

# Corporate Governance Practices And Firm Performance: A Review And Interrogation Of Theory

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*Abstract: This paper reviews literature on corporate governance practices with a focus on banking institutions, and their impact on the performance of these institutions. As such it contributes to the debate on the importance of corporate governance for firms across various sectors. Corporate scandals in the 1990s and 2000s drew the attention of governments to the importance of corporate governance, and induced legislation to prevent similar situations in the future. This paper reviews and interrogates theories that attempt to explain the concept of corporate governance. Based on the synthesis of the theoretical review, a blended model for on corporate governance is suggested. From the literature review done, it is seen that the nature and conduct of corporate behavior has implications on the level of corporate governance effectiveness in terms of transparency, accountability and sustainability which again has implications on firm competitiveness and relevancy. One of the key areas pointed out in the discussion of this paper is the silence by the postulators of the various theories on other forces that may bring about either facilitate or hinder the expected good corporate governance practices. The review and interrogation of theories further reveal that no one single theory can adequately explain the concept of corporate governance. Hence, we have suggested a blended approach to understanding corporate governance practices and also taking into recognition that there could be other forces that may moderate the nature and direction of corporate governance practices and effectiveness. Borrowing from the theoretical postulations, a model on corporate governance has been suggested.*

*Keywords: Corporate governance, agency theory, stakeholder theory, stewardship theory, legitimacy theory*

## I. INTRODUCTION

### A. BACKGROUND

Most of the debate and work in the field of corporate governance picks from the issue highlighted first by Berle and Means (1932), which is the separation of ownership and control. This separation will generate an agency relationship between owners as “the principal” and managers as “the agent”. In an ideal world, managers would invest all of their abilities and skills to generate the best possible returns for investors. In the real world, things are slightly different. A series of unexpected corporate failures in the 1990s brought to attention the importance of the corporate governance system. The 1990s witnessed a series of financial scandals such as Enron, WorldCom, and Parmalat which were facilitated by wrong doings on the part of the management, auditors and

financial market operatives. These scandals shook the confidence and trust of the citizens in the institutions of these economies and led them to devise stricter regulator mechanisms to control excesses from the management. As a result, any serious listed company has had to allocate a part of annual, or other important, reports to addressing and explaining its corporate governance procedures. Furthermore international organizations such as the OECD, stock exchanges, and various government commissioned reports across the world have devised, and some of them imposed corporate governance guidelines. This paper review and interrogates theories that makes an attempt to explain the concept of corporate governance. Based on this review, a synthesis and discussion are done which provides a basis for the suggestions made herein.

## B. CORPORATE GOVERNANCE

The concept of corporate governance has been used by different people differently and still there is no universally accepted definition of corporate governance. 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”. It 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). La Porta et al., (2000) view corporate governance as a set of mechanisms through which outside investors protect themselves against expropriation by insiders. While corporate governance essentially lays down the framework for creating long-term trust between companies and the external providers of capital, it would be wrong to think that the importance of corporate governance lies solely in better access of finance. The term ‘corporate governance’ essentially refers to the relationships among management, the board of directors, shareholders, and other stakeholders in a company. These relationships provide a framework within which corporate objectives are set and performance is monitored.

A more comprehensive definition where corporate governance is looked at as “the process affected by a set of legislative, regulatory, legal, market mechanisms, listing standards, best practices, and efforts of all corporate governance participants, including the company’s directors, officers, auditors, legal counsel, and financial advisors, which creates a system of checks and balances with the goal of creating and enhancing enduring and sustainable shareholder value, while protecting the interests of other stakeholders is provided by Rezaee (2009).

## II. A REVIEW OF THEORIES

The four main sets of theories that have each played an important part in shaping the corporate governance systems are; agency theory, stakeholder theory, stewardship theory and legitimacy theory. It is argued that across sectors individuals involved in corporate governance apply what they believe is common sense, when in reality they draw sub-consciously on long-established economic theory and assumptions that are challengeable. The mentioned theories lay the foundation to this paper’s discussion.

