



### **Theoretical Perspectives of Corporate Governance**

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#### **Abstract**

Corporate Governance is relatively new area and its development has been affected by different theories from different domain, including law, economics, finance and management. This article gives a theoretical overview within the disciplines of corporate governance. This research paper provides an overview of main theory i.e., agency theory as well as other theories like stewardship theory, stakeholder theory, resource dependency theory and transaction cost economics theory that influences the development of corporate governance. Researchers also reveal the differences among these theories, spanning over different disciplines with diverge scope. Some theories are most appropriate are relevant for some context as compared to the others. The study calls the need for the development of a general theory of corporate governance with conjunction of legal system (common law or civil law) and considering other actors. It gives new mode of thinking and new direction of research in analysing corporate governance.

**Keywords:** Corporate Governance, Agency Theory, Stewardship Theory, Stakeholder Theory, Resource Dependency Theory, Transaction Cost Economics

## I. Introduction

Corporate governance (CG) is an emerging phenomenon and its development is based on different complex disciplines including but not limited to legal, cultural, ownership, and other structural differences (Mallin, 2013) but its underpinnings assuredly weak (Tricker, 2012). The corporate governance evolved with the development, growth and advancement of the economy as well as with the enhancement in the corporate structure and the complexities accompanied with it. However, subject lacks a theoretical framework, empirically and methodologically coherence that effectively mirrors the reality of CG. The shared consensus among the CG scholars and practitioners is that there is no single universally recognized theoretical base nor commonly acknowledged paradigm. CG has become the major concern for managing firms in complex environment. Stakeholders are losing confidence due to high profile and unexpected collapses around the globe due to complexity. In fact, as yet, the complex corporate structures continue to be a persistent factor for corporate failures.

Corporate governance is "A set of relationships between a company's board, its shareholders and other stakeholders. It also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (OECD, 1999). The Cadbury Report, para 2.5 (1992) defined it as "the whole system of controls, both financial and otherwise, by which a company is directed and controlled."

CG is a system through which firms are directed and controlled for long term results. Accountability, transparency, fairness and disclosure are the four "pillars" of the CG (Bhasin, 2013). It delivers structure and plan by which the goals of the corporations are set and also the ways for achieving these goals. Furthermore, it also offers structure to monitor the firm performance. It is argued here that corporate governance policies and practices are not on definite mode. Therefore, it cannot operate in any standard form across countries and at diversified corporations (OECD, 1999). This variability is due to the diversified cultures, differences in ownership structures and competitive conditions.

Businesses around the globe aim to attract funding from investors for growing purposes and hence, required efficiency, transparency and accountability. Investors and stakeholders want assurances that their investment will yield greater returns. Before investing in any particular company, investors ensure that the firm/business is financially sound and will continue to be profitable. Therefore, they need to be satisfied that the business is being appropriately managed.

In order to have this assurance, the investors observe and analyse the published annual reports of the business. They believe that the annual report convey true pictures and give a comprehensive view of the firms performance. Hence these reports are analysed and audited by independent external auditors. These auditors analyse the transactions and affirm that the statements are in accordance with the national or international accounting standards. Income statement and balance sheet help to shed light on the true picture of a company's standing and performance. Numerous angles, dimensions and aspects of the business are effectively reflected in the annual report.

However it is to be noted that there are many startling high profile cases of corporate catastrophes (Figure A1) that have cropped up all around the globe despite the fact that the annual reports seem sound (Abid and Ahmed, 2014). These corporate frauds are widespread, costly, multifaceted and lead to adverse effect (Alleyne and Elson, 2013). These corporate catastrophes leave adverse effect on stakeholders including shareholders, workers, creditors and vendors etc. because firm is a "congregation" of all these parties. The gist of the matter is that corporate catastrophes disturb and cause a ripple in the financial world. Few questions crop up in the mind of scholars and practitioners such as; what are the factors that lead to such collapses? How we can rebuild the confidence of potential investors.

