Sir Cadbury defined corporate governance as: *"the system by which companies are directed and controlled"* (Ghita M, 2009). This system of Sir Cadbury constitutes the opinion or attitude of the Board of directors and top management in establishing a favourable environment of control that contributes to the implementation of an effective internal control system. If the persons responsible for governance does not comply with the legislation governing their actions, it is not possible that their subordinates respect it. On the contrary, an administration, that establishes clear objectives, pay attention to the work of preventing risks and demonstrates personal interest in monitoring and developing effective systems of internal control, will promote a culture where the control activities are more likely to function properly.

The research of the past, for today's generations, is a rich source of documentation and guidance. Although early stages of corporate governance were found in ancient Rome, the scientific bases were designed in capitalism, and to validate these arguments we have made a deep study of the period from 19th century to present days. Although we believe that corporate governance refers to the promotion of fairness, transparency and accountability at the company (J. Wolfensohn, 1999), demonstration of these affirmations we are going achieve by searching the answer to a number of questions, such as:

- What are the scientific and pragmatic roots of corporate governance?
- What are the components of corporate governance within the company?
- What are the circumstances which determined the need of corporate governance?

Background

Historical dimentions of corporate governance

It is difficult to talk about the emergence of corporate governance without a reminder of the events that have marked the premises of corporate governance. One of these causes is the failure of corporate organizations, in the past, such as bankruptcy of Medici Bank in 1494 due to unjustified expenditures of managers and the lack of control mechanisms.

History of corporate governance in the middle of the 19th century is oriented towards the railways industry. At the beginning it recorded a period of intense development in the United Kingdom in 1820's and 1830's noted through the need of massive investment in machinery for the equipment manufacture, purchase of land, and specialized labour force. Subsequently, the railway corporations flowerished in the USA until the start of the American Civil War, in 1860. Compairing to older companies, such as the British East India Company, that were considered large companies, the railway corporations were larger and had more than a few hundred employees. Therefore, the new railway companies have developed innovative management infrastructure and hierarchies that allowed the company to operate efficiently and profitably through the coordination of thousands of employees who were performing a variety of complex, interconnected functions. Many railway companies had not less than 50-60 managers before 1850, and hundreds of managers with different hierarchical levels of administration and accountability in the coming years (Galambos, 1975; Micklethwait and Wooldridge, 2003). The federal Government pleased by the rapid growth of corporations, favored investors by the establishment of the New York Stock Exchange (NYSE) în 1817.

The railway corporations dominated the USA economy in the 19th century and their growth stimulated the expansion of other industries. Partially due to new markets arisen generated by the developement of railways, successful corporations in other industries have been established in subsequent years, such as the American Telephone Telegraph &, General Electric, General Motors, Coca-Cola, DuPont, and Standard Oil (Galambos, 1975; Smith and Dyer, 1996). Thus, managers and business investors began to appreciate the large corporations as a desirable objective at the beginning of the 20th century.

Historical dimensions of corporate governance have proved its significance when the owners of the shares suffered major losses. The results of a governance influences directly the entity's performance through the effective use of resources. A good corporate governance (Foreman-Peck & Hannah, 2013) must protect the interests of shareholders and to clarify the disagreements related to the delegation within the company which have not been foreseen in the Act of Incorporation and the company's charter. The separation of the company's owners from current activity involves delegating responsibilities and supervision to the Board of Directors and top management.

Regulation of relations between shareholders and those who manage the owners' estate is a proof of protection of public institutions. In 1845, in the United Kingdom the law called *Clauses Consolidation Act Companies Act*, having as objective the legalization of financial reporting, the voting rules, was introduced. British Bank Royal Bank scandal in 1856 between shareholders and depositors was judged according this law. Radical reforms in the United Kingdom continued through the *Joint Stock Companies Act* in 1856 by encouraging shareholders to continue their rights requirements. Although the main objective of this law was to increase obligation of companies to share the information, however, this law led to many failures in which shareholders' money was lost through negligence or fraud. Another law in this respect represents the *Partnership Act in 1890* that stipulated that company managers guilty for misconduct, misinformation or fraudulent dealings were obliged to pay total compensation to those affected. The Companies Act in 1900 extended the obligations of publishing of company's records at stock echange, contributed to the increase of pressure and led to the decline of some important corporations such as Railway.