### A. AGENCY THEORY

Agency theory is one of the most widely used theories in management (Daily, Dalton and Rajagopalan, 2003; Wasserman, 2006). Broadly, agency theory is about the relationship between two parties, the principal (owner) and the agent (manager; Eisenhardt, 1989; Jensen and Meckling, 1976; Ross, 1973). More specifically, it examines this relationship from a behavioral and a structural perspective. Theory suggests that given the chance, agents will behave in a

self-interested manner, behavior that may conflict with the principal’s interest (Chrisman et al., 2004; Eisenhardt, 1989; Jensen and Meckling, 1976; Wiseman, Cuevas-Rodríguez, and Gómez-Mejía, 2012). As such, principals will enact structural mechanisms that monitor the agent in order to curb the opportunistic behavior and better align the parties’ interests (Eisenhardt, 1989).

Firm performance by way of cost minimization and greater efficiencies is the desired outcome of the agency theory perspective (Corbetta and Salvato, 2004). When the ownership and management of a firm are separated, theory suggests that agency problems are created, and agency costs are incurred to alleviate these problems (Eisenhardt, 1989; Jensen and Meckling, 1976; Karra, Tracey, and Phillips, 2006; Wasserman, 2006). To elaborate, separation of ownership and management is a key component of agency theory; the principal authorizes or delegates work to the agent, and the agent is expected to act in the best interest of the principal (Ross, 1973; Wiseman et al., 2012). An agency problem is created when the interest of the principal and agent are misaligned and the principal lacks the information to accurately assess the behavior of the agent (Eisenhardt, 1989; Karra et al., 2006; Ross, 1973). Agency problems can take the form of moral hazard or adverse selection (Chrisman et al., 2004; Eisenhardt, 1989; Karra et al., 2006). Moral hazard refers to the situation where the agent lacks effort in the scope of the employment relationship (Chrisman et al., 2004; Ross, 1973). It is considered a form of opportunistic behavior that includes free-riding, shirking, and perk-consumption (Chrisman et al., 2004; Karra et al., 2006). Adverse selection refers to the situation where the agent lacks the ability and skills to competently behave in the scope of the employment relationship (Eisenhardt, 1989).

According to this theory, the principal has two options for reducing agency problems (Eisenhardt, 1989), both of which can curb the agent’s opportunistic behavior. The first is to create a governance structure that enables the monitoring and assessment of the actual behavior of the agent (Chrisman et al., 2007). This structure includes for example, reporting procedures, additional management, or a board of directors (Donaldson and Davis, 1991). The second option is to create a governance structure where the contract is based on the actual outcome of the agent’s behavior (Eisenhardt, 1989). An example of this type of structural mechanism is compensation incentive pay (Chrisman et al., 2007), where pay is provided as an incentive for high performance. Risk is thus shifted to the agent, creating the motivation for the agent’s behavior to align with the principal’s interest (Davis et al., 1997; Eisenhardt, 1989). In essence, the principal makes a choice between establishing governance structures based on the agent’s actual behavior or the outcomes of that behavior (Eisenhardt, 1989). Either choice creates agency costs, the costs borne by the principal to monitor and assess agent behavior (Jensen and Meckling, 1976).

The underlying assumption of agency theory is based on the economic model of man (Davis et al., 1997; Eisenhardt, 1989; Jensen and Meckling, 1976). This model assumes that individuals will seek to optimize their own utility. In the principal-agent relationship, an agent is hired to maximize the principal’s utility (Ross, 1973). However, agency theory

assumes agents will instead behave opportunistically because they too are self-serving. Therefore, the principal enacts mechanisms to minimize losses to their own utility (Davis et al., 1997; Eisenhardt, 1989; Jensen and Meckling, 1976; Ross, 1973). Agency theory recognizes that information asymmetries exist between the managers and shareholders. The information available to the shareholders is different from the information that the managers have. So, for the protection of shareholders rights, it is important for firms to monitor the performance of managers and increase accountability of their actions by showing compliance with, among other disclosure requirements, the codes of corporate governance. The reason behind more disclosures is to reduce agency costs that exist between managers and principals (Jensen and Meckling, 1976). According to Jensen and Meckling (1976), agency costs are high due to the existence of high level of agency conflicts between the principal and agents in the diffused ownership environments. In contrast to this, the corporations in the concentrated ownership environments need to make the low level of disclosures as interests of managers and shareholders do not diverge.

