Middle Eastern Finance and Economics
ISSN: 1450-2889 Issue 4 (2009)
© EuroJournals Publishing, Inc. 2009
http://www.eurojournals.com/MEFE.htm

Fundamental and Ethics Theories of Corporate Governance

Haslinda Abdullah
Faculty of Economics & Management, University Putra Malaysia
E-mail: hba@putra.upm.edu.my; drhaslinda@gmail.com
Tel: ++603-8946 7638; Fax: ++603-8948 6188

Benedict Valentine
Graduate School of Management, University Putra Malaysia
E-mail: valentine_benedict@gmail.com
Tel: ++603 - 8946 7440; Fax: ++603 - 8943 4019

Abstract

History has revealed that there is a never-ending evolution of theories or models of corporate governance. One of the reasons is due to the very essence of social consciences that is minimal and profit making took center stage. All over the world, companies are trying to instill the sense of governance into their corporate structure. With the surge of capitalism, corporation became stronger while governments all over the world had to succumb to its manipulations and dominance. Hence, this article is a review of literature on the range of theories in corporate governance. The fundamental theories in corporate governance began with the agency theory, expanded into stewardship theory and stakeholder theory and evolved to resource dependency theory, transaction cost theory, political theory and ethics related theories such as business ethics theory, virtue ethics theory, feminists ethics theory, discourse theory and postmodernism ethics theory. However, these theories address the cause and effect of variables, such as the configuration of board members, audit committee, independent directors and the role of top management and their social relationships rather than its regulatory frameworks. Hence, it is suggested that a combination of various theories is best to describe an effective and good governance practice rather than theorizing corporate governance based on a single theory.

Keywords: Corporate governance, theory, ethics

1.0. Introduction

Corporations have become a powerful and dominant institution. They have reached to every corner of the globe in various sizes, capabilities and influences. Their governance has influenced economies and various aspects of social landscape. Shareholders are seen to be losing trust and market value has been tremendously affected. Moreover with the emergence of globalization, there is greater deterritorialization and less of governmental control, which results is a greater need for accountability (Crane and Matten, 2007). Hence, corporate governance has become an important factor in managing organizations in the current global and complex environment. In order to understand corporate governance, it is important to highlight its definition. Even though, there is no single accepted definition of corporate governance but it can be defined as a set of processes and structures for controlling and directing an organization. It constitutes a set of rules, which governs the relationships

between management, shareholders and stakeholders (Ching et al, 2006). The term "corporate governance" has a clear origin from a Greek word, "kyberman" meaning to steer, guide or govern. From a Greek word, it moved over to Latin, where it was known as "gubernare" and the French version of "governer" . It could also mean the process of decision-making and the process by which decisions may be implemented. Henceforth, corporate governance has much a different meaning to different organizations (Abu-Tapanjeh, 2008). In recent years, with much corporate failures, the countenance of corporate has been scared.

Corporate governance includes all types of firms and its definitions could extend to cover all of the economic and non-economic activities. Literatures in corporate governance provide some form of meaning on governance, but fall short in its precise meaning of governance. Such ambiguity emerges in words like control, regulate, manage, govern and governance. Owing to such ambiguity, there are many interpretations. It may be important to consider the influences a firm has or affected by in order to grasp a better understanding of governance. Owing to vast influential factors, proposed models of corporate governance can be flawed as each social scientist is forming their own scope and concerns. Hence, this article reviews various fundamental theories underlining corporate governance. These theories range from the agency theory and expanded into stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory, political theory and ethics related theories such as business ethics theory, virtue ethics theory, feminists ethics theory, discourse theory and postmodernism ethics theory.