Joint Stock Companies Act of 1911 showed a maturity of corporate governance in companies of the United Kingdom, by increasing the number of shareholders and companies listed on the British stock exchanges.

The first three decades of the 20th century were marked by a situation of prosperity in the USA, many American citizens believed the join stock companies as a profitable investment of their savings. For example, during the 1920s and 1930s, the number of shareholders grew from 2 to 10 million. However, investors doubted the quality and transparency of financial information provided by corporations about profit per share. At that time, there was no large-scale mechanism to implement accounting standards regarding financial information supplied by corporations, there were no requirements for financial information provided by corporate companies to be audited or verified by third parties. Financial statements started to be audited in the United Kingdom in 1900, and the USA Congress also voted such a law in 1914.

The bankruptcy of Allied Crude Vegetable Oil Refining Corporation in the early 1900s was caused by the abuse of Corporation of its clients, including Bank of America. Allied Crude Vegetable Oil Refining Corporation borrwed money leaving as collateral vegetable oil. It was subsequently discovered that the tanks were filled with water, and vegetable oil floated just on the surface (Cheffins, 2013).

In other words, corporate financial statements in the USA were not audited and were different from one company to another before 1930. Investors were blinded, i.e. they could not compare the financial statements of the companies, and the result of such speculations was hyperinflation in prices of shares in 1929 (Micklethwait and Wooldridge, 2003). In October 1929, the stock prices dropped at the NYSE, and when the decline stopped, a few months later, the USA shares listed on stock exchange had lost 90% of their value (Bierman, 2010). The solution for the economic depression recovery was the adoption by USA Congress of Securities Act of 1933 and the Securities Act of 1934. These laws also noted the importance of auditing of corporate financial statements of shares value traded on the NYSE. Since that time, the financial statements of companies listed on the stock exchange should be drawn up according to the generally accepted requirements and principles (GAAP) and should be subject to financial audit. Securities Act also established a new federal agency, the Securities and Exchange Commission (SEC), to oversee the operations of public corporations (Micklethwait and Wooldridge, 2003; Williams, 1999).

Corporate governance: structure and theories

Corporate governance has many definitions, but Margaret Blair defines corporate governance as a set of policies, determined in accordance with the economic reality, but with the role to amplify ordinary activity. Usually these specifications are to anticipate a paper as one part of the entire proceedings, and not as an independent document. Organizational procedure guides the activity of corporate organizations as follows: Activities involving means through which the things are made and answering the questions:

- ⇒ who supposed to do it?
- ⇒ the way things are done, how it should be done?
- ⇒ what are the expedituress to be considered before doing it and the controls measure? (Cornelius & Kogut, 2003).

Corporate governance, according to the Organization for Economic Co-operation Development - OECD (2005), is the way and methods by which organizations are directed and controlled. Corporate governance spells out the rights and responsibilities among the members of an organization and also the regulations and methods for making decisions.

Agency Theory

Agency theory is a main theory in corporate governance literature (Kholeif, 2009). The theory places shareholders as the most important stakeholder (Lan & Heracleous, 2010); (Daily, Dalton, & Cannella, 2003). Chartered Institute of Management Accountants (CIMA) defined Agency theory as premise surrounding the relationships that exist between the owners (principals) of organizations and the managers or directors (agents) of organizations. The interest of agents might be in conflict with the interest of principal in achieving the organizational goal.

Shareholder Theory

Milton Friedman argued that shareholders entrust their capital to organizations' managers and they expect organizations' purpose to use the capital only to increase shareholders returns (Dittmar, Mahrt-Smith, & Servaes, 2003). In other words Milton Friedman spoke about moral responsability of business organizations for shareholders wealth maximization.

Stakeholders Theory

Any individual or company that is affected by organization's decisions is defined as stakeholders. (Bryson, 2004). Stakeholder theory is baed on the idea that business organizations should be concerned about the interest of all involved parties when taking strategic decisions (Mainardes, Alves, & Raposo, 2011). The Shareholder Theory is different from Stakeholder Theory due to the fact that it is focused on shareholder wealth maximization, but stakeholder theorists argue for satisfying stakeholders interests. From stakeholder perspective, shareholders are important members of stakeholder. Shareholders are interested in the company activity as well as stakeholders such as employees, customers, suppliers, etc. are. The stakeholder theory claimed that, as business owes special and particular duties to shareholders, it also has various responsibilities towards other stakeholders (Heath & Norman, 2004).

