A Study of Various Theories and Elements of Corporate Governance

Dr. Niyati Chaudhary
Assistant Professor,
PDM University, Bahadurgarh

Abstract

Now days, which organizations have good governance can sustain in market and has high competitive value. Corporate Governance mechanism protects the interests of stakeholders. This Paper is descriptive in nature. In this paper we discussed various theories of corporate governance. Also, we analyzed various elements of corporate governance. We tried to highlights the various theories of the corporate governance which helps the organizations to develop. This study assists the organizations to enhance their performance as they get aware of various elements which affects the corporate governance. They also get aware of the various benefits of corporate governance to the organizations.

Keywords: Corporate Governance, Firm Performance, Theories,

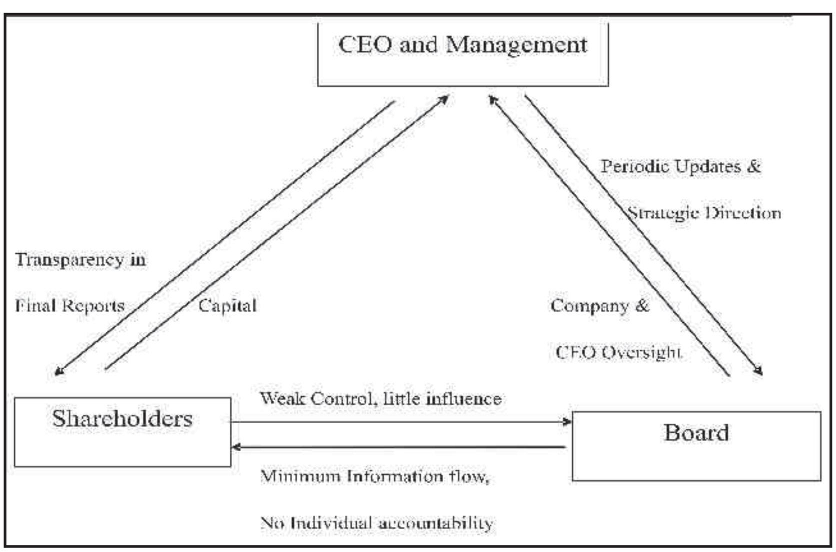
Introduction

Corporate Governance

Corporate governance means a set of practices which safeguards the interest of all stakeholders of a company. Corporate governance refers to a system of rules, practices and processes for controlling and directing the company. In the words of Monks and Minow (1995) "corporate governance is the association between various participants i.e. chief executive officer, management, shareholders, employees, in determining the direction and performance of corporations". According to standard and poor's definition "Corporate Governance is a system in which a company organizes and manages itself to ensure that all financial stakeholders receive their fair share of a company's earnings and assets."

According to Tricker (2009), "Broadly, Corporate Governance is about the way power is exercised over corporate entities". Mayer (1997) said "Corporate governance is concerned with ways of bringing the interests of investors and managers into line and ensuring that firms are run for the benefit of investors". Keasey et al. (1997) stated that "Corporate governance includes 'the structures, processes, cultures and systems that engender the successful operation of organizations".

Figure 1.1 CORPORATE GOVERNANCE SYSTEM



Source: Cynthia, A. Montgomery and Rhonda Kaufman, "The Board's Missing Link," *Harvard Business Review*, March, 2003, p. 89.

Corporate Governance System is clear from figure 1.1. Board members do not have enough time for managing day to day affairs. Managers are doing all these tasks so corporate governance becomes important in the firm. Boards are providing minimum information to shareholders and less accountable to them which leads to weak control and less influence. Every country has different form of corporate governance that affects by various factors such as economic, political and social factors. In developed countries where financial system and political is stable that has effective governance practices while in developing countries like India, political instability and high fiscal deficit affects the governance system of firms.

Corporate governance is concerned with laws, procedures, practices and rules which assists a firm's aptitude to take decisions of firms' which are beneficial for all stakeholders. Corporate bodies are directed through a mechanism or system of governance which consists of board of directors, shareholders, employees and other stakeholders.

Review of literature:

Firms who are having poor corporate governance system are having more agency problems and managers get benefited from this (Core et. al., 1999). Khanna and Black(2007) also found that the reforms of corporate governance enhanced the share prices. Mobius (2002) concluded that prices and demands of the share can enhance due to presence of good corporate governance practices. Khan et al. (2011) defined corporate governance in a way which works for the benefit of the corporate and leads to enhance the firm's performance.

