Corporate Governance: Theoretical Framework

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Received Dec. 04, 2017 Accepted Jan. 05, 2018

ABSTRACT *The present chapter provides detailed and comprehensive analysis of theoretical aspect of corporate governance. It outlines the meaning of corporate governance. It explores various fundamental corporate governance theories viz. agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction theory, political theory, and ethics theory. Further, it elaborates on the various structural models of corporate governance.*

Keywords: *Corporate Governance, Theories, Models.*

INTRODUCTION

Corporate governance refers to ethical business conduct as well as commitment to values. It should be intrinsic to the management of affairs of the organization. It aims at bringing fairness, transparency, accountability and employment of democratic and open processes. Regulatory reform is difficult to do and requires longer time (Klapper and Love 2004). Hence, a relationship of trust is constructed between company and its management and outsiders (investors etc) through corporate governance. Investor's protection is replaced by corporate governance in emerging markets like India where investors are poorly protected (Loukel and Yusfi, 2010).

FUNDAMENTAL CORPORATE GOVERNANCE THEORIES

Agency Theory: Agency theory is defined as the relationship between principals, such as shareholders and agents such as the company executives and managers (Jensen and Meckling, 1976; Eisenhardt, 1989; Fadun, 2013). According to agency theory, man is rooted in economic rationality (Davis et al., 1997). Rooted in economics, agency theory suggests that *agents* will choose opportunistic self-interested behaviour rather than behaviour aimed at maximizing the principal's interest (Jensen and Meckling, 1976).

Stewardship Theory: Stewardship Theory, developed by Donaldson and Davis (1991) is a new perspective to understand the existing relationships between ownership and management of the company (Pastoriza and Arino, 2011). As depicted from Figure 1, this theory holds that there is no conflict of interest between managers and owners, and that the goal of governance is, precisely, to find the mechanisms and structure that facilitate the most effective coordination between the two parties (Donaldson, 1990).

Figure 1: Principal-Manager Choice Model

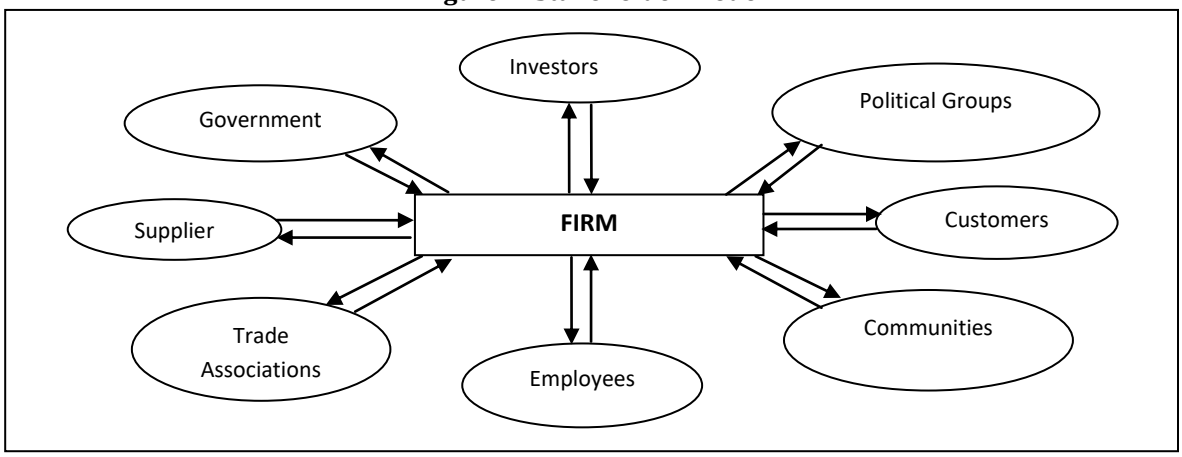
		Principal's Choice	
		Agent	Steward
Manager's Choice	Agent	Minimize potential costs Mutual agency relationship	Agent acts Opportunistically Principal is Angry Principal is Betrayed
	Steward	Principal acts Opportunistically Manager is Frustrated Manager is Betrayed	Maximize Potential Performance Mutual Stewardship Relationship

Source: Davis et al., 1997

Stakeholder Theory: Stakeholder theory was embedded in the management discipline in 1970 and gradually developed by Freeman (1984) incorporating corporate accountability to a broad range of

stakeholders (Abdullah and Valentine, 2009). As can be inferred from Figure 2, stakeholders refer to the group of constituents who have a legitimate claim on the firm (Freeman, 1984). This theory focuses on managerial or strategic decision-making and suggests that the interests of all stakeholders have intrinsic value, and no sets of interests are assumed to dominate others (Donaldson & Preston, 1995).

