In Christine A. Mallin (2010): Corporate Governance.

2 Theoretical Aspects of Corporate Governance

LEARNING OBJECTIVES

- To understand the various main theories that underlie the development of corporate governance
- To be aware of the impact of the form of legal system, capital market, and ownership structure on the development of corporate governance

Introduction

Corporate governance has only relatively recently come to prominence in the business world; the term 'corporate governance' and its everyday usage in the financial press is a new phenomenon of the last fifteen years or so. However, the theories underlying the development of corporate governance, and the areas it encompasses, date from much earlier and are drawn from a variety of disciplines including finance, economics, accounting, law, management, and organizational behaviour.

It must be remembered that the development of corporate governance is a global occurrence and, as such, is a complex area including legal, cultural, ownership, and other structural differences. Therefore some theories may be more appropriate and relevant to some countries than others, or more relevant at different times depending on what stage an individual country, or group of countries, is at. The stage of development may refer to the evolution of the economy, corporate structure, or ownership groups, all of which affect how corporate governance will develop and be accommodated within its own country setting. An aspect of particular importance is whether the company itself operates within a shareholder framework, focusing primarily on the maintenance or enhancement of shareholder value as its main objective, or whether it takes a broader stakeholder approach, emphasizing the interests of diverse groups such as employees, providers of credit, suppliers, customers, and the local community.

Table 2.1 Summary of theories affecting corporate governance development

Theory name	Summary
Agency	Agency theory identifies the agency relationship where one party, the principal, delegates work to another party, the agent. In the context of a corporation, the owners are the principal and the directors are the agent.
Transaction cost economics	Transaction cost economics views the firm itself as a governance structure. The choice of an appropriate governance structure can help align the interests of directors and shareholders.
Stakeholder	Stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders. Where there is an emphasis on stakeholders, then the governance structure of the company may provide for some direct representation of the stakeholder groups.
Stewardship	Directors are regarded as the stewards of the company's assets and will be predisposed to act in the best interest of the shareholders.
Class hegemony	Directors view themselves as an elite at the top of the company and will recruit/promote to new director appointments taking into account how well new appointments might fit into that elite.
Managerial hegemony	Management of a company, with its knowledge of day-to-day operations, may effectively dominate the directors and hence weaken the influence of the directors.

Theories associated with the development of corporate governance

Given that many disciplines have influenced the development of corporate governance, the theories that have fed into it are quite varied. Table 2.1 gives a summary of some of the theories that may be associated with the development of corporate governance.

The main theories that have affected the development of corporate governance—agency theory, transaction cost economics, stakeholder theory, and stewardship theory—are discussed in more detail below. For a comprehensive exposition of theories underlying the development of corporate governance, Clarke (2004) is well worth reading. Coffee (2006) also adds new dimensions with his seminal book on gatekeepers whom he defines as 'the professional agents of the board and the shareholders, who inform and advise them: auditors, attorneys, securities analysts, credit-rating agencies and investment bankers'. He states that 'only if the board's agents properly advise and warn it, can the board function properly'.

Agency theory

A significant body of work has built up in this area within the context of the principal–agent framework. The work of Jensen and Meckling (1976) in particular, and of Fama and Jensen (1983), are important. Agency theory identifies the agency relationship where one party, the principal, delegates work to another party, the agent. The agency relationship can have a number of disadvantages relating to the opportunism or self-interest of the agent: for example, the agent may not act in the best interests of the principal, or the agent may act only partially in the best interests of the principal. There can be a number of dimensions to this including, for example, the agent misusing his power for pecuniary or other advantage, and the agent not taking appropriate risks in pursuance of the principal's interests because he (the agent) views those risks as not being appropriate (he and the principal may have different attitudes to risk). There is also the problem of information asymmetry whereby the principal and the agent have access to different levels of information; in practice, this means that the principal is at a disadvantage because the agent will have more information.