According to Barbu & Bocean (2007), rights and equitable treatment of shareholders, transparency, disclosure, accountability, board's role and stakeholder's responsibility are the essential elements of corporate governance system. Their study indicated that good governance system is a vital variable which affects the performance. Most important variable which enhances market value is insider ownership while outside ownership concentration demolishes it. They stated that capital market's growth and functions get affected by the governance system of firm. They further stated that legal framework and historical and cultural factors of a country also effects the corporate governance systems. Development of corporate governance framework is a main challenge for the policy makers.

Gallagher (1997) mentioned the various roles of boards in a firm. He stated that board's vital role as counselor, strategic planning body, and as a check on management's direction for the firm. He asserted that corporate governance committees which are combinations of inside and outside directors , must have authority to monitor mangers' work for the protection of shareholders' right. He articulated that the expansion of corporate governance includes both the activism of shareholders and board.

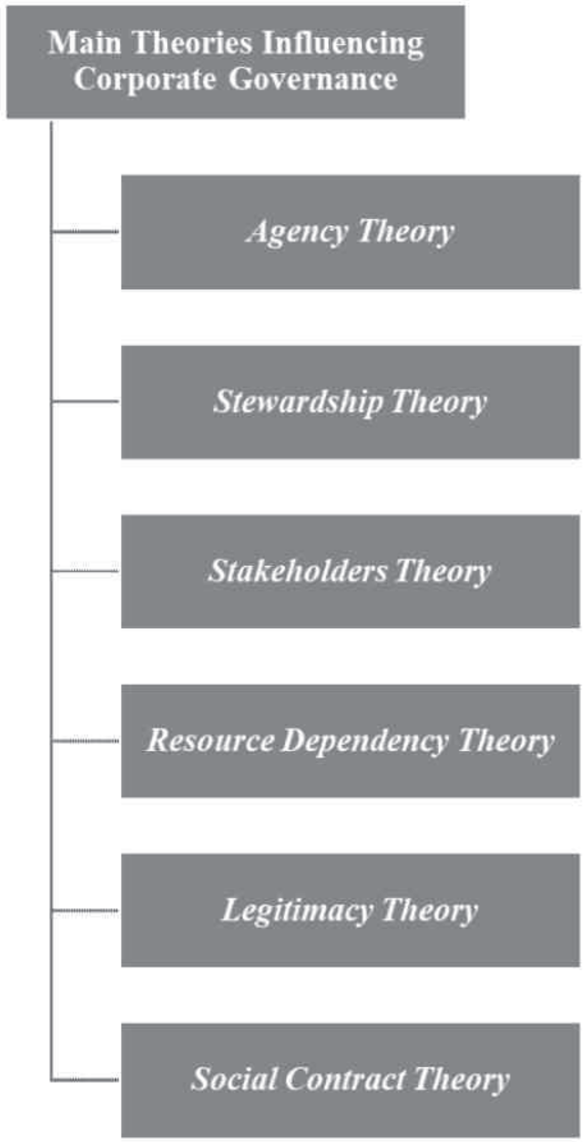
Shanikat and Abbadi (2011) identified the framework of corporate governance and mentioned main five principles of corporate governance. They conducted a study to discuss the current legislative environment and institutional framework of corporate governance. They also examined corporate governance practices in Jordan by comparing these with the principles issued by OECD in 2004. They interviewed the employees such as CEOs, CFOs, chief accountants, human-resources managers and managers of shareholders' affairs, for assessing the reality of corporate governance in Jordan and studied related laws. Information gathered related to shareholders' rights, board roles and composition, disclosure status and transparency of the information the firms provided. Six dimensions of governance have been identified by them such as transparency, board control, protection of minority rights, capital market, accounting standards and disclosure and legal framework and government oversight.They recommended that corporate governance make sure that investors have appropriate information before making their investment decision and equal voting rights to all shareholders.

Hendry and Kiel (2004) investigated board's role and how the board's strategic role affects the firm's performance. They defined board's approach to strategy on the basis of strategic and financial control. They observed more control by reducing management self-interest activities. They mentioned that board's role is main critical area for consideration. In their integrative theoretical perspective, they mentioned two roles of board such as control and access to resources. Strategy and monitoring are sub sets of control while legitimacy and links to other organizations are included in other role of board. They stated that firm's framework helps to determine the level of strategic or financial control and further stated that firm performance will get affected by the choice of control mechanism done by board. They further developed proposals that how strategic and financial control will get effected by the power of board and uncertainty of environment and information asymmetry. They suggested that firm performance influenced by the process and context of board.