Figure 2: Stakeholder Model



Source: Donaldson and Preston, 1995

Resource Dependency Theory: Resource dependence theory is pioneered by Pfeffer and Salancik's (1978). The central thesis of this approach is that organisations attempt to exert control over their environment by co-opting the resources needed to survive (Pfeffer and Salancik, 1978; Duztas, 2008). Resource dependency theory focuses on the role of board of directors in providing access to resources needed by the organisation and reduces uncertainty (Pfeffer and Salancik, 1978; Abdullah and Valentine, 2009; Fadun, 2013).

Transaction Cost Theory

Transaction cost theory was first initiated by Cyert and March (1963) and later theoretically described and exposed by Williamson (1996) as quoted in Abdullah and Valentine (2009). Transaction cost economics is the study of governance concerned with identification, explication, and mitigation of all forms of contractual hazards (Williamson, 1996). This theory has been developed to facilitate an analysis of the comparative costs of planning, adapting, and monitoring task completion under alternative governance structures (Williamson, 1985). He also stresses that three environmental factors lead to transactions costs such as uncertainty, small number of trading to affect discipline and asset specifying. Williamson argues that these dimensions affect the type of governance structure chosen for the transaction.

Political Theory

Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting (Abdullah and Valentine, 2009; Fadun, 2013). At the macro level, the political model of corporate governance recognizes the allocation of corporate power, privileges and profits between owners, managers and other stakeholders and how this is done by the government through its various constituencies (Fadun, 2013).

Ethics Theory

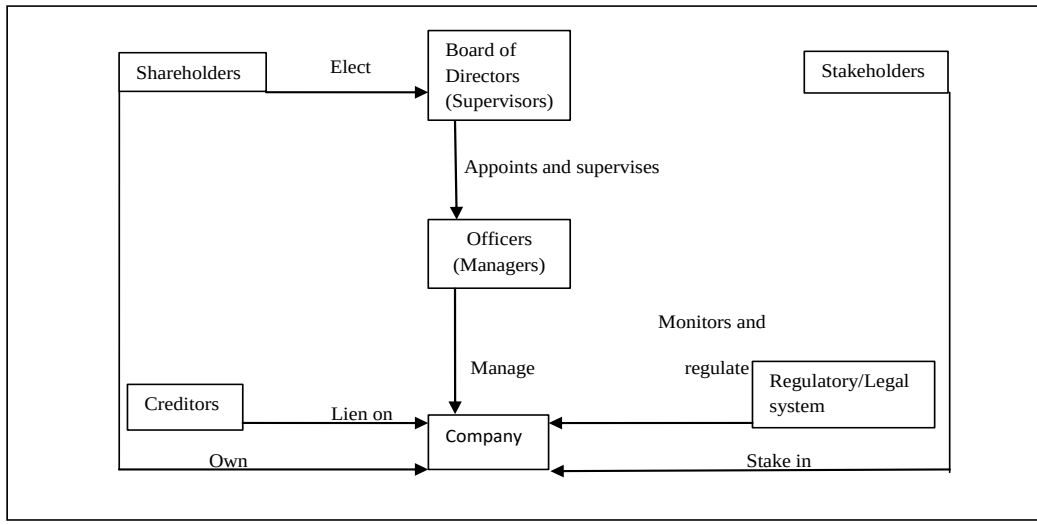
In the opinion of Abdullah and Valentine (2009), ethics theory comprises of business ethics theory (focus on business activities, decision and situations where the right or wrong are addressed), virtue ethics theory (concerned with moral value, goodness charity and good character), feminist ethics theory (emphasizes on empathy, healthy social relationship, loving care for each other and the avoidance of harm), discourse ethics theory (concerned with peaceful settlement of conflicts), postmodern ethics theory (provides a holistic style in which firm may focus on goal accomplishment and addresses the inner feeling which is beyond the facial value).

STRUCTURAL MODELS OF CORPORATE GOVERNANCE

The Anglo-US Model/ Anglo-Saxon Model

US Model of governance is also known as unitary board model, in which all directors participate in the single board comprising both executive and non-executive directors in varying proportions (Figure 3). The approach to governance tends to be shareholder-oriented (Fernando, 2012). Anglo-Saxon model is characterized by the dominance in the company of independent persons and individual shareholders (Ungureanu, 2012).