In the context of corporations and issues of corporate control, agency theory views corporate governance mechanisms, especially the board of directors, as being an essential monitoring device to try to ensure that any problems that may be brought about by the principal–agent relationship, are minimized. Blair (1996) states:

> Managers are supposed to be the 'agents' of a corporation's 'owners', but managers must be monitored and institutional arrangements must provide some checks and balances to make sure they do not abuse their power. The costs resulting from managers misusing their position, as well as the costs of monitoring and disciplining them to try to prevent abuse, have been called 'agency costs'.

Much of agency theory as related to corporations is set in the context of the separation of ownership and control as described in the work of Berle and Means (1932). In this context, the agents are the managers and the principals are the shareholders, and this is the most commonly cited agency relationship in the corporate governance context. However, it is useful to be aware that the agency relationship can also cover various other relationships including those of company and creditor, and of employer and employee.

Separation of ownership and control

The potential problems of the separation of ownership and control were identified in the eighteenth century by Smith (1838): 'the directors of such companies [joint stock companies] however being the managers rather of other people's money than of their own, it cannot well be expected that they should watch over it with the same anxious vigilance [as if it were their own]'. Almost a century later, the work of Berle and Means (1932) is often cited as providing one of the fundamental explanations of investor and corporate relationships. Berle and Means' work highlighted that, as countries industrialized and developed their markets, the ownership and control of corporations became separated. This was particularly the case in the USA and the UK where the legal systems have fostered good protection of minority shareholders and hence there has been encouragement for more diversified shareholder bases.

However, in many countries, especially where there is a code of civil law as opposed to common law, the protection of minority shareholders is not effective and so there has been less impetus for a broad shareholder base. The common law system builds on England's medieval laws whilst the civil law system is based on Roman law. A succinct comparison of the two legal systems is provided by Wessel (2001), who states that 'common-law countries – including the US and other former British colonies – rely on independent judges and juries and legal principles supplemented by precedent-setting case law, which results in greater flexibility', whilst 'in civil-law countries – which include much of Latin America – judges often are life-long civil servants who administer legal codes packed with specific rules, which hobbles them in their ability to cope with change'. In countries with a civil law system, there is therefore more codification but weaker protection of rights, hence there is less encouragement to invest.

In other words, the relationship between ownership and control outlined by Berle and Means is largely applicable to the USA and the UK but not to many other countries. This was highlighted by La Porta *et al.* (1999) who found that the most common form of ownership around the globe is the family firm or controlling shareholders, rather than a broad shareholder base (family firms and their corporate governance implications are discussed in more detail in Chapter 5).

However, the influence of Berle and Means' work cannot be underestimated: it has coloured thinking about the way companies are owned, managed, and controlled for over seventy years, and represents the reality in many US and UK companies. Monks (2001) states: 'The tendency during this period [the twentieth century] has been the dilution of the controlling blocks of shares to the present situation of institutional and widely dispersed ownership – ownership without power.'

In the last few years, there has been increasing pressure on shareholders, and particularly on institutional shareholders who own shares on behalf of the 'man in the street', to act more as owners and not just as holders of shares. The drive for more effective shareholders, who act as owners, has come about because there have been numerous instances of corporate excesses and abuses, such as perceived overpayment of directors for poor performance, corporate collapses, and scandals, which have resulted in corporate pension funds being wiped out, and shareholders losing their investment. The call for improved transparency and disclosure, embodied in corporate governance codes and in International Accounting Standards (IASs), should improve the information asymmetry situation so that investors are better informed about the company's activities and strategies.

Once shareholders do begin to act like owners again, then they will be able to exercise a more direct influence on companies and their boards, so that boards will be more accountable for their actions and, in that sense, the power of ownership will be returned to the owners (the shareholders). Useem (1996) highlights, however, though that institutional investors will ultimately become accountable to 'the millions of ultimate owners . . . who may come to question the policies of the new powers that be. Then the questions may expand from whether the professional money managers are achieving maximum private return to whether they are fostering maximum public good. Their demands for downsizing and single-minded focus on shareholder benefits – whatever the costs – may come to constitute a new target of ownership challenge'.