## B. STAKEHOLDER THEORY

Stakeholder theory has its origins in R. Edward Freeman's (1984) seminal book *Strategic Management: A stakeholder approach*, published in 1984. In this book, Freeman (1984) emphasizes the importance of fully comprehending the dynamics of a business, and argues that a successful firm necessarily has to create value for its stakeholders i.e. for customers, suppliers, employees, communities and financiers (shareholders, banks etc.). The success of a firm cannot be measured by studying one stakeholder in isolation, but a wider approach including the full range of stakeholders is necessary to fully evaluate the performance of the firm. Subsequently, the purpose of the firm is defined by the overall value creation for stakeholders. This view place a responsibility to articulate business processes and to define and explain the relationship with stakeholders and how value will be created with a firm's management. Accordingly, the role of the manager is not merely the role of an employee, but he is also responsible for safeguarding the welfare of the firm through an understanding and balancing of numerous stakeholder interests.

Freeman further raises two important challenges to managerial capitalism: the economic and the legal arguments, the first argument is founded on the concept of externalizing costs and internalizing profits, subsequently redistributing wealth from the society to the firm. The concept is also represented within the tragedy of the commons where individuals exhaust shared resources by over-usage, to the detriment of long term societal interest. Stakeholder theory addresses the problem and argues that both cost and profits should be internalized by the firm, thereby aligning its interest with those of the stakeholder society. The second argument, on the other hand, highlights the importance of laws as a means to align stakeholder and firm interests, More recently, several scholars have extended the Freeman (1984) framework to incorporate new areas (Donaldson & Preston 1995). 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. There is an argument that agency theory is narrow (Coleman, 2008: 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).

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. 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. In order to differentiate among stakeholder types, Rodriguez et al., (2002): classification was adopted; consubstantial, contractual and contextual stakeholders. 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 (Rodriguez et al., 2002). Rajan 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.

## C. STEWARDSHIP THEORY

In contrast to agency theory, stewardship theory 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 behavior of executives. The steward's behavior 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 maximized too, because organizational success will serve most requirements and the stewards will have a clear mission. 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 maximize 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 organizational 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).

Stewardship theory is also about the employment relationship between two parties, the principal (owner) and the steward manager (Davis et al., 1997; Donaldson and Davis, 1991). It too examines this relationship from a behavioral and a structural perspective. Theory suggests that stewards will behave in a pro-social manner, behavior which is aimed at the interest of the principal and thus the organization (Davis et al., 1997; Zahra et al., 2009). This behavior is fostered by the quality of the relationship between the principal and steward and the environment and ideals of the organization (Corbetta and Salvato, 2004; Davis et al., 1997). Maximum firm performance, such as sales growth or profitability, is the desired outcome of a stewardship perspective (Davis et al., 1997). The theory further suggests this outcome is achieved when both the principal and the manager in the employment relationship select to behave as stewards (Davis et al., 1997). At the heart of stewardship theory is the assumption that the principal-steward relationship is based on a choice. When both parties choose to behave as stewards and place the principal's interest first, theory suggests a positive impact on performance because both parties are working toward the same goal (Davis et al., 1997; Eddleston and Kellermanns, 2007).

The choice of stewardship behavior is impacted by both psychological and situational factors (Corbetta and Salvato, 2004; Davis et al., 1997). Psychological factors such as intrinsic motivation, high identification, and personal power can steer the behavioral choice to stewardship (Davis et al., 1997; Zahra et al., 2008). Intrinsic motivation exists within individuals and provides satisfaction in and of itself (Ryan and Deci, 2000); it is a psychological attribute of stewardship theory because steward managers are motivated by intangible, higher order rewards (Davis et al., 1997). Individuals who have high levels of identification with their organization are more likely to choose stewardship because they feel a strong sense of membership with their organization (Zahra et al., 2008). Stewardship theory applies a personal power perspective, describing power based on interpersonal relationships that develop over time (Davis et al., 1997) which in turn influence and empower steward managers. These

psychological factors facilitate the choice of stewardship, which ultimately have a positive impact on firm performance. Situational factors depict the organizational structure and include the management philosophy and culture (2006; Davis et al., 1997; Donaldson and Davis, 1991; Zahra et al., 2008). Theory suggests that involvement-oriented, collectivist, low power distance cultures help influence the choice of stewardship behavior (Davis et al., 1997). An involvement oriented management philosophy is portrayed by an environment where employees are trusted with challenges, opportunities, and responsibility (Davis et al., 1997; Eddleston et al., 2012). In organizations typified by collectivism, individuals put the goals of the collective ahead of individual personal goals; the emphasis is on belonging, identifying, and displaying loyalty due to the tight-knit social framework present in the organization (Davis et al., 1997). Low power distance describes an environment where equality perceived between different levels of the organizational hierarchy (Davis et al., 1997). An organizational structure that accommodates and influences the choice of stewardship behavior helps facilitate maximum performance for the firm.