Corporate governance and responsability

The presence of corruption reveals deviations, in other words, the neglect of the strategic concerns by the management of the entity. The perception of this phenomenon was different from country to country, until the approval of the Organisation for Economic Co-operation and Development (OECD) in 1997 and the law relating to bribery (Bribery Act 2010) in the United Kingdom. The United States was one of the countries with an explicit punishment for corruption according FCPA"-Foreign Corrupt Practices Act adopted in 1977.

FCPA specifies two directions of control of corruption:

- anti-bribery provisions;
- accounting provisions (books and record and internal controls)

However, following events demonstrated that this approach of the FCPA law is not sufficient because the internal control did not adequately monitor the decisions made at the top level. The need of strong and effective corporate governance in a regulatory framework is appropriate to ensure that the entities operate in an ethical manner. Finally, persons responsible for corporate governance have the task to ensure the implementation of the law conditions. According to the New York Times of December 15, 2009, Siemens has paid 1.34 billion dollars for FCPA violations, 450 million dollars has been paid to the US Department of Justice (DOJ) and 350 million to settle civil claims brought by the Securities and Exchange Commission (SEC) and about 540 million to German authority Munich Public Prosecutor 's Office.

The accounting amendments of the FCPA laws are the result of investigations led by the SEC and presented at the Conference in 1976 (U.S. GAO report, 1981) about American companies that misspresented accounting data to be able to pay bribes to both domestic and foreign officials and political parties. So, a year later the FCPA modified Section 13 (b) according to the Securities Exchange Act of 1934 and Statement of Auditing Procedure No.54 (Lacey and George, 1998). Internal control has been designed as an instrument of top management in corporations, problem solving, and, no doubt, was an important tool in the United States to fight against corruption of various types - not just those involving foreign public officials.

Management's responsibility for the maintenance of internal control was not a novelty. Subsequently to FCPA law, other acts have been issued; such as Treadway Report (the National Commission on Fraudulent Financial Reporting, 1987), the COSO model (Committee of Sponsoring Organizations, 1992), COBIT standards (Information Systems Audit and Control Foundation, 1996) with purpose to continually improve the internal control system. Sections 404 and 302 of the Sarbanes-Oxley Act (SOX) of 2002 strengthened the internal control requirements by requiring certification of effective internal controls (over financial reporting) by both the CEO and the CFO of large public corporations, as well as the attestation by an external auditor.

With an experience of more than three decades of fighting against corruption, it would be expected that USA companies are relatively free of bribery. It is vice versa, another survey, conducted by the Transparency International, has asked respondents to name three Governments believed to be prepared to use various practices to gain advantages in trade and international investment. Thus, the USA was the most frequently chosen: 58% of respondents chose the USA, followed by 26% shoosing France.

Analyses on the development or failure of corporations have demonstrated that entities are not often able to evolve due to changes in the economic environment constantly and the failure is the result of incapacity of governance. (Jensen (1993). Jensen defines governance as ‘‘the top-level control structure, consisting of the decision rights possessed by the board of directors and the CEO, the procedures for changing them, the size and membership of the board, and the compensation and equity holding of managers and the board’’ (Jensen, 1993)).
The hierarchy of governance: corporate boards and external auditors

The Board of Directors is responsible for corporate governance, ellect and dismiss the top management, provides appropriate incentives and sets the tendecy for the company's global strategies (Smeltzer and Jennings, 1998).

Internal and external audit is intended to provide the required information to the Board in case they are not involved in the day-to-day operations of the company. Despite of the fact that internal auditors are employees of the company, for not causing conflicts of interest, they must be independent from management.

External auditors, should also be independent from top management, but it is difficult to say that external auditors should protect the interests of shareholders because auditors are paid by top management. The question is: who audits the external auditors? The answer was given by the Sarbanes-Oxley Act (SOX) by the establishemnt of the Public Company Accounting Oversight Board(PCAOB) in the USA in 2002. Before signing a contract for the provision of audit services to an entity external audit firms must register with the Public Company Accounting Oversight Board. Auditing firms, having more than 100 clients, are inspected by PCAOB once a year, bur firms, offering less than 100 audit repotrs during a year, are verified once in tree years. External auditors should take into consideration the following:

⇒ If the transactions that generate revenue and expenditure shall be made only with the approval of top management;

⇒ If the client company has adequate internal controls and the auditors must describe any significant weaknesses in internal audit structures.