2.0. Fundamental Corporate Governance Theories

2.1. Agency Theory

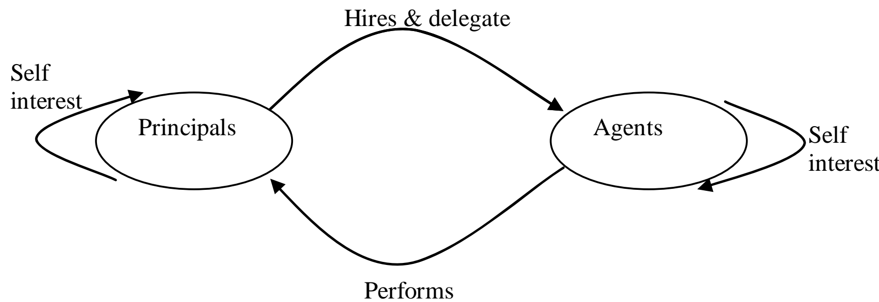
Agency theory having its roots in economic theory was exposited by Alchian and Demsetz (1972) and further developed by Jensen and Meckling (1976). Agency theory is defined as "*the relationship between the principals, such as shareholders and agents such as the company executives and managers*". In this theory, shareholders who are the owners or principals of the company, hires the gents to perform work. Principals delegate the running of business to the directors or managers, who are the shareholder's agents (Clarke, 2004). Indeed, Daily et al (2003) argued that two factors can influence the prominence of agency theory. First, the theory is conceptually and simple theory that reduces the corporation to two participants of managers and shareholders. Second, agency theory suggests that employees or managers in organizations can be self-interested.

The agency theory shareholders expect the agents to act and make decisions in the principal's interest. On the contrary, the agent may not necessarily make decisions in the best interests of the principals (Padilla, 2000). Such a problem was first highlighted by Adam Smith in the 18th century and subsequently explored by Ross (1973) and the first detailed description of agency theory was presented by Jensen and Meckling (1976). Indeed, the notion of problems arising from the separation of ownership and control in agency theory has been confirmed by Davis, Schoorman and Donaldson (1997).

In agency theory, the agent may be succumbed to self-interest, opportunistic behavior and falling short of congruence between the aspirations of the principal and the agent's pursuits. Even the understanding of risk defers in its approach. Although with such setbacks, agency theory was introduced basically as a separation of ownership and control (Bhimani, 2008). Holmstrom and Milgrom (1994) argued that instead of providing fluctuating incentive payments, the agents will only focus on projects that have a high return and have a fixed wage without any incentive component. Although this will provide a fair assessment, but it does not eradicate or even minimize corporate misconduct. Here, the positivist approach is used where the agents are controlled by principal-made rules, with the aim of maximizing shareholders value. Hence, a more individualistic view is applied in this theory (Clarke, 2004). Indeed, agency theory can be employed to explore the relationship between the ownership and management structure. However, where there is a separation, the agency model can

be applied to align the goals of the management with that of the owners. Due to the fact that in a family firm, the management comprises of family members, hence the agency cost would be minimal as any firm's performance does not really affect the firm performance (Eisenhardt, 1989). The model of an employee portrayed in the agency theory is more of a self-interested, individualistic and are bounded rationality where rewards and punishments seem to take priority (Jensen & Meckling, 1976). This theory prescribes that people or employees are held accountable in their tasks and responsibilities. Employees must constitute a good governance structure rather than just providing the need of shareholders, which maybe challenging the governance structure.