The potential answer to both of the questions is related to lack and misuse of CG and its practices. Hence, good and effective corporate governance may help to prevent such catastrophes occurring again and thus bring back confidence of all the stakeholders (Abid and Ahmed, 2014). Regulatory bodies are currently trying to investigate and improve the prevailing imperfections in system to regain public confidence. Therefore, countries are developing its codes. To date, there are approximately 101 modified CG codes (Figure A2) prevailing all around the world (ECGI, 2014) and it's continue improvement reflect the conventional wisdom as well as new conceptual thinking of best practices. As per Figure A2, the majority of modified codes are clustered in the year 2002 and onwards because the majority of scams transpire in the same time period. Now days, growing body of work on comparative CG has begun to identify the similarities and differences in CG structures and practices across nations.

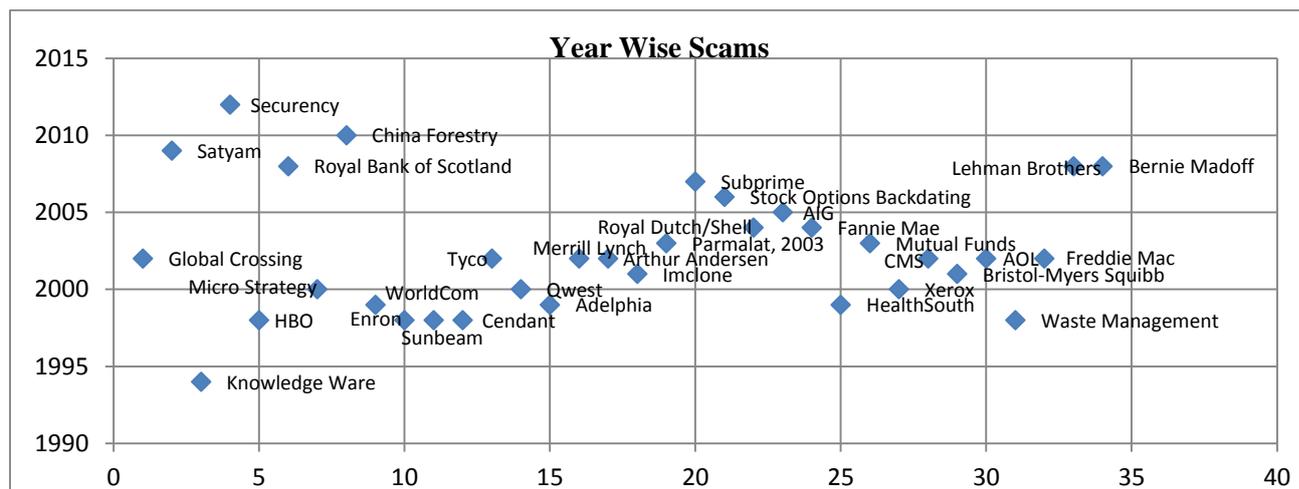


Figure A1: Year-Wise Breakup of Scams Source: Authors

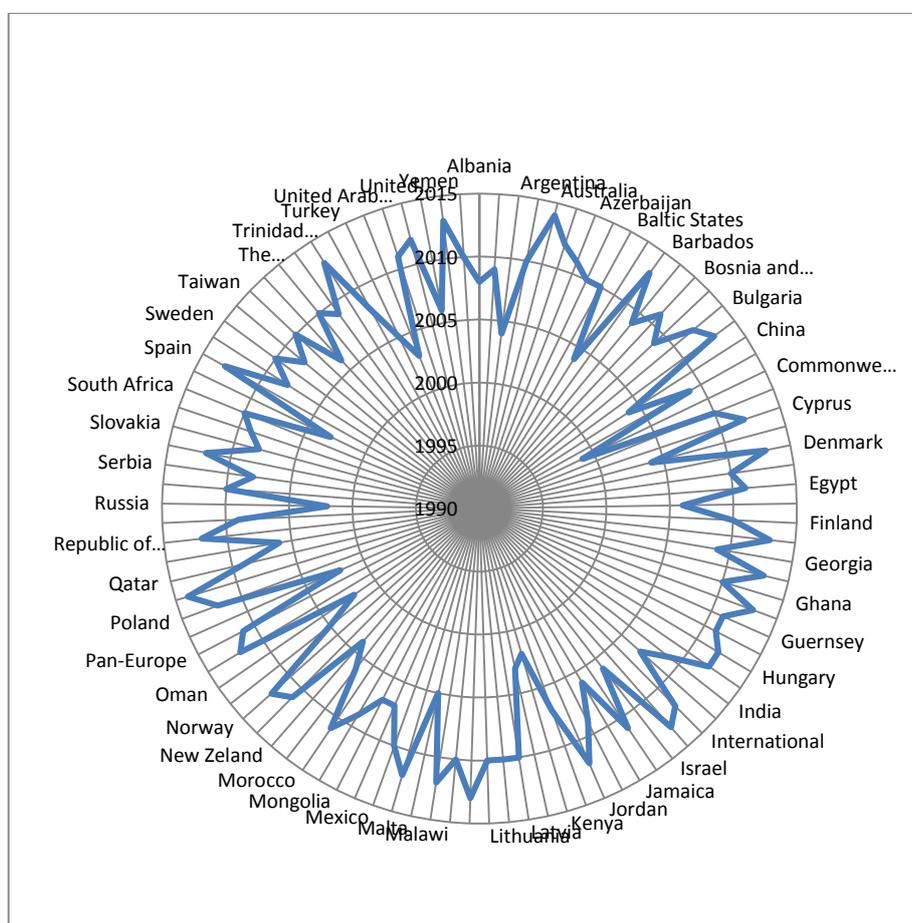
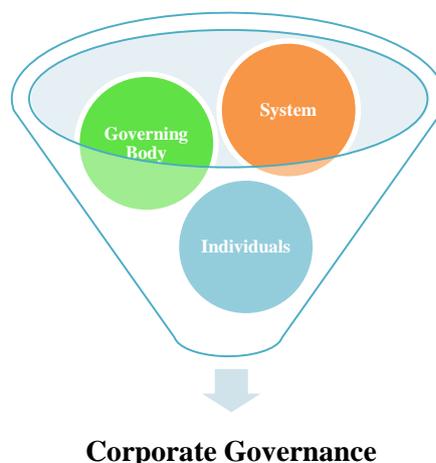


Figure A2: Country Wise Development of Corporate Governance Codes Source: Authors

The association between shareholders and managers, and their dependence on each other replete with conflicting interests and objectives which crop up due to the segregation of ownership, authority and control. These opposing interests, management have the reason and capability to boost their desires at the cost of corporate stakeholders. The CG theories such as agency theory, transactions cost economics, stewardship theory, stakeholders theory and resource dependency theory, facilitate us to interpret the role that directors may play in achieving the performance goals of the firm that they govern (Nicholson and Kiel, 2007). These theories help us to understand the role and preferences of the different stakeholders. All the theoretical perspectives emphasized

on diversified level of abstraction (Figure A3). It is to be noted that some focus on the relevant systems which covers the financial markets. For example agency theory and stewardship theory reflect the Anglo-Saxon case-law-based legal situation and financial market (Tricker, 2012). Others believe that the governing body are the important and some emphasised on individuals i.e., chairman, CEOs, and directors.



**Figure A3: Theoretical Perspectives-Level of Abstraction Source: Authors**

To exemplify why corporate collapse appear regardless of the firms seems sound, it is worthwhile to see the challenges and theoretical perspectives of CG. Therefore, this paper explores the theoretical perspectives on the basis of existing important CG theories and highlighted the difference that each theory has compared to the others. The challenge to corporate governance is as old as highlighted by Adam Smith, *The wealth of nations* (abridged) in 1776.

“The directory of companies, being managers of other people’s money, cannot be expected to watch over it with the same vigilance with which they watch over their own.”