PCAOB establishes additional requirements to stress on the independence of audit

⇒ The prohibition of the provision of non-audit services simultaneously with the audit service);

⇒ Mandatory rotation of the lead auditor ; and

⇒ the empowerment of audit committees. The audit committee of the Board of Directors of the company and is directly responsible for the appointment, payment and supervision of the work of external audit

Corporate control mechanisms

Corporate control mechanisms are designed to protect and ensure compliance of interests of the management and stakeholders (Walsh & Seward raining day stay inside). Ultimately, corporate performance is a function of the effectiveness of the mechanisms of corporate control.

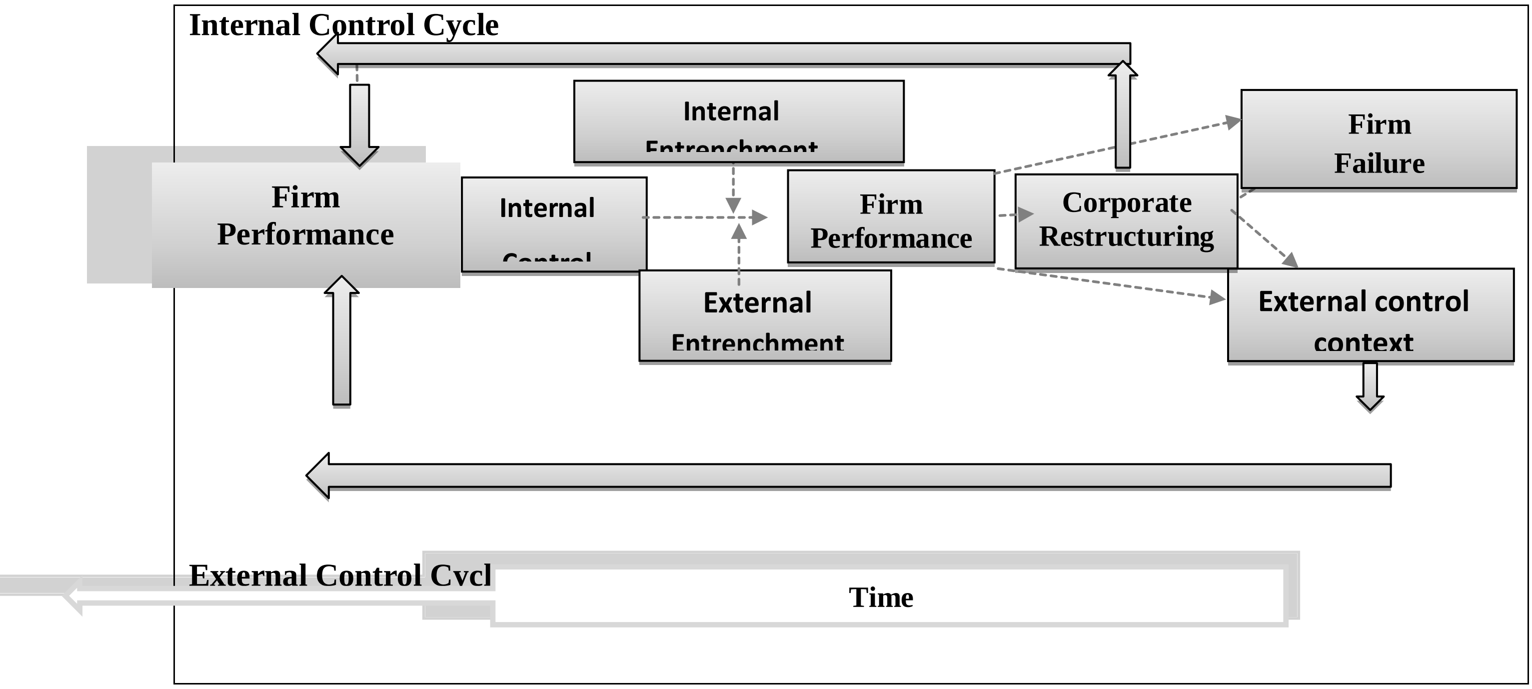

Figure 1. The correlation between internal and external control mechanisms [1]

Figure 1 present the relationships between internal and external control mechanisms and performance of the entity. Internal control phases include entity activity that is monitored by the board of directors and occasionally controlled by top managers according to strategic policies of forecast strengthening. Stages of external control is passed over the reliability of corporate control (the market for corporate control) and are designed to correct the gaps in internal control and to reveal deficiencies of top managers. External control is accomplished through additional control procedures. Moreover, the change of owners generates new costs, new owners must pay for managers previous errors and costs for introducing new strategies.