Figure 1: The Agency Model



2.2. Stewardship Theory

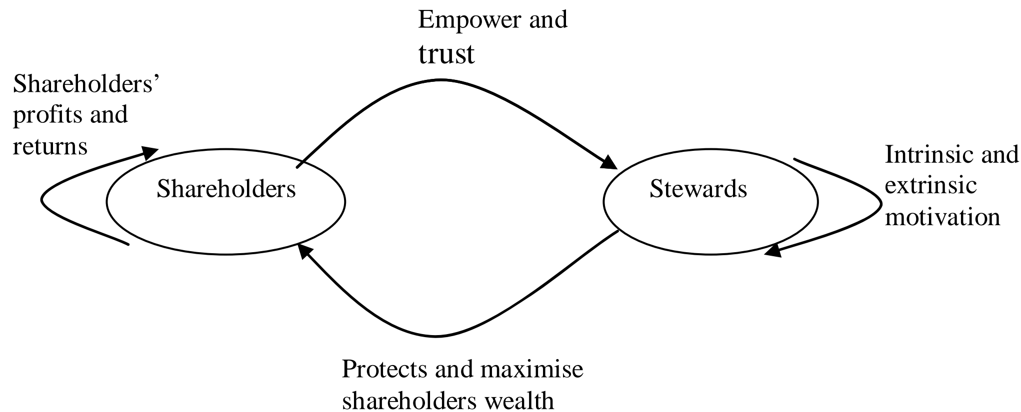
Stewardship theory has its roots from psychology and sociology and is defined by Davis, Schoorman & Donaldson (1997) as *"a steward protects and maximises shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximised*". In this perspective, stewards are company executives and managers working for the shareholders, protects and make profits for the shareholders. Unlike agency theory, stewardship theory stresses not on the perspective of individualism (Donaldson & Davis, 1991), but rather on the role of top management being as stewards, integrating their goals as part of the organization. The stewardship perspective suggests that stewards are satisfied and motivated when organizational success is attained.

Agyris (1973) argues agency theory looks at an employee or people as an economic being, which suppresses an individual's own aspirations. However, stewardship theory recognizes the importance of structures that empower the steward and offers maximum autonomy built on trust (Donaldson and Davis, 1991). It stresses on the position of employees or executives to act more autonomously so that the shareholders' returns are maximized. Indeed, this can minimize the costs aimed at monitoring and controlling behaviours (Davis, Schoorman & Donaldson, 1997).

On the other end, Daly et al. (2003) argued that in order to protect their reputations as decision makers in organizations, executives and directors are inclined to operate the firm to maximize financial performance as well as shareholders' profits. In this sense, it is believed that the firm's performance can directly impact perceptions of their individual performance. Indeed, Fama (1980) contend that executives and directors are also managing their careers in order to be seen as effective stewards of their organization, whilst, Shleifer and Vishny (1997) insists that managers return finance to investors to establish a good reputation so that that can re-enter the market for future finance. Stewardship model can have linking or resemblance in countries like Japan, where the Japanese worker assumes the role of stewards and takes ownership of their jobs and work at them diligently.

Moreover, stewardship theory suggests unifying the role of the CEO and the chairman so as to reduce agency costs and to have greater role as stewards in the organization. It was evident that there would be better safeguarding of the interest of the shareholders. It was empirically found that the returns have improved by having both these theories combined rather than separated (Donaldson and Davis, 1991).

Figure 2: The Stewardship Model



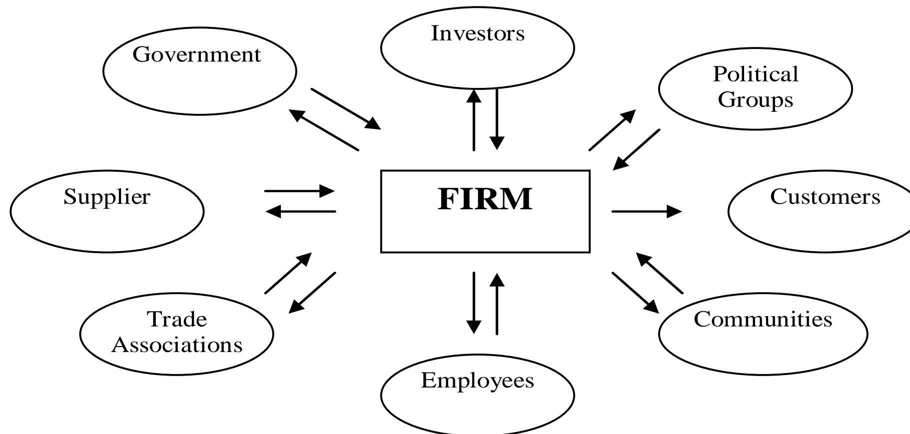
2.3. Stakeholder Theory

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. Wheeler et al, (2002) argued that stakeholder theory derived from a combination of the sociological and organizational disciplines. Indeed, stakeholder theory is less of a formal unified theory and more of a broad research tradition, incorporating philosophy, ethics, political theory, economics, law and organizational science.