The underlying assumption of stewardship theory is based on the humanistic model of man due to its foundation in sociology and psychology (Donaldson and Davis, 1991). This model assumes that individuals are motivated by higher order needs fulfillment (Davis et al., 1997). In the principal-steward relationship, a steward will put the interests of the principal ahead of self-serving interests (Corbetta and Salvato, 2004; Davis et al., 1997; Davis et al., 2010; Zahra et al., 2009). A principal will create an organizational structure where these stewardship behaviors can flourish. As such, a stewardship structure is seen as collectivistic and cooperative, resulting in positive benefits for the organization (Davis et al., 1997).

#### D. 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. Similar to social contract theory, legitimacy theory is based upon the notion that there is a social contract between the society and an organization. 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. 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).

### III. DISCUSSION AND SYNTHESIS

This review has seen corporate governance from various theoretical perspectives. 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 maximization, "which utilizes much of the enlightened 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 presents a different model of management, where managers are considered good stewards who will act in the best interest of the owners. 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.

Legitimacy theory is based upon the notion that there is a social contract between the society and an organization. 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. The organization therefore 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. From the reviewed theoretical literature, factors outside the control of the owners and managers have not been given attention, hence the need to acknowledge them when discussing matters corporate governance practices and corporate governance effectiveness. Further in this review, the literature review showed a lack of consensus on which performance indicators and which corporate governance indicators are the most adequate ones for testing the relationship between corporate governance and firm performance.

### IV. CONCLUSION

The interrogation of various theories that attempt to explain the concept of corporate governance reveals that each theory places different emphasis on different areas in the subject of corporate governance. For example agency theory's primary emphasis is on shareholders' interests, while stakeholder theory's emphasis is on taking care of the interests of all organization's stakeholders. Stewardship theory puts emphasis on the managers, where managers are considered

good stewards who will act in the best interest of the owners. On the other hand legitimacy theory puts emphasis on the responsibility an organization has towards the society where the organization 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. It is clear no single theory can fully explain the subject of corporate governance exhaustively on its own and hence there is a need to integrate different theories rather than consider any single theory. The corporate governance theories cannot fully explain the intricacy, heterogeneity and behavior 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.

### V. RECOMMENDATION

The individual theories have taken a rather narrow view on the subject of corporate governance since they tend to focus on a specific area on the subject. Agency theory for example only focuses on the interests of the shareholders, stewardship theory on the other hand focuses on the management while stakeholder theory tends to shift focus from the shareholders who are major stakeholders to other stakeholders whose contribution in the organization could be minor. Capturing the key elements from the theories reviewed herein, the generic model on corporate governance effectiveness is suggested. This model could be subjected to an empirical testing across institutions of diverse sectors. The model is developed from the various arguments advanced through the agency, stakeholder, stewardship and legitimacy theories. Cognizance has also been given to the fact that none of the theories brought into context the imbalances that can crop up in trying to embrace good and desirable corporate governance practices as a result of the less controllable macro-environment forces such as politics and cultures.

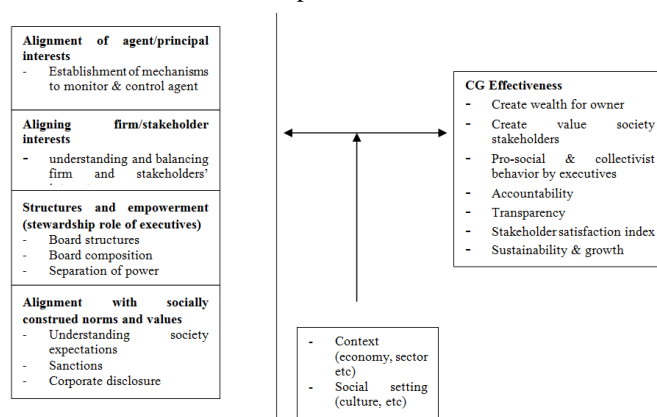


Figure 1: Corporate governance practices: prerequisites and effectiveness

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