METHODOLOGY

The methodology, as part of the present article, is to validate the arguments presented in the part relating to the sources study.

The most recent studies in the field of corporate governance usually end with the development of a normative legal act, or a regulation, or code that operates within the Corporation. Therefore, in order not to reduce the scientific value of the research, we refer to

[1]Walsh, I.,and Seward, I., *On the efficiency of internal and external corporate control mechanisms,* Academy of Mnagement Review, 1990, vol.15, nr.3, 421-458p.

investigating the development of corporate governance in different historical periods in order to find solutions related to scientific and real roots of corporate governance, the elements and the circumstances which have led to the its emergence. The most useful method used in investigating issues of this kind is the conceptual analysis of content. I.e. it is used to study documents with a large volume of text, allowing the distance study of information and reveals the messages difficult to notice by other means. Initially it was established a scheme for coding, the resulting elements were subsequently converted into table 1 and figures 1 and 2.

We have analysed the historical roots of control in 29 articles written in different periods, the earliest source being from 1968 and till 2014 and we have noted that a number of authors have translated manuscripts and old works from their original language. Articles and parts of books in English were accessed in the database: *www://search.ebscohost.com* . Finally, the text represents an empirical analysis, and after coding ideas and arguments we obtained the following issues (table 1):

The overview of the concepts according to periods and countries
Table 1

15th century Italy, Florence	**Corporate organization:** Medici Bank
	Financial scandals: the Medici Bank
	The causes of financial scandals: unjustified expenditure, lack of control mechanisms
The first half of the 19th century **United Kingdom**	**Corporate organization:** the railway industry
	Defining elements of corporate governance: the massive capital investment, thousands of employees, 50-60 managers
	Legal regulation: Companies Clauses Consolidation Act 1845
	The results of legal regulation: drawing up of accounting reports
The second half of the 19th century USA, United Kingdom	**Corporate organization:** the railway Industry, the American Telephone & Telegraph , General Electric, General Motors, DuPont, Coca-Cola and Standard Oil.
	Financial scandals: the Royal Bank in 1856 (United Kingdom)
	The causes of financial scandals: the conflict between shareholders and depositors
	Defining elements of corporate governance: thousands of employees, more than 100 managers
	Legal regulation (United Kingdom): Joint Stock Companies Act 1856, the Partnership Act 1890, the Companies Act 1900
	The results of the legal regulation: settlement of the conflict the Royal Bank in 1856
The first half of the 20th century	**Financial scandals**: Allied Crude Vegetable Oil Refining, Bank of America
	The causes of financial scandals: tanks with vegetable oil left as collateral for loans were filled mostly with water with oil floating on the top

<table>
<tr><td rowspan="3">USA, United Kingdom</td><td>Defining elements of corporate governance: an increasing in the number of shareholders, up 2-10 million, shareholders required the transparency of profit per share. Financial statements were audited starting with 1900 in United Kingdom</td></tr>
<tr><td>Legal regulation:
– Joint Stock Companies in 1911 - United Kingdom,
– Securities Act of 1933 - USA
– Securities Act of 1934 - USA</td></tr>
<tr><td>The results of legal regulation:
- financial statements of companies listed on the Stock Exchange were issued according GAAP
- required financial audit
- the establishment of Securities and Exchange Commission (SEC) to oversee the operations of corporations listed on a stock exchange</td></tr>
<tr><td rowspan="3">The second half of the 20th century U.S., worldwide</td><td>Defining elements of corporate governance: organizational theory, shareholder and stakeholder theories, corporate responsibility</td></tr>
<tr><td>Legal regulation:
- Foreign Corrupt Practices Act "FCPA") (USA, 1977)
- the The OECD Anti-Bribery Convention (OECD,1997)
- Bribery Act (United Kingdom, 2010)</td></tr>
<tr><td>The results of legal regulation:
- sustainable economic growth, employment, financial stability by creating Organization for Economic Cooperation Development (OECD,1961) with 30 member countries where the largest share is held by: USA-24,97%, Japan 22, 23%, 9,30% Germany, England 7,12%, France 6,40%, Italy 5,19%
- increased responsibility of management for the maintenance of internal control:
✓ Treadway Report (the National Commission on Fraudulent Financial Reporting, 1987)
✓ COSO model (Committee of Sponsoring Organizations , 1992)
✓ COBIT standards (Information Systems Audit and Control Foundation, 1996))</td></tr>
<tr><td rowspan="2">The beginning 21st century USA</td><td>Financial scandals: Enron, Tyco, WorldCom, Gobal, TelLink, Adelphia</td></tr>
<tr><td>The causes of financial scandals:
– transferring losses from Enron's balance sheet to the accounts of entities created "ad hoc"
– the Board of director of Tyco International has approved millions of dollars dubious loans and bonuses to CEO
– the board of directors of WorldCom has approved loans and guaranties of more than $ 366 million for Chief Executive
– establishing strategic plans the Board of Directors of Global Crossing has</td></tr>
</table>