Stakeholder theory can be defined as "*any group or individual who can affect or is affected by the achievement of the organization's objectives*". Unlike agency theory in which the managers are working and serving for the stakeholders, stakeholder theorists suggest that managers in organizations have a network of relationships to serve – this include the suppliers, employees and business partners. And it was argued that this group of network is important other than owner-manager-employee relationship as in agency theory (Freeman, 1999). On the other end, Sundaram & Inkpen (2004) contend that stakeholder theory attempts to address the group of stakeholder deserving and requiring management's attention. Whilst, Donaldson & Preston (1995) claimed that all groups participate in a business to obtain benefits. Nevertheless, Clarkson (1995) suggested that the firm is a system, where there are stakeholders and the purpose of the organization is to create wealth for its stakeholders.

Freeman (1984) contends that the network of relationships with many groups can affect decision making processes as stakeholder theory is concerned with the nature of these relationships in terms of both processes and outcomes for the firm and its stakeholders. Donaldson & Preston (1995) argued that this theory focuses on managerial decision making and interests of all stakeholders have intrinsic value, and no sets of interests is assumed to dominate the others.

Figure 3: The Stakeholder Model (Donaldson and Preston, 1995)



2.4. Resource Dependency Theory

Whilst, the stakeholder theory focuses on relationships with many groups for individual benefits, resource dependency theory concentrates on the role of board directors in providing access to resources needed by the firm. Hillman, Canella and Paetzold (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to the external environment. Indeed, Johnson et al, (1996) concurs that resource dependency theorists provide focus on the appointment of representatives of independent organizations as a means for gaining access in resources critical to firm success. For example, outside directors who are partners to a law firm provide legal advice, either in board meetings or in private communication with the firm executives that may otherwise be more costly for the firm to secure.

It has been argued that the provision of resources enhances organizational functioning, firm's performance and its survival (Daily et al, 2003). According to Hillman, Canella and Paetzold (2000) that directors bring resources to the firm, such as information, skills, access to key constituents such as suppliers, buyers, public policy makers, social groups as well as legitimacy. Directors can be classified into four categories of insiders, business experts, support specialists and community influentials. First, the insiders are current and former executives of the firm and they provide expertise in specific areas such as finance and law on the firm itself as well as general strategy and direction. Second, the business experts are current, former senior executives and directors of other large for-profit firms and they provide expertise on business strategy, decision making and problem solving. Third, the support specialists are the lawyers, bankers, insurance company representatives and public relations experts and these specialists provide support in their individual specialized field. Finally, the community influentials are the political leaders, university faculty, members of clergy, leaders of social or community organizations.

2.5. Transaction Cost Theory

Transaction cost theory was first initiated by Cyert and March (1963) and later theoretical described and exposed by Williamson (1996). Transaction cost theory was an interdisciplinary alliance of law, economics and organizations. This theory attempts to view the firm as an organization comprising people with different views and objectives. The underlying assumption of transaction theory is that firms have become so large they in effect substitute for the market in determining the allocation of resources. In other words, the organization and structure of a firm can determine price and production. The unit of analysis in transaction cost theory is the transaction. Therefore, the combination of people with transaction suggests that transaction cost theory managers are opportunists and arrange firms' transactions to their interests (Williamson, 1996).

2.6. Political Theory

Political theory brings the approach of developing voting support from shareholders, rather by purchasing voting power. Hence having a political influence in corporate governance may direct corporate governance within the organization. Public interest is much reserved as the government participates in corporate decision making, taking into consideration cultural challenges (Pound, 1993). The political model highlights the allocation of corporate power, profits and privileges are determined via the governments' favor. The political model of corporate governance can have an immense influence on governance developments. Over the last decades, the government of a country has been seen to have a strong political influence on firms. As a result, there is an entrance of politics into the governance structure or firms' mechanism (Hawley and Williams, 1996).

