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Insight of Corporate Governance Theories

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Abstract: The progression of theories or models of corporate governance, it is one of the new dimensions taken in a very crux of social ethics that is minimal and profit making took center stage. In this competitive world, companies are trying to inculcate the wisdom of good governance into their corporate organization. With the massive outpouring of capitalism, companies became stronger while governments around the globe had to accede to its influences and supremacy. However, this paper is a review of literature on the variety of theories in corporate governance. The ultimate theories in corporate governance started with the agency theory, extended into stewardship theory and stakeholder theory and evolved to resource dependency theory, political theory, legitimacy theory and social contract theory. However, these theories discourse the cause and consequence of variables, such as the formation of board structure, audit committee, independent non-executive directors and the duties of upper management and their organizational and social responsibilities rather than its regulatory structures. Similarly, it is proposed that a mixture of various theories is best to describe an effective and efficient good governance practice rather than hypothesizing corporate governance based on a sole theory.

JEL Classifications: M00, M1

Keywords: Corporate governance, theory and Applications

1. Introduction

Organizations are the main concern and dominant institution. They have gone through every part of the world in various sizes, abilities and inspirations. The organizational contribution in good governance has influenced economies and various aspects of social background. Shareholders are seen to be losing confidence and market value has been extremely affected. However with the advent of globalization, there is greater deterritorialization and less of governmental control, which results is a greater need for accountability (Crane and Matten, 2007). Hence, corporate governance has become a vital issue in managing organizations in the current global and complex environment. In order to understand corporate governance, it is imperative to highpoint its definition.

Corporate governance refers to the private and public institutions, including laws, regulations and accepted business practices, which together govern the relationship, in a market economy, between corporate managers and entrepreneurs (corporate insiders) on one hand, and those who invest resources in corporations, on the other (OECD, 2001, p. 13). Rezaee (2009) defined corporate governance as “a process through which shareholders induce management to act in their interest, providing a degree of confidence that is necessary for capital markets to function effectively”. La Porta et al., (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders, i.e. the managers and controlling shareholders. The insiders may simply steal the profits; sell the output, the assets or securities in the forum they control to another firm they own at below market prices; divert corporate opportunities for firms; put unqualified family members in managerial positions; or overpay managers. Mohd Sulaiman and Bidin (2002) defined Corporate Governance as an expression used to describe the way companies are directed and managed. The definition of corporate governance quoted above by Tricker, (1994) focuses on the board room but extends the scope to include 'owners and others interested in the affairs of the company, including creditors, debt financiers, analysts, auditors and corporate regulators'. Such wider concerns reflect the audience for company financial reports, consistent with both Trickers' accounting background and the target audience for his publication.

It has been contended that corporate governance practices is not a standard mode (not a "one size fits all") and thus cannot operate in any standard form but rather vary across nations and firms (OECD, 2000). This variety reflects distinct societal values, different ownership structures, business circumstances, and competitive conditions strength and enforceability of contracts. The political standing of the shareholders and debt holders, and the development as well as the enforcement capacity of the legal system is all crucial to effective corporate governance (Gregory & Simms, 1999).

Based on the above definitions and arguments, it is clearly that corporate governance is concerned with the social political and legal environment in which the corporation operates systems practices and procedures-the formal and informal rules that governed the corporation. In not shell corporate governance is very vital in every organization, because good corporate governance contribute to better firm performance, it is expected for every other organization to enforce corporate governance policy, in order to achieve a stated goal.

2. Corporate Governance Theories

For the purpose of this paper various corporate governance theories have been reviewed: agency, stakeholders and resource dependency theory, stewardship theory, social contract theory legitimacy theory and political theory.

2.1 Agency Theory

Much of the research into corporate governance derives from agency theory (see Figure 1). Since the early work of Berle and Means in 1932, corporate governance has focused upon the separation of ownership and pedals which results in principal-agent problems arising from the dispersed ownership in the modern corporation. They regarded corporate governance as a mechanism where a board of directors is a crucial monitoring device to minimize the problems brought about by the principal-agent relationship. In this context, agents are the managers, principals are the owners and the boards of directors act as the monitoring mechanism (Mallin, 2004). Moreover, literature on corporate governance attributes two factors to agency theory. The first factor is that corporations are reduced to two participants, managers and shareholders whose interests are assumed to be both clear and consistent. A second notion is that humans are self-interested and disinclined to sacrifice their personal interests for the interests of the others (Daily, Dalton & Cannella, 2003).