	not taken into account the real capacities of optical fibers and thus, artificially, increased the company revenues and " bottom line".
	Legal regulation: Sarbanes-Oxley Act (SOX, 2002)
	The results of legal regulation: – Strengthening of internal control by requiring certification of control by CEO and CFO of large public corporations, as well as certification by an external auditor. – Establishment of the Public Company Accounting Oversight Board (PCAOB, 2002): additional requirements for external financial audit firms.

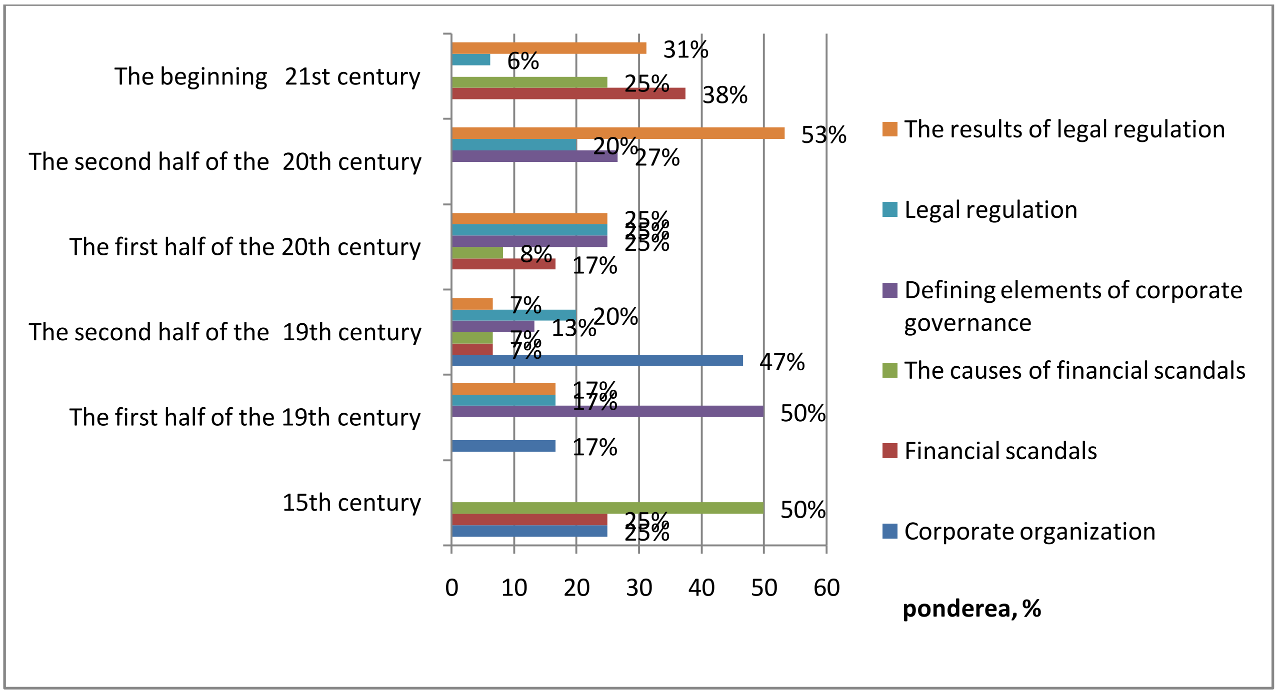

Figure 1. Determinants of corporate governance according to periods

The resulting issues are characterized by a level of generalization on the basis of an established group of elements whose percentage differs from one period to another. Actually we would like to argue that corporate governance in the 15th century was characterised by measures taken by the Bank's management to remove the causes of financial scandals. Later corporate governance involved massive capital investment, thousand of employees and a large number of managers, and legal regulations on accounting have been noted in the United Kingdom. The second half of the 19th century corporate governance established its foundations with all its characteristics. The first half of the the 20th century demonstrates a developing maturity in evolution being determined by nationally important legislative acts and a pragmatic base: increasing the number of shareholders up to 2-10 million, transparency of the profit per share, the audit of financial statements. The corporate governance scientific base was established in the second half of the 20th century due to theories: organizational theory, stakeholders of shareholders theories, corporate responsibility.

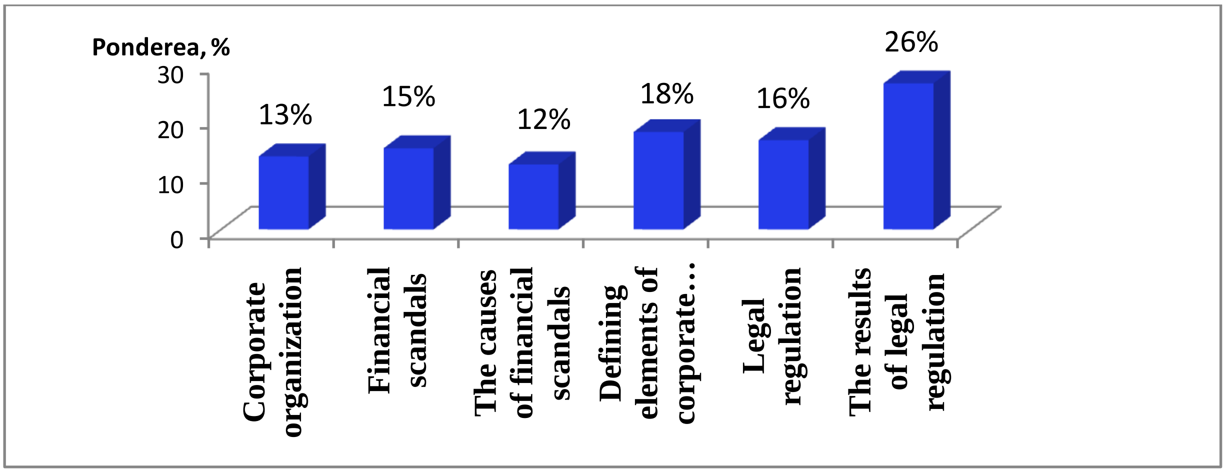

Figure 2. Comparison of corporate governance determinants