Theoretical Background Corporate Governance:

This section reviews the theoretical perspectives of a board's accountability. There are six major six theories such as agency theory, stewardship theory, stakeholder theory, social contract theory, legitimacy theory and resource dependency theory.

Figure 1.2 THEORIES OF CORPORATE GOVERNANCE



Agency Theory:

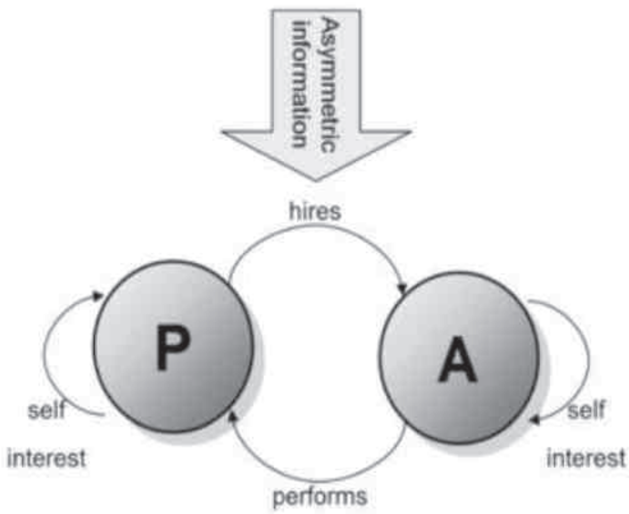
The focal point of this theory is the principal - agent relationship. This theory states that the main responsibility of board members is to maximization the value of shareholders. In this they discussed various governance mechanisms with guard the interest of shareholders, reduce agency cost and ensuring association between principle and agent. In this context, Mallin (2004) stated that managers are the agents of the firm while the owners are the principals. On the other hand, the board of directors are the monitoring mechanism of the company. As per this theory, Corporates are indistinguishable units and managed through agents who manage on behalf of principal (Corporate).

It is suggested by the agency theorists that the corporate governance system is a mechanism which can minimize the agency conflicts and aligns the interest of both principle and agent. Incentive schemes for the managers works as mechanism in which they get reward if they maximize the interest of shareholders.

Agency theorists recommended that corporate governance mechanisms are needed to reduce agency conflicts and to align the interests of the agent to the principal. These mechanisms include incentive schemes for managers which reward them financially for maximizing shareholders' interests.

Jensen & Meckling (1976) stated that the managers get benefits from the separation of ownership from management. Therefore, a monitoring mechanism such as corporate governance is designed to save the interest of shareholders. They also described that the agency cost is an amount of expenditure by the owners to control the agent's activities and also agent's expenses to do actions with is beneficial for the principals. As per this theory, if proper corporate governance structure presence in the firm then mangers will act to the maximize the value of shareholders and do all activities with is beneficial for the shareholders.

Figure 1.3 CONFLICT OF INTEREST AMONG AGENTS AND PRINCIPALS



Stewardship Theory:

This theory states that the managers want to do a good work and try to maximize the profit of the firm and that brings good return and enhance the value of the shareholders. This theory is in contrast to the agency theory. As in this, theorist assumes that the managers of the firms are stewards whose activities, purpose and behavior are associated with the principle's objective. Donaldson & Davis (1991) stated that the managers of the firms are superior stewards who do all activities in the favor of owners and try to meet their interest. This theory rejects the self-interest of the managers. This theory suggested that an organization must have leadership structure which allow the good relationship among the managers and owners.

If CEO duality is presence in the firm that means CEO and chairman of the board are same person then this leadership structure helps to maintain relationship strong among the managers and owners. This also helps to better performance because CEO has full power in hand and steward's behavior is in favor to attain the objectives of the firm (Davis et. al. 1997). They also stated that the stewards protects the interest of the shareholders and maximize the wealth of shareholders wealth by enhancing the firm's performance.

Stakeholder Theory:

A stakeholder is a group of the people who affects or affected by the process or system of the organizations and also affects the activities performed to achieve the goals of the firms (Freeman, 1984). Goal of the firm could be achieved if there is balance between the conflicting interest of all stakeholders of the firm (Ansoff,1965). This approach describes that various stakeholders (group of peoples) runs the business and every stakeholder has different demands from the firm. Stakeholders wants maximum benefit from the firm by optimum running the firm. It also suggests that all organizations must consider all stakeholder's demands while framing the policies.