The seminal papers of Alchian and Demstez (1972) and Jensen and Meckling (1976), describe the firm as a nexus of contracts among individual factors of production resulting in the emergence of the agency theory. The firm is not an individual but a legal fiction, where conflicting objectives of individuals are brought into equilibrium within a framework of contractual relationships. These contractual relationships are not only with employees, but with suppliers, customers and creditors (Jensen & Meckling, 1976). The intention of these contracts is that all the parties acting in their self-interest are motivated to maximize the value of the organization, reducing the agency costs and adopting accounting methods that most efficiently reflect their own performance (Deegan, 2004).

The agency role of the directors refers to the governance function of the board of directors in serving the shareholders by ratifying the decisions made by the managers and monitoring the implementation of those decisions. This role has been examined in a large body of literature (Fama & Jensen, 1983; Baysinger & Butler, 1985; Lorsch & MacIver, 1989; Baysinger & Hoskisson, 1990; Daily & Dalton, 1994). Much of this research has examined board composition due to the importance of the monitoring and governance function of the board (Pearce & Zahra, 1992; Barnhart, Marr & Rosenstein, 1994; Daily & Dalton, 1994; Gales & Kesner, 1994; Bhagat & Black, 1998; Kiel & Nicholson, 2003;), because according to the perspective of agency theory the primary responsibility of the board of directors is towards the shareholders to ensure maximization of shareholder value. The focus of agency theory of the principal and agent relationship (for example shareholders and corporate managers) has created uncertainty due to various information asymmetries (Deegan, 2004). The separation of ownership from management can lead to managers of firms taking action that may not maximize shareholder wealth, due to their firm specific knowledge and expertise, which would benefit them and not the owners; hence a monitoring mechanism is designed to protect the shareholder interest (Jensen & Meckling, 1976). This emphasizes the role of accounting in reducing the agency cost in an organization, effectively through written contracts tied to the accounting systems as a crucial component of corporate governance structures, because if a manager is rewarded for their performance such as accounting profits, they will attempt to increase profits which will lead to an increase in bonus or remuneration through the selection of a particular accounting method that will increase profits.

Arising from the above is the agency problem on how to induce the agent to act in the best interests of the principal. This results in agency costs, for example monitoring costs and disciplining the agent to prevent abuse (Shleifer & Vishny, 1997). Jensen and Meckling (1976) define agency costs: the sum of monitoring expenditure by the principal to limit the aberrant activities of the agent; bonding expenditure by the agent which will guarantee that certain actions of the agent will not harm the principal or to ensure the principal is compensated if such actions occur; and the residual loss which is the dollar equivalent to the reduction of welfare as a result of the divergence between the agents decisions and those decisions that would maximize the welfare of the principal. However, the agency problem depends on the ownership characteristics of each country. In countries where ownership structures are dispersed, if the investors disagree with the management or are disappointed with the performance of the company, they use the exit options, which will be signaled through reduction in share prices. Whereas countries with concentrated ownership structures and large dominant shareholders, tend to control the managers and expropriate minority shareholders in order to gain private control benefits (Spanos, 2005).

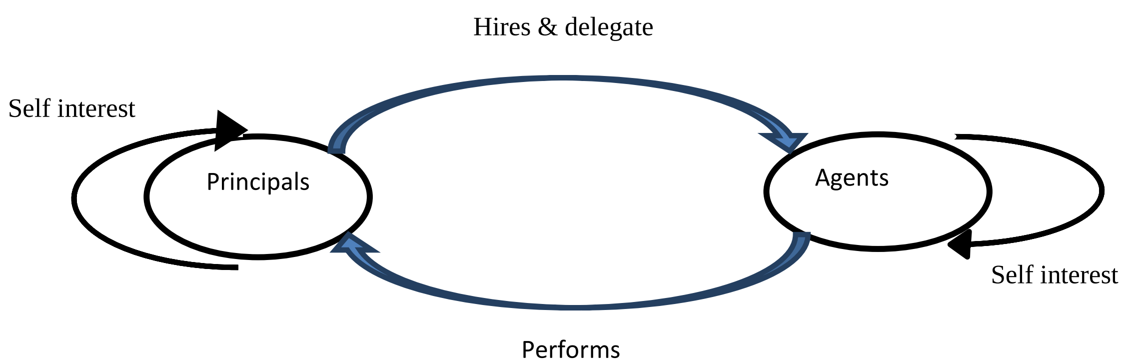

Figure 1. The Agency Model
Adapted from Abdallah, H. (2009)