Examining corporate governance elementes percentage lead us to conclude that the events that have marked the emergence of corporate governance were many persistent scandals in all periods, and the purpose of its introduction was to settle those scandals. The corporate governance approach has shown that in most of the scandals were settled by introducing new laws and monitoring bodies or by strenthening the conditions under existing laws. As a rule, those legislative measures related the financial reporting requirements, introduction and control of external audit and reporting mechanisms of corporate control.

Conclusions

The answer to the above questions we have found due to the content analysis in history, but the essential elements of the modern corporate governance are difficult to define because it is a subjective function of time and depends on the attitude of top management, the board of directors and national and international legislation in the field. Finally, we can say with confidence that the objectives of the research were reached, generating the following conclusions:

- ❑ Corporate governance has existed since ancient times;
- ❑ Investigation of historical roots has confirmed that the governance originates from conflicts between various categories of stakeholders and its role was to settle and prevent other possible conflicts;
- ❑ The emergence of corporate governance relates to the birth of great corporations in economically developed countries;
- ❑ Scientific support of corporate governance is the result of development of relations between owners and managers, as well as the development of legal framework;
- ❑ Financial performance is a element of direct corporate control mechanisms;
- ❑ Control activities and stimulation of innovation are the main factors of ensuring

the economic activity efficiency.

In other words, an organization's performance and results vary and depend on the attitude of those responsible for the governance towards the events occurring inside and outside it.

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