Resource Dependency Theory

As per this theory, board of directors has resources such their skills and information's. The directors of the firm try to maintain the best use of the available resources to cope up with the external environment. Corporate governance variables such as board size and board composition give a stable firm response to cope up with the situation of external environment (Pfeffer,1972). Hillman et. al. (2000) recommended that a company can survive if they effectively cope up with the uncertainty. So, therefore the board directors of that firm try to connect the external resources with the firm to overcome the uncertainty.

Social Contract Theory

Donaldson (1983) recommended that firms grow in a society, so social responsibility is a contractual obligation of the firms towards the society. In 1999, Donaldson and Dunfee, developed an integrated social contract theory. They suggested that managers must take an ethical decision while taking the micro and macro social contract. Macro social presents the communities. The communities expect the support and all activities which are beneficial for the society. Micro social presents the business's specific for. Therefore, the firm must fulfill their social responsibility.

Legitimacy Theory

Suchman (1995) defined this theory 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". This theory depicts that there is presence of social contract between the firm and the society. This theory is like the social contract theory.

Deegan (2004) stated that this theory emphasis to consider the rights of the stakeholders such as investors and public. Any firms who fails to comply with the societal expectations, then there will be restrictions on the operations and resources of the firm. He also recommended that a firm flourish in the society and how the firms operates and what activities are involved for all this firm is obliged to the society.

Corporate governance gives the guidelines to the firms as how to direct and how to control so that it achieves its objective. It is also beneficial for all stakeholders and enhance the value of firm. Stakeholders include the board members, managers , suppliers, society, buyers, consumers and employees.

Elements of Good Corporate Governance:

There are so many elements of the good corporate governance system but some of them as follows which makes governance best for the Corporates and stakeholders. Now a day's corporate governance is a vital part of the corporate system. Some of the elements are as following:

Skills of the Board Members:

This is the top most vital element of the governance system of firm because to undertake the functions properly and in efficient manner board members must have knowledge, skills qualities and experience related field so that each and every person give her / his best contribution.

Board Independence:

Independence of the board is also a essential element as it is necessary to have adequate independent members in the board so that non-bias decision can be taken and it also helps for the sound organization. This helps to ensure the effective supervising, coping with the challenging activities and handling of conflict of interest in the firm.

Meetings of the Boards:

For its effective results attending the meetings and pre-preparation for the meeting makes it important because if board members are prepared thoroughly for the meetings then it has effective result.

Appointment of the Board Members:

By appointing most competent members in the board makes it effective board. A well-defined process must be follow for in the firms for director's appointment .

Observing the Board Members:

There must be monitoring and examination of the performance of the board as combined and individual members, both at different time intervals to know the key performance.

Authority and Responsibility of the Board:

The board's prime duty is to ensure the value creation interest of the stakeholders. If there is absence of the pure understanding regarding the board's role, authority and responsibility then this will make organization weak and difficult to achieve organization goals.

Environment of the Management:

Management environment includes clear understanding of the process of the organization, proper organization structure, clear objectives , proper transparence , proper communication and coordination among all parts of the

organization.

Board induction and Training to members:

Board members must have proper induction to all organization process and departments. They must have training of the process to have proper understanding of the firm. Operation, strategy and challenges must be clear to members of the board.

Code of conduct:

For effective corporate governance it is very essential elements. There must be code of conduct and prescribed norms for ethical practices in the firm. These must be properly communicated to all stakeholders of the firm. These must be clearly understood and communicated to each and every person of the firm.

Financial Reporting:

Financial reporting must not be too much detailed such that it removes its key issues. Corporate performance can be monitored if board has reliable and timely information.

Benefits of Corporate Governance:

If a firm has strong corporate governance that firm has high investors' confidence and this helps to raise the capital from the market. Corporate governance mainly emphasizes the effect of a governance system for economic efficiency and shareholders' welfare. Corporate governance also ensures whether the strategic decision is made effective or not. Corporate governance establishes the relationship between the firm's owners and its top-level managers.

Corporate governance system is a process of management which considers the interest of all stakeholders and follow the principles of corporate governance. (Van Horne and Machowicz, 2005). It is also Corporate endorses the better utilization of resources within the firm and for the economy. It assists the firm's to response as per the society need and that helps to improve the firm's performance. (Gregory & Simms 1999).