The agency model assumes that individuals have access to complete information and investors possess significant knowledge of whether or not governance activities conform to their preferences and the board has knowledge of investors' preferences (Smallman, 2004). Therefore according to the view of the agency theorists, an efficient market is considered a solution to mitigate the agency problem, which includes an efficient market for corporate control, management labour and corporate information (Clarke, 2004). According to Johanson and Ostergen (2010) even though agency theory provides a valuable insight into corporate governance, its' applies to countries in the Anglo-Saxon model of governance as in Malaysia. Various governance mechanisms have been discussed by agency theorists in relation to protecting the shareholder interests, minimizing agency costs and ensure alignment of the agent-principal relationship. Among the mechanisms that have received substantial attention, and are within the scope of this study, are the governance structures (Davis, Schoorman & Donaldson, 1997).

2.2 Stakeholder Theory

This theory centres on the issues concerning the stakeholders in an institution. It stipulates that a corporate entity invariably seeks to provide a balance between the interests of its diverse stakeholders in order to ensure that each interest constituency receives some degree of satisfaction (Abrams, 1951). However, there is an argument that the theory is narrow (Coleman, 2008: 4) because it identifies the shareholders as the only interest group of a corporate entity. However, the stakeholder theory is better in explaining the role of corporate governance than the agency theory by highlighting different constituents of a firm (Coleman, 2008: 4).

With an original view of the firm the shareholder is the only one recognized by business law in most countries because they are the owners of the companies. In view of this, the firm has a fiduciary duty to maximize their returns and put their needs first. In more recent business models, the institution converts the inputs of investors, employees, and suppliers into forms that are saleable to customers, hence returns back to its shareholders. This model addresses the needs of investors, employers, suppliers and customers. Pertaining to the scenario above, stakeholder theory argues that the parties involved should include governmental bodies, political groups, trade associations, trade unions, communities, associated corporations, prospective employees and the general public. In some scenarios competitors and prospective clients can be regarded as stakeholders to help improve business efficiency in the market place.

Stakeholder theory has become more prominent because many researchers have recognized that the activities of a corporate entity impact on the external environment requiring accountability of the organization to a wider audience than simply its shareholders. For instance, McDonald and Puxty (1979) proposed that companies are no longer the instrument of shareholders alone but exist within society and, therefore, has responsibilities to that society. One must however point out that large recognition of this fact has rather been a recent phenomenon. Indeed, it has been realized that economic value is created by people who voluntarily come together and cooperate to improve everyone's position (Freeman et. al., 2004). Jensen (2001) critiques the Stakeholder theory for assuming a single-valued objective (gains that accrue to a firm's constituency). The argument of Jensen (2001) suggests that the performance of a firm is not and should not be measured only by gains to its stakeholders. Other key issues such as flow of information from senior management to lower ranks, interpersonal relations, working environment, etc. are all critical issues that should be considered. Some of these other issues provided a platform for other arguments. An extension of the theory called an enlightened stakeholder theory was proposed. However, problems relating to empirical testing of the extension have limited its relevance (Sanda et. al., 2005).

In order to differentiate among stakeholder types, Rodriguez et al., (2002): classification was adopted; consubstantial, contractual and contextual stakeholders (see Figure 2). Consubstantial stakeholders are the stakeholders that are essential for the business's existence (shareholders and investors, strategic partners, employees). Contractual stakeholders, as their name indicates, have some kind of a formal contract with the business (financial institutions, suppliers and sub-contractors, customers). Contextual stakeholders are representatives of the social and natural systems in which the business operates and play a fundamental role in obtaining business credibility and, ultimately, the acceptance of their activities (public administration, local communities, countries and societies, knowledge and opinion makers) Rodriguez et al., (2002). Rajan and Zingales (1998) and Zingales (1998) argue that the company has to safeguard the interests of all who contribute to the general value creation, that is, make specific investments to a given corporation. These firms-specific investments can be diverse and include physical, human and social capital. These specific investments ex ante, nor evaluated independency from the firm's functioning.