Transaction cost economics

Transaction cost economics (TCE), as expounded by the work of Williamson (1975, 1984), is often viewed as closely related to agency theory. TCE views the firm as a governance structure whereas agency theory views the firm as a nexus of contracts. Essentially, the latter means that there is a connected group or series of contracts amongst the various players, arising because it is seemingly impossible to have a contract that perfectly aligns the interests of principal and agent in a corporate control situation.

In the discussion of agency theory above, the importance of the separation of ownership and control of a firm was emphasized. As firms have grown in size, whether caused by the desire to achieve economies of scale, by technological advances, or by the fact that natural monopolies have evolved, they have increasingly required more capital, which has needed to be raised from the capital markets and a wider shareholder base has been established. The problems of the separation of ownership and control and the resultant corporate governance issues have thus arisen. Coase (1937) examines the rationale for firms' existence in the context of a framework of the efficiencies of internal, as opposed to external, contracting. He states:

> the operation of a market costs something and by forming an organisation and allowing some authority (an 'entrepreneur') to direct the resources, certain marketing costs are saved. The entrepreneur has to carry out his function at less cost, taking into account the fact that he may get factors of production at a lower price than the market transactions which he supersedes.

In other words, there are certain economic benefits to the firm itself to undertake transactions internally rather than externally. In its turn, a firm becomes larger the more transactions it undertakes and will expand up to the point where it becomes cheaper or more efficient for the transaction to be undertaken externally. Coase therefore posits that firms may become less efficient the larger they become; equally, he states that 'all changes which improve managerial technique will tend to increase the size of the firm'.

Williamson (1984) builds on the earlier work of Coase, and provides a justification for the growth of large firms and conglomerates, which essentially provide their own internal capital market. He states that the costs of any misaligned actions may be reduced by 'judicious choice of governance structure rather than merely realigning incentives and pricing them out'.

Hart (1995) states that there are a number of costs to writing a contract between principal and agent, which include the cost of thinking about and providing for all the different eventualities that may occur during the course of the contract, the cost of negotiating with others, and the costs of writing the contract in an appropriate way so that it is, for example, legally enforceable. These costs tend to mean that contracts are apt to be incomplete in some way and so contracts will tend to be revisited as and when any omissions or required changes come to light. Hart indicates that, 'in a world of incomplete contracts (where agency problems are also present), governance structure does have a role. Governance structure can be seen as a mechanism for making decisions that have not been specified in the initial contract'.

Stiles and Taylor (2001) point out that 'both theories [TCE and agency] are concerned with managerial discretion, and both assume that managers are given to opportunism (self-interest seeking) and moral hazard, and that managers operate under bounded rationality ... [and] both agency theory and TCE regard the board of directors as an instrument of control'. In this context, 'bounded rationality' means that managers will tend to satisfice rather than maximize profit (this, of course, not being in the best interests of shareholders).

Stakeholder theory

In juxtaposition to agency theory is stakeholder theory. Stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders. A consequence of focusing on shareholders is that the maintenance or enhancement of shareholder value is paramount, whereas when a wider stakeholder group, such as employees, providers of credit, customers, suppliers, government, and the local community, is taken into account, the overriding focus on shareholder value becomes less self-evident. Nonetheless, many companies do strive to maximize shareholder value whilst at the same time trying to take into account the interests of the wider stakeholder group. One rationale for effectively privileging shareholders over other stakeholders is that they are the recipients of the residual free cash flow (being the profits remaining once other stakeholders, such as loan creditors, have been paid). This means that the shareholders have a vested interest in trying to ensure that resources are used to maximum effect, which in turn should be to the benefit of society as a whole.