3.0. Ethics Theories and Corporate Governace

Other than the fundamental corporate governance theories of agency theory, stewardship theory, stakeholder theory, resource dependency theory, transaction cost theory and political theory, there are other ethical theories that can be closely associated to corporate governance. These include business ethics theory, virtue ethics theory, feminist ethics theory, discourse ethics theory, postmodern ethics theory.

Business ethics is a study of business activities, decisions and situations where the right and wrongs are addressed. The main reasons for this are the power and influence of business in any given society is stronger than ever before. Businesses have become a major provider to the society, in terms of jobs, products and services. Business collapse has a greater impact on society than ever before and the demands placed by the firm's stakeholders are more complex and challenging. Only a handful of business giants have had any formal education on business ethics but there seems to be more compromises these days. Business ethics helps us to identify benefits and problems associated with ethical issues within the firm and business ethics is important as it gives us a new light into present and traditional view of ethics (Crane and Matten, 2007). In understanding the 'right and wrongs' in business ethics, Crane & Matten, (2007) injected morality that is concerned with the norms, values and beliefs fixed in the social process which helps right and wrong for an individual or social community. Ethics is defined as the study of morality and the application of reason which sheds light on rules and principle, which is called ethical theories that ascertains the right and wrong for a situation.

Whilst business ethics theory focuses on the "rights and wrongs' in business, f*eminist ethics theory* emphasizes on empathy, healthy social relationship, loving care for each other and the avoidance of harm. In an organization, to care for one another is a social concern and not merely a profit centered motive. Ethics has also to be seen in the light of the environment in which it is exercised. This is important as an organization is a network of actions, hence influencing trans-communal levels and interactions (Casey, 2006). On the other end, *discourse ethics theory* is concerned with peaceful settlement of conflicts. Discourse ethics, also called argumentation ethics, refers to a type of argument that tries to establish ethical truths by investigating the presuppositions of discourse (Habermas, 1996). Meisenbach (2006) contends that such kind of settlement would be beneficial to promote cultural rationality and cultivate openness.

Virtue ethics theory focuses on moral excellence, goodness, chastity and good character. Virtue is a state to act in a given situation. It is not a habit as a habit can be mindless (Annas, 2003). Aristotle calls it as disposition with choice or decision. For example, if a board member decides to be honest, now that a decision which he makes and thus strengthens his virtue of honesty. Virtue involves two aspects, the affective and intellectual. The concept of affective in virtue theory suggests "doing the right thing and have positive feelings", whilst, the concept of intellectual suggests "to do virtuous act with the right reason". Virtues can be instilled with education. Aristotle mentions that knowledge on ethics is just like becoming a builder (Annas, 2003). Through the process of educating and exposure to good virtues, the development of ethical values in a child's life is evident. Hence, if a person is

exposed to good or positive ethical standards, exhibiting honesty, just and fairness, than he would exercise the same and it will be embedded in his will to do the right thing at any given situation. Virtue ethics is eminent to bring about the intangibles into an organization. Virtue ethics highlights the virtuous character towards developing a morally positive behavior (Crane and Matten, 2007). Virtues are a set of traits that helps a person to lead a good life. Virtues are exhibited in a person's life. Aristotle believed that virtue ethics consists of happiness not on a hedonistic sense, but rather on a broader level. Nevertheless, *postmodern ethics theory* goes beyond the facial value of morality and addressed the inner feelings and 'gut feelings' of a situation. It provides a more holistic approach in which firms may make goals achievement as their priority, foregoing or having a minimal focus on values, hence having a long term detrimental effect. On the other hand, there are firms today who are so value driven that their values become their ultimate goal (Balasubramaniam, 1999).