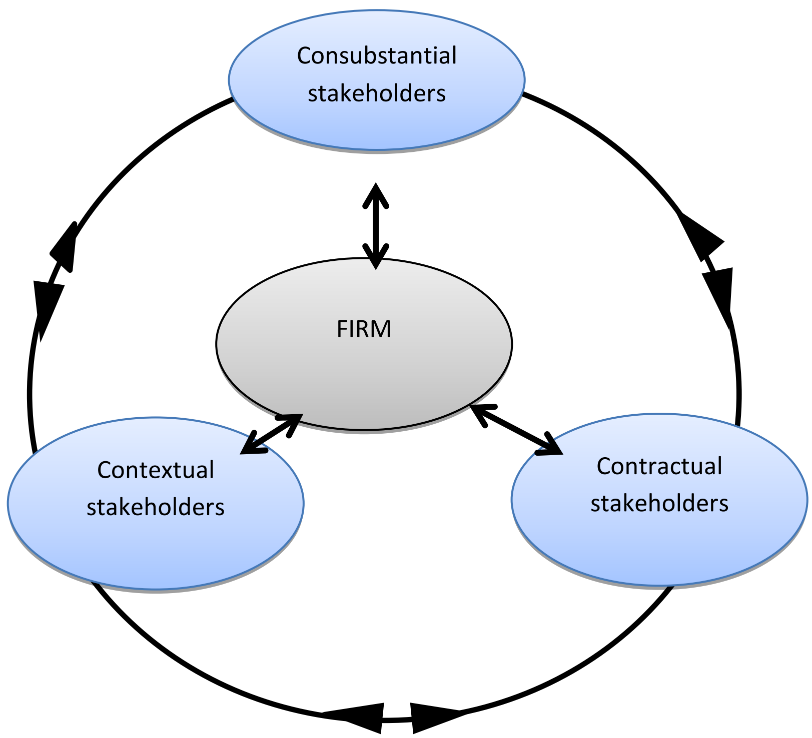

Figure 2. Stakeholders classification. Adapted from Rodriguez et. al., (2002)

2.3 Resource Dependency Theory

The basic proposition of resource dependence theory is the need for environmental linkages between the firm and outside resources. In this perspective, directors serve to connect the firm with external factors by co-opting the resources needed to survive (Pfeffer and Salancik, 1978). Thus, boards of directors are an important mechanism for absorbing critical elements of environmental uncertainty into the firm. Williamson (1985) held that environmental linkages or network governance could reduce transaction costs associated with environmental interdependency. The organization's need to require resources and these leads to the development of exchange relationships or network governance between organizations. Further, the uneven distribution of needed resources results in interdependence in organizational relationships. Several factors would appear to intensify the character of this dependence, e.g. The importance of the resource(s), the relative shortage of the resource(s) and the extent to which the resource(s) is concentrated in the environment (Donaldson and Davis, 1991).

Additionally, directors may serve to link the external resources with the firm to overwhelm uncertainty (Hillman, Cannella Jr & Paetzols, 2000), because managing effectively with uncertainty is crucial for the existence of the company. According to the resource dependency rule, the directors bring resources such as information, skills, key constituents (suppliers, buyers, public policy decision makers, social groups) and legitimacy that will reduce uncertainty (Gales & Kesner, 1994). Thus, Hillman et al. (2000) consider the potential results of connecting the firm with external environmental factors and reducing uncertainty is decrease the transaction cost associated with external association. This theory supports the appointment of directors to multiple boards because of their opportunities to gather information and network in various ways.

2.4 Stewardship Theory

In contrast to agency theory, stewardship theory (see Figure 3) presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners (Donaldson & Davis 1991). The fundamentals of stewardship theory are based on social psychology, which focuses on the behaviour of executives. The steward's behaviour is pro-organizational and collectivists, and has higher utility than individualistic self-serving behavior and the steward's behavior will not depart from the interest of the organization because the steward seeks to attain the objectives of the organization (Davis, Schoorman & Donaldson 1997). According to Smallman (2004) where shareholder wealth is maximized, the steward's utilities are maximised too, because organisational success will serve most requirements and the stewards will have a clear mission. He also states that, stewards balance tensions between different beneficiaries and other interest groups. Therefore stewardship theory is an argument put forward in firm performance that satisfies the requirements of the interested parties resulting in dynamic performance equilibrium for balanced governance.