Whenever the owner of wealth (principal) contracts with someone else (agent) to manage his or her affairs, the agency dilemma crop up. In 18<sup>th</sup> and 19<sup>th</sup> centuries, majority of the contracts were, indeed, based on one principal and one agent only (Tricker, 2012). It is not easy to ensure that agent solely work for the interest of the principal. The separation of ownership and control was pinpointed in the 18<sup>th</sup> century by Smith (1838). Almost century later, Berle and Means in 1932, CG concentrates on the separation of ownership as countries industrialized, diverse shareholders and developed markets particularly in USA and UK. It guides the way the firms are owned, managed and owned. Therefore, significant body of work has been done in the context of the principal-agent structure. It help us to establish the and understand the relationship of intense ownership and control (Filatotchev et al., 2011; Gamble et al., 2013) Whenever there is separation of members (shareholders, trade union, group of owners, members of professional institutions) and the monitoring body (board of directors) exist to protect the interest of the members. The agency dilemma crop up and corporate governance issues occurs. This agency problem arises when the same agent performs two different role (i.e. manage as well as control) (Fama and Jensen, 1983). It can occur in public companies, private companies, joint ventures, not-for-profit organizations, professional institutions and governmental bodies. However, when family owners are personally managing the company, then the interest of shareholders and managers are aligned, therefore the agency problem are minimized (Yoshikawa and Rasheed, 2010).

## II. Agency Theory

Lot of empirical work has been done on CG on theoretical perspectives of agency theory because it has theoretical roots in it (Filatotchev and Wright, 2011). Agency theory was proposed by Alchian and Demsetz in field of Economics, directed at the agency relationship, in which on party (principal) delegates work to another (agent), who performs that work (Alchian and Demsetz, 1972; Eisenhardt, 1989). It discusses that shareholders’ interests necessitate security by split-up incumbency of the role of board and CEO (Donaldson and Davis, 1991). The segregation of management role and ownership lead to a serious matter of control over the risk attitude (Berle and Means, 1934). The basis of the theory is on mechanism where board of directors and owners act as the monitoring authority whereas agents are the managers (Mallin, 2004).

The disadvantage of the framework is that agent may not work for paramount interest of principal. Agent misusing his/her power for monitory and non-monitory benefits. Agent doesn’t take precautionary risk measures

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or agent and principals may have different attitude towards risk. It explains the behaviour of persons in firms in their own self-interest, if it is not govern to minimize this behaviour. Agency problem arises because contracts are written and enforced by considering costs. There are agency costs to demoralize agents from benefiting at the expense of principals (Alexander, 2010). Agency costs include the costs of structuring, monitoring and bonding a set of contracts among agents of divergent interests (Fama and Jensen, 1983).

Principal-agent theory specifies mechanism which reduces agency loss (Eisenhardt, 1989). This includes incentives (equity-based) to management for maximising shareholder interest and aligns the interest of principals and agents (Filatotchev and Wright, 2011; Jensen and Murphy, 1990). Various agency researchers have discussed the governance mechanism to protecting the shareholders interest and alignment of principal and agent liaison. Although the major emphasis given on the monitoring dimension of governance (Filatotchev and Wright, 2011).

The “model of man” underlying agency is based on self-interested actor those aims at the maximising their own personal gain. The model is individualistic and in-built conflict of interest among owner and managers always stand. This model is called by organizational psychologists as Theory X (Mcgregor, 1960). CG issues crop up whenever there is an agency problem (misalignment of interest, conflict of interest) among the parties of the organization (Eisenhardt, 1989; Fama, 1980; Ross, 1973). This misalignment of interest crop up due to the divergent goals, priorities and information asymmetries (Gamble et al., 2013). Second issue, the transaction costs are such that the agency problem cannot be dealt with contract (Hart, 1995). The theme behind the agency theory is aligning the interests of owners and management (Jensen and Meckling, 1976; Fama and Jensen, 1983) and to resolve two problems that crop up in agency relationship. The first problem appears when there is conflict between the principal’s desires and agent’s desire. The second problem is when principal cannot validate whatever agent is doing.