Shareholders and stakeholders may favour different corporate governance structures and also monitoring mechanisms. We can, for example, see differences in the corporate governance structures and monitoring mechanisms of the so-called Anglo-American model, with its emphasis on shareholder value and a board comprised totally of executive and non-executive directors elected by shareholders, compared to the German model, whereby certain stakeholder groups such as employees, have a right enshrined in law for their representatives to sit on the supervisory board alongside the directors. Chapter 4 is devoted to shareholders and stakeholders, and discusses various aspects in more detail.

An interesting development is that put forward by Jensen (2001), who states that traditional stakeholder theory argues that the managers of a firm should take account of the interests of all stakeholders in a firm but, because the theorists refuse to say how the trade-offs against the interests of each of these stakeholder groups might be made, there are no defined measurable objectives and this leaves managers unaccountable for their actions. Jensen therefore advocates enlightened value maximization, which he says is identical to enlightened stakeholder theory: 'Enlightened value maximization utilizes much of the structure of stakeholder theory but accepts maximization 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'.

Stewardship theory

Stewardship theory draws on the assumptions underlying agency theory and TCE. The work of Donaldson and Davis (1991) cautioned against accepting agency theory as a given and introduced an alternative approach to corporate governance – stewardship theory.

The thrust of Donaldson and Davis' paper was that agency theory,

> emphasises the control of managerial 'opportunism' by having a board chair independent of the CEO and using incentives to bind CEO interests to those of shareholders. Stewardship theory stresses the beneficial consequences on shareholder returns of facilitative authority structures which unify command by having roles of CEO and chair held by the same person ... The safeguarding of returns to shareholders may be along the track, not of placing management under greater control by owners, but of empowering managers to take autonomous executive action.

Whilst Table 2.1 gives a summary of the theories that may be associated with the development of corporate governance, Figure 2.1 illustrates the main theories that have influenced the development of corporate governance: agency theory, transaction cost economics, stakeholder theory and stewardship theory.

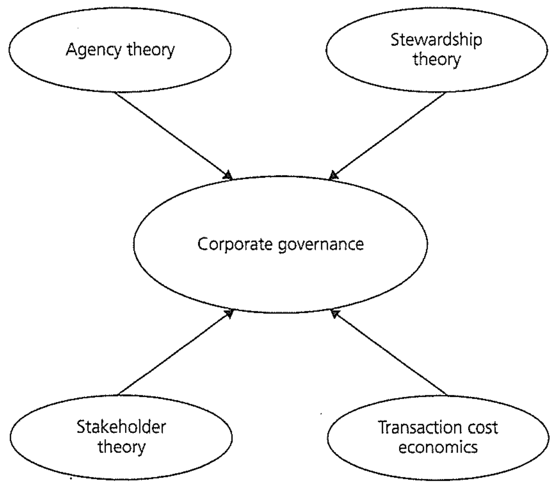

Figure 2.1 Main theories influencing the development of corporate governance

The theories in context

The approach taken in this book is to assume a public corporation business form (that is, a publicly quoted company), unless specifically stated otherwise. Therefore the theories discussed above should be viewed in the light of this type of business form. In the UK, this type of business form generally has a dispersed shareholder base, although there is concentration of shareholdings amongst the institutional investors such as the pension funds and insurance companies. Agency theory, together with the work of Berle and Means, seems particularly relevant in this context.

The theories that have affected the development of corporate governance should also be viewed in conjunction with the legal system and capital market development, as well as the ownership structure. For example, countries like the UK and the USA have a common law system that tends to give good protection of shareholder rights, whilst civil law countries, such as France, tend to have less effective legal protection for shareholder rights, and more emphasis may be given to the rights of certain stakeholder groups.

However, it is clear that companies cannot operate in isolation without having regard to the effect of their actions on the various stakeholder groups. To this end, companies need to be able to attract and retain equity investment, and be accountable to their shareholders, whilst at the same time giving real consideration to the interests of their wider stakeholder constituencies.