4.0. Conclusion

This review has seen corporate governance from various theoretical perspectives. The emergence of agency theory, stewardship theory, stakeholder theory, transaction cost theory and political theory addresses the cause and effect of variables, such as the configuration of board members, audit committee, independent directors and the role of top management. In addition, ethics in business have been closely associated with corporate governance. This can be seen with the association of business ethics theory, feminist ethics theory, discourse ethics theory, virtue ethics theory and postmodern ethics theory. Hence, it can be argued that corporate governance is more of a social relationships rather than process orientated structure. In addition, these theories focused on the view that the shareholders' aimed to get a return on their investments. In todays business environment, business process should also focus on other critical factors such as legislation, culture and institutional contexts. Corporate governance is constantly changing and evolving and changes are driven by both internal and external environmental dynamics. The internal environment has a fixed mindset of shareholders' relationship with stakeholders and maximizing profits. Whilst, issues in the external environment such as the break-up of large conglomerates like Enron, mergers and acquisitions of corporation, business collaborations, easier financial funding, human resource diversity, new business start-ups, globalization and business internationalization, and the advance of communication and information technology have directly and indirectly caused the changes in corporate governance. The current corporate governance theories cannot fully explain the complexity and heterogeneity of corporate business. Governance for different country may vary due to its cultural values, political and social and historical circumstances. In this sense, governance for developed countries and developing countries can vary due to the culture and economic contexts of individual country.

Moreover, an effective and good corporate governance cannot be explained by one theory but it is best to combine a variation of theories, addressing not only the social relationships but also emphasize on the rules and legislation and stricter enforcement surrounding good governance practice and going beyond the norms of a mechanical approach towards corporate governance. Literature has proven that even with strict regulations, there have been infringements in corporate governance. Hence it is crucial that a holistic realization be driven across the corporate world that would bring about a different perspective towards corporate governance. The days of cane and bridle are becoming a mere shadow and the need to get to the root of a corporation is essential. Therefore, it is important to re-visit corporate governance in the light of the convergence of these theories and with a fresh angle, which has a holistic view and incorporating subjectivity from the perspective of social sciences.

References

[1] Abu-Tapanjeh. M. A. (2008) “Corporate Governance From Islamic Perspective: A Comparative Analysis With OECD Principles”. Elsevier Ltd.

[2] Agyris, C. (1973) “Some Limits of Rational Man Organizational Theory”. *Public Administration Review*, Vol. 33, pp. 253-267

[3] Annas. J. (2003) “:Virtue Ethics and Social Psychology”. A Priori, Vol. 2, pp. 20

[4] Alchian, A.A. and Demsetz, H. (1972) “Production, Information Costs and Economic Organization”. *American Economic Review*, Vol. 62, pp. 772-795

[5] Balasubramaniam, (1999) “An International Perspective on Corporate Boards and Governance”, Malaysian Insurance Institute.

[6] Bhimani, A. (2008) “Making Corporate Governance Count: The Fusion of Ethics and Economic Rationality”. *Journal of Management and Governance,* Vol. 12, No. 2, pp. 135-147

[7] Ching, K. W.; Tan, J.S. & Chi Ching R. G. (2006) “Corporate Governance in East Asia, The Road Ahead”. Prentice Hall Publication.

[8] Clark, T. (2004) “Theories of Corporate Governance: The Philosophical Foundations of Corporate Governance” London and New York: Routledge,

[9] Clark. T. (1998) “The Stakeholder Corporation: A Business Philosophy for The Information Age”. Long Range Planning Publication.

[10] Clarkson, M. B. E. (1995). “A Stakeholder Framework for Analyzing and Evaluating Corporate Social Performance”. Academy of Management Review, Vol. 20, No. 1, pp. 92-117

[11] Crane. A and Matten. D. (2007) “Business Ethics” (2nd Ed). Oxford University Press.