According to Keong (2002) that better management, prudent allocation of resources and better firm performance is the result of good governance practices of the firm. Therefor it enhances the share price of the firm and increase the shareholder's value. According to Heenetigala (2011), better management and good corporate governance practices helps to enhance the performance of the firm. Shleifer and Vishny (1997) viewed the corporate governance that the main aim of corporate governance is to confirm that managers opt all the possible strategies which maximizing the firm value.

Good Corporate Governance guarantees transparency in the firm, that results in balanced economic progress. This also confirms that all shareholders' interest is protected and they fully exercise their rights. This also reduce the wastage, mismanagement and corruption in the corporations.

It helps to reduce the vulnerability of the financial crises, capital's cost and leads to development of capital market. Corporate governance can play a significant role in attracting foreign direct investment for capital, which improves the development of the country. It also mobilizes more saving by capital, which makes that the firm having good governance system is more capable of raising external equity by capital market. Corporate governance also helps to Foreign institutional investors while taking investment decision for a firm. The companies can raise capital at more reasonable cost, if they have a clean awareness on the corporate governance of firm. Thus, it assists the firms to attract investment capital at low cost.

Accountability, reliability and well qualified financial information's is a result of effective governance system of firm.it also enhance the investor's confidence and efficiency of capital market (Rezaee 2009).

Well governed companies has stable financial and economic growth as well increases the national and global growth rate while bad governed firms has opposite results (Banks 2004).

Good Corporate governance system reduces the risk and which enables the board members to have better decision which improve the bottom line of the firm.

Barton et.al (2004) stated that well- governed firm attracts the investors who are willing to pay a premium of up to 25% . Gompers, et al. (2003) and Bebchuk, et al. (2009) concluded that better governance and performance have an affirmative co-relation. Mobius (2002) concluded that prices and demands of the share can enhance due to presence of good corporate governance practices.

Conclusion:

Investor's get fair return on their money through good governance. Because it builds assurance amongst present stakeholders as well as prospective. The firms who are strictly following the norms of corporate governance can attracts the investors who are willing to pay high prices.

Quality of corporate governance can shape the growth and future of emerging economy. Absence of corporate governance makes it difficult to enhance the value of shareholders' and their interest. Management of corporate bodies is associated to corporate governance.

Both Agency and stewardship theory are in contrast.

The stakeholder theory is a descriptive as well as a normative. It is descriptive in nature as it describes how the organization is instituted and controlled. It is a normative in nature as it recommends how to run the firms?

Lawrence and Lorsch (1967) link the corporate governance and resource dependency theory and reported that internal structures is a main element of successful organizations.

Important elements of the governance system are board members' skill, Independence of board, meetings of the boards, authority and responsibility of the board members, Code of conduct, Financial Reporting.

References

Ansoff, I (1965). Corporate Strategy. McGraw Hill, New York

Banks, E (2004). Corporate Governance, Financial Responsibility, Controls and Ethics, Palgrave Macmillan, New York.

Barbu, C. M., & Bocean, C. G. (2007). Corporate governance and firm performance. Management & Marketing-Craiova, (1), 125-131.

Barton, D., Coombes, P., and Wong,S. C. Y. (2004). Asia's governance challenge. McKinsey Quarterly, 2, pp. 54- 61.

Bebchuk, L., A. Cohen, A. Ferrell (2009). What matters in corporate governance? Review of Financial Studies, 22, pp. 783-827.

Core, J. E., Holthausen, R. W. and Larcker, D. F. (1999). Corporate governance, chief executive officer compensation, and firm performance. Journal of Financial Economics, 51, pp. 371-406.

Cynthia, A. Montgomery and Rhonda Kaufman, "The Board's Missing Link," Harvard Business Review, March, 2003, p. 89.

Davis, JH, Schoorman, FD & Donaldson, L (1997). Towards a Stewardship Theory of Management. Academy of Management Review, 22, pp. 20-47.

Deegan, C (2004). Financial Accounting Theory, New York : McGraw-Hill Australia Pty Ltd.

Donaldson, T (1983). Constructing a Social Contract for Business. Donaldson, T and Werhane, P. (Eds), Ethical Issues in Business, Prentice-Hall, Englewood Cliffs, NJ.

Donaldson, L & Davis, JH (1991). Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns. Australian Journal of Management, 16, pp. 49-64.

Donaldson, T & Dunfee, TW (1999). Ties That Bind. Harvard School of Business Press, Boston, MA.

Freeman, RE (1984). Strategic Management: A Stakeholder Approach. Pitman Publishing, Boston, MA.