Convergence

There are a number of views as to where corporate governance systems are converging or are likely to converge. Roe (2003) states 'That corporate governance structures around the world have differed is hardly contested. The very fact that many people talk today, at the beginning of the twenty-first century, about corporate convergence due to globalization tells us that people believe that corporate structures have sharply varied'. He goes on to discuss the influence of political forces which may impact in different ways at different times and in different countries, and he states 'a democratic polity does not easily accept powerful pro-shareholder institutions'. He illustrates this with the example of the United States where traditionally there have been limits on the power of pro-shareholder institutions, for example, not encouraging hostile takeovers; whilst in Europe, employees have comparatively good job protection. He sums up 'If one fails to understand these political impulses, one cannot fully understand the world's, or any single nation's, corporate governance institutions'. Branson (2004) and Guillén (2004) argue against convergence occurring on economic, legal, and cultural grounds. For example, the family-owned firm is the dominant form of business around the globe and not the publicly owned corporation on which US and UK corporate governance is premised, hence we can see that one size is unlikely to fit all and that there will likely continue to be some divergence. There does, however, seem to be convergence on the core aspects of corporate governance, such as transparency, disclosure, and the important contribution that independent non-executive directors can make.

Conclusions

Corporate governance is a relatively new area and its development has been affected by theories from a number of disciplines, including finance, economics, accounting, law, management, and organizational behaviour. The main theory that has affected its development, and that provides a theoretical framework within which it most naturally seems to rest, is agency theory. However, stakeholder theory is coming more into play as companies increasingly become aware that they cannot operate in isolation and that, as well as considering their shareholders, they need also to have regard to a wider stakeholder constituency. Nonetheless it is fair to say that corporate governance is still seeking its theoretical foundations and as Tricker (2009) states 'corporate governance, as yet, does not have a single widely accepted theoretical base nor a commonly accepted paradigm . . . the subject lacks a conceptual framework that adequately reflects the reality of corporate governance'.

Future developments in the theory of corporate governance need to take account of a multitude of parts that make up the whole labrynthine of corporate governance: different business forms, different legal and cultural characteristics, and of course, different 'actors' (directors, shareholders and various stakeholders). The interaction of these different actors, and the effects both from, and on, the environment in which they operate, means that corporate governance is of its nature a complex and evolving system.

SUMMARY

- Corporate governance is a relatively new area and its development has been affected by theories from a number of disciplines, including finance, economics, accounting, law, management, and organizational behaviour.
- Agency theory has probably affected the development of the corporate governance framework the most. Agency theory identifies the agency relationship where one party, the principal, delegates work to another party, the agent. In the context of a corporation, the owners are the principal and the directors are the agent.
- Stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders. Where there is an emphasis on stakeholders, then the governance structure of the company may provide for some direct representation of the stakeholder groups.
- The development of corporate governance is a global occurrence and, as such, is a complex area including legal, cultural, ownership, and other structural differences. Therefore some theories may be more appropriate and relevant to some countries than others.

QUESTIONS

The discussion questions below cover the key learning points of this chapter. Reading of some of the additional reference material will enhance the depth of the students' knowledge and understanding of these areas.

1. Critically discuss the main theories that have influenced the development of corporate governance.
2. Do you think that different theories are more appropriate to different types of ownership structure?
3. What are the main problems that may arise in a principal–agent relationship and how might these be dealt with?
4. What links might there be between a country's legal system and capital market developments, and the impact of the theories underlying corporate governance?
5. 'Shareholders are more likely to lose money because the relevant people in the firm are not up to the mark than merely because they are 'agents' bent on pursuing their own interests at the expense of others.' (Charkham and Simpson, 1999) Critically discuss this statement.
6. 'Stakeholders can, and should, be principals enabling them to further their interests in the same way as shareholders.' Critically discuss this statement.

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Visit the website for links to useful sources of further information

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USEFUL WEBSITES

http://www.thecorporatelibrary.com Contains many useful and topical articles/references for the study of corporate governance.

http://leadership.wharton.upenn.edu/governance/resources/centers.shtml Contains references to key academic articles in a number of corporate governance areas.