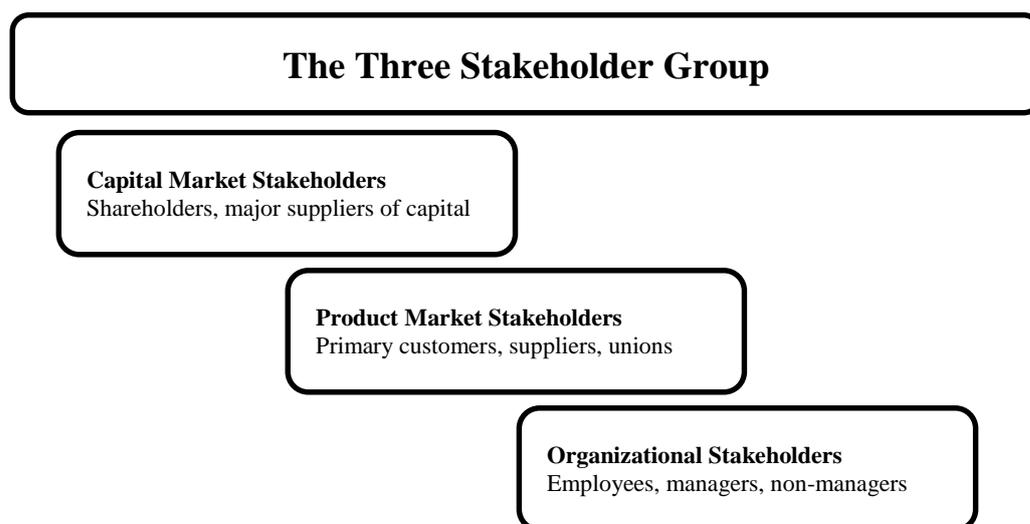
Early perspectives on CEO-directors relationship (fiduciary relationship) was on the base of agency theory. According to the theory, directors monitor the decisions and performance of the top management. The top management gives valuable information that enables the directors to monitor them efficiently (Fama and Jensen, 1983). The agency role of the directors serves as a governing function which translates into the interests of the shareholders. They not only approved the decisions made by the managers but also monitor its implementation over the time period. It has been investigated in vast majority of literature (Daily and Dalton, 1994).

Majority of the work focused on analysing the board composition (Kiel and Nicholson, 2003). The reason behind is that the responsibility of the board of directors towards the shareholders is to enhance their wealth. Therefore, theory is normally used to predict the behaviour of the management. However, critics have clarified that agency theory and its applications is Anglo-American specific (Phan and Yoshikawa, 2000). The board structure, process and board management relationship is based on agency theory view of CG firms (Kaplan, 1995; Kaplan and Minton, 1994). Scholars in the field of CG moved forward the simple solutions often suggested in studies conducted on the basis of agency theory (Filatotchev and Wright, 2011; Westphal, and Zajac, 2013). According to Jensen et al., (2004) (as cited by Benz and Frey, 2007), that agency theory failed to examine the rational reaction of top management subjected to pay-for-performance. Agency theory is a control-based theory and its supporters recognized that the CG mechanisms need to be described so that top management self-interest is accommodated (Jensen and Meckling, 1976). Furthermore, it focuses on the link between the board independence or leadership structure and firm performance.

### **III. Stakeholders Theory**

Stakeholder theory is mainly developed to identify, analyse, develop and manage strong coordination among the stakeholders (Freeman, 1984). It is in juxtaposition to agency theory. In agency theory, the maximizing the shareholders’ wealth is paramount, whereas the stakeholder theory focuses on wider stakeholders groups (Figure A4). Now a day, many corporations endeavor to maximize shareholder wealth whilst at the same time emphasizing on range of other stakeholders. The theory is prominent corporate governance theory because of the accountability of the firm to a wider audience than simply its shareholders. The theory suggests that the performance of corporate cannot be measured only in term of gain to its shareholders (Jensen 2001).

Shareholders and stakeholders encourage distinct CG structures and monitoring mechanism. For example, Anglo-American model emphasizing on shareholders’ value and board consists of executives and non-executive directors. Whereas, in German model, stakeholders have constitutional right allow representatives to actively participate in board meetings, sit on the supervisory board alongside the directors. Theory and empirical work often do not ensure which corporate governance structure would be most efficient (Bebchuk & Roe, 1999).



**Figure A4: Stakeholders Group Source: Hitt et al., (2012)**

#### **IV. Stewardship Theory**

Stewardship theory is alternative to agency theory in term of managerial motivation. It argues that shareholders' interests are maximised by stockholder incumbency of the roles of board chair and CEO (Donaldson and Davis, 1991). They stated that it focuses on the proportion of insiders on board to analyse link with firm performance. Dalton and Kesner (1987) highlighted that about 8 percent USA firms has CEOs who are board chair too. This duality proportion is very in USA compared to other countries like Japan (Kesner and Dalton, 1986) and Australia (Korn-Ferry, 1988) and highly criticised. The executive members are far from being opportunistic shirker. Their aim to do work effectively and efficiently and to be great steward of the assets they are controlling within corporation. The theory holds the notion that there is no hidden dispute or trouble of top management's motivation.