Figure 3: The Anglo-US Model



Source: Fernando, 2012

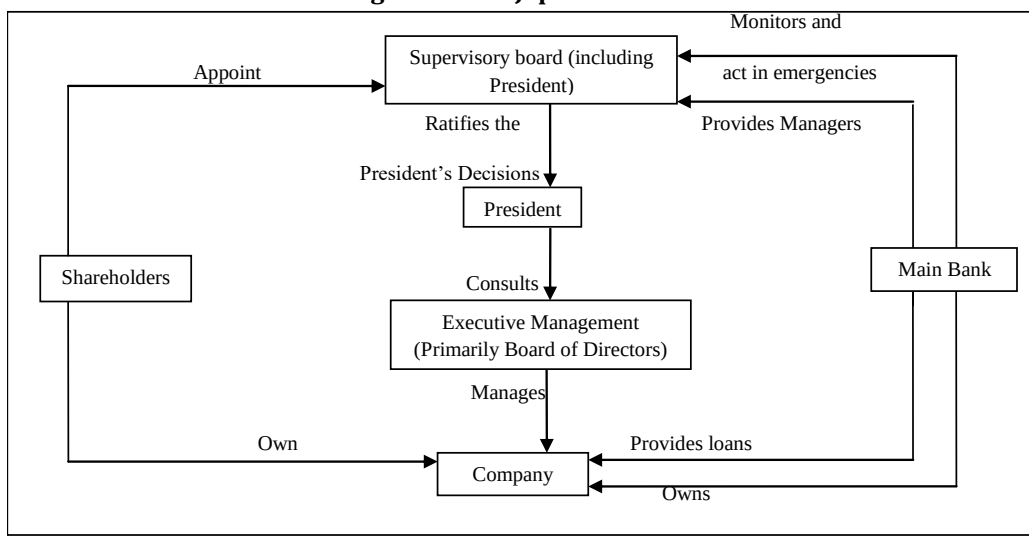
The UK Model

In contrast to the legislatively-based approach of the United States, UK corporate governance emphasizes board engagement with shareholders and compliance with a voluntary code of best practice that helps in promoting high standards of corporate governance behaviour without stifling wealth creation. The UK approach combines high standards of corporate governance with relatively low associated costs.

The Japanese Model

As illustrated in Figure 4, the Japanese model is characterized by a high level of stock ownership by affiliated banks and companies; a banking system characterized by strong, long-term links between bank and corporation; a legal, public policy and industrial policy framework designed to support and promote "keiretsu" (industrial groups linked by trading relationships as well as cross-shareholdings of debt and equity); boards of directors composed almost solely of insiders; and a comparatively low (in some corporations, non-existent) level of input of outside shareholders, caused and exacerbated by complicated procedures for exercising shareholders' votes (Mallin, 2007).

Figure 4: The Japanese Model



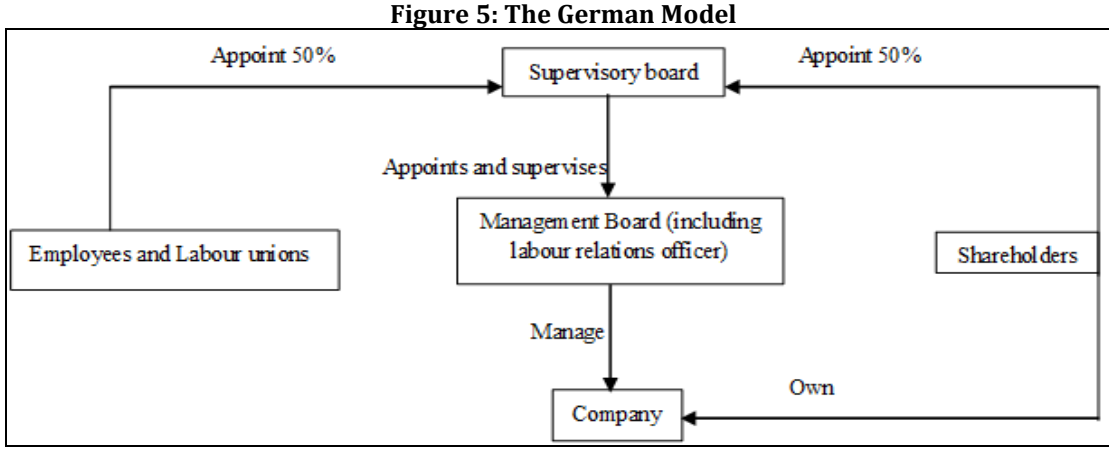
Source: Fernando, 2012

The German Model

In Germany and other countries following this model, voting right restrictions are legal; these limit a shareholder to voting a certain percentage of the corporation's total share capital, regardless of share

ownership position (Figure 5). It is also known as two-tier model as executive board is supervised by upper board on behalf of the stakeholders.