[12] Cyert, R.M. and March, J.G. (1963) “A Behavior Theory of the Firm”. New Jersey-USA, Prentice Hall,

[13] Daily, C.M., Dalton, D.R. and Canella, A.A. (2003) “Corporate Governance: Decades of Dialogue and Data”. *Academy of Management Review*, Vol. 28, No. 3, pp. 371-382

[14] Davis, J.H., Schoorman, F.D. and Donaldson, L. (1997) “Toward a Stewardship Theory of Management”. *Academy of Management Review*, Vol. 22, pp. 20-47

[15] Donaldson, T. and Preston, L.E. (1995) “The Stakeholder Theory of the Corporation: Concepts, Evidence and Implications”. *Academy of Management Review*, Vol. 20, No. 1, pp. 65-91

[16] Donaldson. L and Davis. J. (1991) “Stewardship Theory or Agency Theory: CEO Governance and Shareholder Returns”. *Academy Of Management Review*, Vol. 20, No. 1, pp. 65

[17] Eisenhardt, K.M. (1989) “Agency Theory: An Assessment and Review”. *Academy of Management Review,* Vol. 14, pp. 57-74

[18] Fama, E.F. (1980) “Agency Problems and the Theory of the Firm”. *Journal of Political Economy,* Vol. 88, pp. 288-307

[19] Freeman, R. E. (1984) “Strategic Management: A Stakeholder Approach”. Pitman, London

[20] Freeman, R.E. (1999) “Response: Divergent Stakeholder Theory”. *Academy of Management Review,* Vol. 24, No. 2, pp. 233-236

[21] Hawley, J.P. and Williams, A.T. (1996) “Corporate Governance in the United States: The Rise Of Fiduciary Capitalism”. *Working Paper,* Saint Mary's College of California, School of Economics and Business Administration

[22] Habermas, J. (1996) “Between Facts and Norms”. Cambridge Polity Press

[23] Hillman, A.J., Canella, A.A., and Paetzold, R.L. (2000) “The Resource Dependency Role Of Corporate Directors: Strategic Adaptation Of Board Composition In Response To Environmental Change”. *Journal of Management Studies*, Vol. 37, No. 2, pp. 235-255

[24] Holmstrom, B. and Milgrom, P. (1994) “The Firm as an Incentive System”. *The American Economic Review*, Vol. 84, No. 4, pp. 972-991

[25] Jensen, M.C. and Meckling, W. (1976) “Theory Of The Firm: Managerial Behavior, Agency Costs And Ownership Structure”. *Journal of Financial Economics*, Vol. 3, pp.305-360

[26] Johnson, J.L., Daily, C.M. and Ellstrand, A.E. (1996) “Boards of Directors: A Review of Research Agenda”. *Journal of Management*, Vol. 22, No. 3, pp. 409-438

[27] Maisenbach, R.J. (2006) "Habermas's Discourse Ethics and Principle of Universalization as a Moral Framework for Organizational Communication". *Management Communication Quarterly,* Vol. 20, No. 1, pp. 39-62.

[28] Padilla, A. (2002) "Can Agency Theory Justify The Regulation Of Insider Trading". *The Quarterly Journal of Austrian Economics*, Vol. 5, No. 1, pp. 3-38

[29] Pound, J. (1993) "Proxy Contest And The Efficiency Of Shareholder Oversight". *Journal of Financial Economics,* Vol. 20, pp. 237-265

[30] Ramani. V. (2006) "The ICFAI University Press On Corporate Governance; Current Developments". ICFAI Books.

[31] Ross, S.A. (1973) "The Economic Theory of Agency: The Principal's Problem". *The American Economic Review*, Vol. 63, No. 2, pp. 134-139

[32] Shleifer, A. and Vishny, R.W. (1997) "A Survey Of Corporate Governance". *Journal of Finance*, Vol. 52, No. 2, pp. 737-783

[33] Sundaram, A.K. and Inkpen, A.C. (2004) "The Corporate Objective Revisited" *Organization Science*, Vol. 15, No. 3, pp. 350-363

[34] Wheeler, D., Colbert, B. and Freeman, R.E. (2003) "Focusing On Value: Reconciling Corporate Social Responsibility, Sustanibility And A Stakeholder Approach In A Network World". *Journal of General Management*, Vol. 28, pp. 1-28

[35] Williamson, O. (1996) "The Mechanisms of Governance". Oxford University Press, Oxford