Stewardship theory is that the managers, left on their own, will indeed act as responsible stewards of the assets they control (Davis et al., 1997). In theory, the model of man (agent) is grounded on a steward. Their behaviour is pro-organizational and collectivistic. The logic behind is that stewards main aim to achieve the objectives of the organizations. This behaviour ultimately beneficial for principals in terms of increased in share prices and return on shares. Theory assist that board and management are single, collective stewardship team. Board or stewards basically support and assist the management and CEO. Stewardship philosophers expect a significance association between the growth of the firm and stockholder's well-being.

Unlike most theories of corporate governance and Agency theory which focuses individual work for self-interest at the expense of owners. The stewardship theory rejects this notion. In stewardship theory the agent is self-actualizing focused on higher order needs (achievement and self-actualization). They place the firm ahead of their personal interest. The stewards are involvement-oriented and trusty. The stewards do not primarily target "survival" needs. No doubt human must have income to survive. The theory is best applicable in low-power distance culture. It argues that agents inherently seek to do good job. They don't treat themselves as outer employees instead they treated themselves important member of the firm. They align own psyche and way of work with the prestige of the corporation.

The relevance of stewardship theory to CG, manager needs to be given clear and unambiguous role. The organizational structure should give and support acceptable authority, worth and power to the management. This is why the stewards are referred to as the company man .i.e. man who will be committed and pace the firm ahead of his self-interests. This theory gives different angle then agency theory, in which top management are expected to act for self-interests at the expense of shareholders.

#### **V. Transaction Cost Economics**

Transaction cost economics is closely related to agency theory borrowed from the work of Coarse 1937. His main viewpoint is that corporations could save costs by performing tasks within the organization instead of focusing entirely on externals. Theory proposes that the costs and hardship in transactions sometimes support

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in-house production and sometimes markets as economic governance structure or an intervene mechanism (known hybrid or relational), between the two extremes in governance structure (Williamson, 1975).

It is mainly corporation governance theory which emphasis on entirely transaction costs which is opposed to production costs. Theory states that managers operate under bounded rationality and they are self-interest seeking. In other words we can say that both the top management and director act for the intention to enhance their own wealth instead of shareholder's wealth. Williamson (1975; 1979; 1985) suggested that the idea form of governance (i.e. market vs. hybrid vs. hierarchy) is with the aim to reduce the transaction costs. Therefore, the theory emphasize on governance structures and mechanisms.

The theory has three assumptions i.e. risk neutrality, opportunism and bounded rationality. Furthermore, it also has dimensions of transactions; 1) asset specificity, which attributes to the amount of unique investment to favour transaction; 2) frequency of transaction and finally; 3) uncertainty. There are three main types of uncertainty i.e. 1) volume uncertainty in future demand which is not predictable; 2) technology uncertainty and 3) behaviour uncertainty.

TCEs emphases on the application cost or check-and-balance mechanisms in form of internal and external audit controls, information disclosure, independent outside directors, separation of board chairmanship from CEO, risk analysis, nomination and remuneration committees (Tricker, 2012).

### VI. Resource Dependency Theory

Resource dependency theory (RDT) draws from both sociology and management (Pettigrew, 1992), states that how the external resources of the firm affect the behaviour of the firm and takes a strategic view of CG. Therefore the acquisitions of external resources are vital for strategic management of any organization. Every corporation depends on the resources. Hence, RDT recognized that the administrative body of any firm as the linchpin among the firm and the resources that are required to accomplish the goals (Tricker, 2012).