Stewardship theory sees a strong relationship between managers and the success of the firm, and therefore the stewards protect and maximise shareholder wealth through firm performance. A steward who improves performance successfully, satisfies most stakeholder groups in an organization, when these groups have interests that are well served by increasing organisational wealth (Davis, Schoorman & Donaldson 1997). When the position of the CEO and Chairman is held by a single person, the fate of the organization and the power to determine strategy is the responsibility of a single person. Thus the focus of stewardship theory is on structures that facilitate and empower rather than monitor and control (Davis, Schoorman & Donaldson 1997). Therefore stewardship theory takes a more relaxed view of the separation of the role of chairman and CEO, and supports appointment of a single person for the position of chairman and CEO and a majority of specialist executive directors rather than non-executive directors (Clarke 2004).

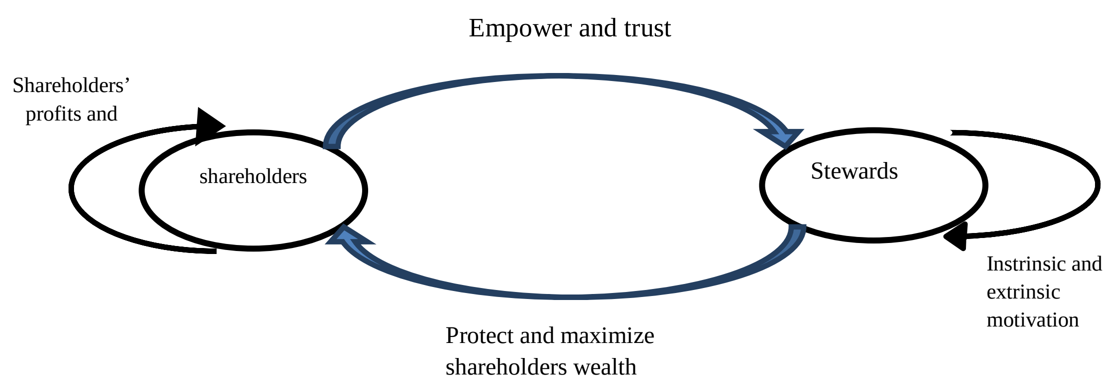

Figure 3. The Stewardship theory
Adapted from Abdallah, H. (2009)

2.5 Social Contract Theory

Among other theories reviewed in corporate governance literature social contract theory, sees society as a series of social contracts between members of society and society itself (Gray, Owen & Adams 1996). There is a school of thought which sees social responsibility as a contractual obligation the firm owes to society (Donaldson 1983). An integrated social contract theory was developed by Donaldson and Dunfee (1999) as a way for managers make ethical decision making, which refers to macrosocial and microsocial contracts. The former refers to the communities and the expectation from the business to provide support to the local community, and the latter refers to a specific form of involvement.

2.6 Legitimacy Theory

Another theory reviewed in the corporate governance literature is legitimacy theory. Legitimacy theory is defined as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate with some socially constructed systems of norms, values, beliefs and definitions" (Suchman 1995). Similar to social contract theory, legitimacy theory is based upon the notion that there is a social contract between the society and an organisation. A firm receives permission to operate from the society and is ultimately accountable to the society for how it operates and what it does, because society provides corporations the authority to own and use natural resources and to hire employees (Deegan 2004).

Traditionally profit maximization was viewed as a measure of corporate performance. But according to the legitimacy theory, profit is viewed as an all inclusive measure of organizational legitimacy (Ramanathan 1976). The emphasis of legitimacy theory is that an organization must consider the rights of the public at large, not merely the rights of the investors. Failure to comply with societal expectations may result in sanctions being imposed in the form of restrictions on the firm's operations, resources and demand for its products. Much empirical research has used legitimacy theory to study social and environmental reporting, and proposes a relationship between corporate disclosures and community expectations (Deegan 2004).