Figure 5: The German Model



Source: Fernando, 2012

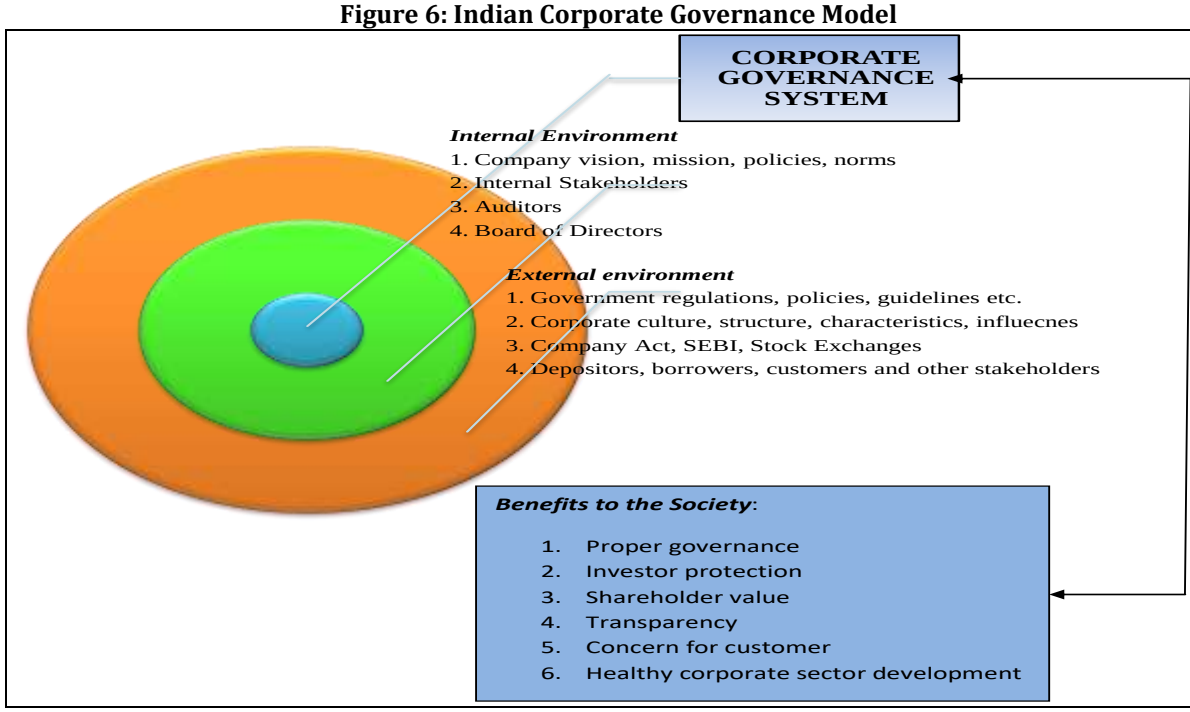
The Asian Family-Based Model (Overseas Chinese and Chaebol Groups in South Korea)

As quoted by Tricker (2009), the research studies have suggested that "such companies are family centric with close family control; controlled through an equity stake kept within the family; entrepreneurial often with a dominant entrepreneur so that decision making is centralised; close personal links emphasizing trust and control; paternalistic in management style; social fabric dependent on relationships and social harmony; strategically intuitive with business seen as more of a succession of contracts or ventures, rather than strategic plans".

The Indian Model

Unlike the Anglo-Saxon prototype of governance, in which the agency problem is primarily between managers and dispersed shareholders, the agency problem in India (as is typical of many other countries around the world, both developed and developing) is between the dominant inside-shareholders and the minority outside-shareholders (Sarkar and Sarkar, 2011). Company's Act, 1956 governs Indian corporates that tend to more or less the UK model. India shares many features of the German/Japanese model, but of late, recommendations of various committees and consequent legislative measures are driving the country to adopt increasingly the Anglo-American model (Fernando, 2012).

Figure 6: Indian Corporate Governance Model



Source: Researcher's own compilation based on Fernando, 2012

The Myopic Market Model

According to myopic market model, corporate governance reforms should encourage both shareholders and the managers to share long-term performance horizon (Keasey et al., 1997; Brink, 2011). Myopic model suggests that maximization of shareholder welfare is not the same as share price maximization because the market system tends to undervalue long-term expenditures which may lead to the increase of the shareholder welfare (Brink, 2011).

The Abuse of Executive Power

This model believes that Anglo-American companies suffer from a widespread abuse of executive power (Brink, 2011). The fundamental argument of this model rests on the premise that corporate governance problems arise from the excessive powers granted to senior management, and as a consequence they abuse these powers in pursuit of their own self-interest (Hutton, 1995).

CONCLUSION

Corporate governance in India has undergone a paradigm shift by gradually becoming more conscience-driven due to interests of customers, employees, vendors and regulators. Corporate governance is about promoting fairness, transparency and accountability; by controlling and managing company in such a way that helps in mitigating the cost in aligning the interests of various interested parties viz. shareholders, stakeholders, management, board of directors, suppliers of finance, creditors, employees, clients, government and other parties with whom the firm conduct its business; by using incentive mechanisms such as contracts, organisational designs and legislations; to increase company's performance and achieve sustainable shareholder value.

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