The resources emanate from the environment consist of other firms. We can say that the resources are in the hand of other firms. Therefore, firms are depends on each other and exchange resources. This is why resources are the basis of power for firms because the resources are valuables, costly to imitate, rare and no substitutable (Hitt et al., 2012). In other words, resources and power are directly linked. Those firms who have resources can be considered more powerful as compared to its competitors those don't have access to that. The dependence on other firms normally affects the productivity of firms. The scarcity of resources leads to uncertainty for organizations. Firms always seek to find ways to exploit the resources for the safeguard of its own long term survival. The resource dependency theory investigate the association between directors interlink and different facets of organization performance or behaviour (Pfeffer and Salancik, 1978).

### VII. Comparing the CG Theories

The difference of the main theories that have affected the development of CG is given below in Table A1.

**Table A1 Comparing the CG Theories**

Basis	Agency	TCE	Stewardship	Stakeholders	RDT
<b>Focus</b>	Reciprocity (Self-interest)	Transactional costs	Shareholder's interest	Stakeholder's interest and Relationship building	Firm resources and power
<b>Objective</b>	Minimize agency cost	Reduce transaction cost	Maximize Productivity	Long term relationship	Acquire & exploit resources
<b>Base</b>	Normative	Classical idea	Classical idea	Normative	Classical idea
<b>Model</b>	Individualistic	Individualistic	Collectivistic	Collectivistic	Collectivistic
<b>Time horizon</b>	Short term view	Long term view	Long term view	Long term view	Long term view
<b>Rooted</b>	Economics	Micro-Economics	Law	Management	Sociology and management
<b>Behavior</b>	Opportunistic	opportunistic	Pro-organizational	Pro-social	Pro-organizational
<b>Approach</b>	Economic	Economic	Sociological and psychological	Societal Level	Strategic

<b>Main theme</b>	Goal congruence	Goal alignment	Goal alignment	Goal alignment	Goal congruence
<b>Cultural suitability</b>	High power distance	Mixed	Low power distance	Low power distance	Mixed
<b>Model of man</b>	Economic man	Economic man	Self-Actualizing man	Self-Actualizing man	Economic man
<b>Motivated by</b>	Self-objectives	Self-objectives	Principal's objectives	Shareholder and other stakeholder's objectives	
<b>Motivation</b>	Extrinsic	Extrinsic	Intrinsic	Intrinsic as well as extrinsic	Intrinsic as well as extrinsic
<b>Structure</b>	Monitor and Control	Monitor and Control	Facilitation and empowerment	Facilitation and empowerment	Monitor and Control
<b>Need</b>	Economic need(lower order)	Economic need(lower order)	Growth, achievement (higher order)	Economic and long term firm growth	Economic and long term firm growth
<b>Principal and agent interest</b>	Diverge	Diverge	Converge	Converge-Liaison	Converge
<b>Management philosophy</b>	Control oriented	Control oriented	Involvement oriented	Involvement with all stakeholders	Control oriented
	Control mechanism	Control mechanism	Trust mechanism	Trust mechanism	Control mechanism
<b>Attitude towards risk</b>	Risk aversion	Risk aversion	Risk propensity	Risk propensity	Risk aversion
<b>Power</b>	Institutional base	Institutional base	Personal base	Institutional base	Institutional base
<b>Commitment</b>	Low level commitment	High level (shared) commitment	High level (shared) commitment	High level (shared) commitment	High level (shared) commitment
<b>Relationship</b>	Contract base relationship	Contract base relationship	Trust base relationship	Trust base relationship	Contract base relationship

### VIII. Conclusion

It is argued that the strength of research in the organizational field is its polyglot of different theoretical perspectives that yield additional convincing view of firms. Agency theory is revolutionary, powerful foundation and predominantly used to explain and predict phenomena in corporate governance. The theory does not address any clear problem, is in restricted focus and hence lacks the practicality. Therefore, it should be used with other complementary theoretical views. Agency theory only gives restricted view of the governance that somehow is effective. It neglects the intricacy and complexity of the firms. Additional theoretical perspectives should also be considered to capture the complexity. Furthermore, there is a need to develop a general theory of CG by keeping in view the qualities of good theory i.e. parsimonious and generalizability. The tenants of more general and specific CG theory should reflect the individual, state and enterprise, their relationship, expectations, requirements, demands, duties and responsibilities of each participant. It should also grasp the accountabilities and sanctions of participants in case of negligence, avoidance and misuses of CG's policies, rules, regulations and acts.

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