2.7 Political Theory

Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1983). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments' favor. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism (Hawley and Williams, 1996).

3. Discussion — Corporate Governance Theories and Applications

This appraisal has seen corporate governance from various theoretical perspectives. The essense of agency theory focuses on the conflicting interests between the principals and agents while stakeholder theory explores the dilemma regarding the interests of different groups of stakeholders. Resource dependency theory underscores the importance of board as a resource and envisages a role beyond their traditional control responsibility considered from the agency theory perspective, legitimacy theory is based upon the notion that there is a social contract between the society and an organisation and political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power.

Among various theories discussed, the agency theory perspective was the most popular and has received a great deal and numerous attention from academics (Jensen & Meckling, 1976; Fama & Jensen, 1983) as well as practitioners. It provided the basis for governance standards, codes and principles developed by many institutions (CalPERS, 1999; OECD, 1999, 2004; ICGN, 1999, 2005). Boards are appointed by the shareholders to monitor and control managerial decision making to protect the shareholders' interest. In particular, this monitoring role was expected to be effectively performed through independent non-executive directors and that the positions of Chairman and CEO should be held by different persons (Cadbury, 1992; OECD, 1999; ICGN, 1999, Combined Code, 2006). However, other alternative theories of stewardship theory, resource dependency theory and stakeholder theory have become prominent over the recent times.

Others scholars (e.g. Boyd, 1995; Hillman & Dalziel, 2003) have taken different approached and limited themselves to a particular distinctive perspective. Boyd (1995) argues that the seemingly opposing perspectives of both agency and stewardship theories can be correct, but under different environmental conditions, by using a contingency approach. Hillman and Dalziel (2003) integrated the agency and resource dependency perspectives and argued that each board has board capital and it affects both board monitoring (agency perspective) and the provision of resources (resources dependency perspective) and that board incentives moderate these relationships. Hendry and Kiel (2004) explain that the choice of a particular theoretical perspective depends on 'contextual factors' such as board power, environmental uncertainty and information asymmetry. Though there are different perspectives regarding the firm, "many of these theoretical perspectives are intended as complements to, not substitutes for, agency theory" (Daily et al., 2003, p. 372). Review of different perspectives clarifies that there is need to take an integrated approach rather than a single perspective to understand the effect of good corporate governance. While agency theory places primary emphasis on shareholders' interests, stakeholder theory places emphasis on taking care of the interests of all stakeholders, and not just the shareholders. In line with this, Jensen (2001) suggests enlightened value maximisation, "which utilises much of the enlightened stakeholder theory but accepts maximisation of the long-run value of the firm as the criterion for making the requisite trade-offs among its stakeholders and therefore solves the problems that arise from multiple objectives that accompany traditional stakeholder theory" (p. 298). To gain a greater understanding of board process and dynamics, as discussed in this section, there is a need to integrate different theories rather than consider any single theory. Such an approach was supported by Stiles (2001) who calls for multiple theoretical perspectives and Roberts et. al., (2005) who suggests theoretical pluralism.

4. Conclusion

The outcome of a good corporate governance practice is an accountable board of directors who ensures that the investors' interests are not jeopardized (Hashanah and Mazlina, 2005). The accountability and transparency component of corporate governance would help companies gain shareholders' and investors' trust. These stakeholders need assurance that the company will be run both honestly and cleverly. This is where corporate governance is critical. (Morck and Steier, 2005). Corporate governance improves stakeholders' confidence and this would aid the sustainability of business in the long run. The present corporate governance theories cannot fully explain the intricacy and heterogeneity of corporate business. Governance may differ from country to country due to their various cultural values, political and social and historical circumstances. In this sense, governance in developed countries and developing countries can vary due to the cultural and economic contexts of individual countries. However, the literature has confirmed that even with strict regulations, there have been breaches in corporate governance. Hence it is vital that a rounded recognition be driven across the corporate world that would bring about a different perspective towards corporate governance. The days of cane and halter are becoming a mere shadow and the need to get to the root of a corporation is crucial. Therefore, it is significant to re-visit corporate governance in the light of the conjunction of these theories and with a fresh angle, which has a universal view and incorporating subjectivity from the perspective of social sciences.

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