Gallagher, Terrence J.(1997), "The Activist Board and Corporate Governance", Fordham Journal of Corporate & Financial Law, 2(1).

Gompers, P., J. Ishii, and A. Metrick (2003). Corporate governance and equity prices. Quarterly Journal of Economics, 118, pp. 107-155.

Gregory, HJ and Simms, ME (1999). Corporate Governance: What it is and why it Matters. Paper presented to the 9th International Anti-Corruption Conference, Kuala Lumpur.

Heenetigala, Kumudini (2011) . Corporate Governance Practices and Firm Performance of Listed Companies in Sri Lanka (Doctor of Business Administration. Thesis). Victoria Graduate School, Victoria University

Hendry, Kevin and Kiel , Geoffrey C. (2004), The Role of the Board in Firm Strategy: integrating agency and organisational control perspectives, -- Volume 12(4), CORPORATE GOVERNANCE pp 500-520.

Hillman, AJ, Cannella Jr, AA & Paetzols, RL (2000). The Resource Dependency Role of Corporate Directors: Strategic Adaptation of Board Composition in Response to Environmental Change. Journal of Management Studies.

Jensen, M., and Meckling, W. (1976). Theory of the Firm, Managerial Behaviour,Agency Costs and Ownership Structure. Journal of Financial Economics , pp. 305-360.

Khan, Khurram ; Nemati , Ali Raza; Iftikhar ,Moazzam (2011), "Impact of Corporate Governance on Firm Performance- Evidence from the Tobacco Industry of Pakistan", International Research Journal of Finance and Economics,61.

Khanna, V. and B. Black (2007). Can corporate governance reforms increase firms' market values? : Evidence from India. Journal of Empirical Legal Studies, 4,pp. 749-796.

Keasey,K. , S. Thompson and M. Wright (1997), 'Introduction: The corporate governance problem - competing diagnoses and solutions,' In K. Keasey,

S. Thompson and M. Wright, Corporate Governance: Economic, Management, and Financial Issues. Oxford University Press: Oxford.

Keong, LC (ed.) (2002). Corporate Governance: An Asia-Pacific Critique. Sweet & Maxwell Asia, Hong Kong.

Lawrence, PR & Lorsch, JW (1967). Organisation and Environment: Managing Differentiation and Integration. Division of Research, Harvard University School of Business Administration, Harvard University, Boston.

Mallin, CA (2004). Corporate Governance. Oxford University Press.

Mayer, F. (1997), 'Corporate governance, competition, and performance', In Enterprise and Community: New Directions in Corporate Governance, S. Deakin and A. Hughes (Eds), Blackwell Publishers: Oxford.

Mobius, JM (2002). Issues in Global Corporate Governance. in Lc Keon (ed.), Corporate Governance: An Asia-Pacific Critique, Sweet & Maxwell Asia, Hongkong.

Monks, R. A. G. and Minow, N. (1995), Corporate Governance, Basil Blackwell, Cambridge, cited by Ghosh, Saibal, "Do Board Characteristics Affect Corporate Performance? Firm- Level Evidence for India," Applied Economics Letters, 13, 2006, p. 436.

OECD (2004). OECD Principles of Corporate Governance. Organization for Economic Co-operation and Development.

Pfeffer, J (1972). Size and Composition of Corporate Board of Directors: The Organization and its Environment, Administrative Science Quarterly, 17, pp. 218-29.

Rezaee, Z (2009). Corporate Governance and Ethics. John Wiley & Sons, Inc, USA.

Shanikat, Mohammed and Abbadi, Sinan S. (2011) , Assessment of Corporate Governance in Jordan: An Empirical Study, Australasian Accounting Business and Finance Journal, 5(3), 93-106.

Shleifer, A and Vishny, RW (1997). A Survey of Corporate Governance. The Journal of Finance, 50(2), pp. 737-783

Standard and Poor a certified rating agency's definition on Corporate Governance Strict CSR Rules, non-Compliance fine, Business Standard, Dec 15th, 2011.

Suchman, MC (1995). Managing Legitimact: Strategic and Institutional Approaches. Academy of Management Review, 20, pp. 571-610.

Tricker, Adrian(2009) .Essentials for Board Directors: An A-Z Guide, New York :Bloomberg Press, ISBN 978-1-57660-354-3.

Van Horne James, J., and J. M. Machowicz Jr. (2005). Fundamentals of financial management. (2nd ed.). New Jersey :Pearson Education Limited.