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Corporate Governance: Relevance in 21st century

Ajay Kumar Pandey

ABS, Amity University Gurgaon, India.

Dr. Deependra Sharma

ABS, Amity University Gurgaon, India.

Abstract

Purpose of study:

- To understand the inherent principles and evolving framework of corporate governance theories
- To assess the relevance of corporate governance theories in modern organizations.

Research-Methodology: Data from the secondary sources have been utilised to attain the objectives of the study. Extensive review has been made of the extant literature by the researchers. The paper studies various conceptual frameworks of Corporate Governance theories and critically examines their relevance so as to provide integrated, comprehensive model of Corporate Governance.

The study suggests that unifying Corporate Governance model should take 'organisations as an organism' with an aim of creating maximisation of long term strategic value for it, so as to ensure longevity and growth for the organisation.

Results: The goal of Agency Theory is to maximize shareholders value in long term, but this goal is not always valid particularly when the interest and decisions of Board of Directors are in conflict, in that situation Stakeholders Theory and Stewardship Theory becomes valid which ensures alignment of interests. For modern organization the concept of organization as organic entity is the valid theoretical framework for decision making function of Board of Directors, this concept is based on growth and longevity of the organization as the prime goal of organizations.

Implications: Results of the study are of relevance not only to the academician but to practioners as well. It suggests what model of Corporate Governance should be followed by an organisation to create maximum value and how it may ensure longevity and growth on a sustainable basis.

Keywords: Corporate Governance, Agency Theory, Stakeholder Theory, Stewardship Theory.

Evolution of Corporate Governance:

Agency Theory

The concept of separation of ownership and management of an organization is the basis of Agency Theory. This distinction was first analyzed by Adam Smith in 1776, wherein he suggested that separation of ownership and control made it difficult for the managers to effectively manage the functioning of organizations.

This Agency problem concerning separation of ownership and control in modern firms came from classic work of Berle & Means (1932).The core of the agency problem is the separation of management and finance (Shleifer and Vishny, 1997).

Business organization raises funds from investors to put them to productive use while the investors need specialized human capital to generate return on their investment. The investor concern is how to insure that, once they have put in their funds in the venture. The agency problem refers to these issues that investors face in insuring that the funds, which have invested, are not wasted on unviable projects.

Jensen and Meckling (1976) integrated elements from agency theory, property rights and finance to develop a theory of the ownership structure of the firm. They argued that agency costs are unavoidable results of the relationship between investors and managers and the contractual relation are the essence of the firm, not only with employees but also with other stakeholders. According to them, since decision makers ultimately bear the costs, these decision makers have the economic incentive to minimize agency costs.

Corporate governance came into existence as an instrument to deal with the agency problem .According to Shleifer and Vishny (1997) corporate governance explains "…*how to assure financiers that they get a return on their investment".* Corporate governance principles required listed companies to have unitary boards, independent outside directors, and board committees. In accordance with the assumptions of the agency theory these principles mainly targeted on appreciating shareholder value and, also, rewarding top executives. This been the principal basis for developing codes for governance around the world.

Stewardship Theory

Shleifer et al's (1997) surveyed the Japan-German model for corporate governance that is prevalent in these two countries where corporate and institutional block holders play an important monitoring role, from where an alternative framework for corporate governance had evolved. This approach to corporate governance, found support in the prevalent legal framework in those countries, some of which even mandated (for instance in Germany) that half the seats on the supervisory board of the companies were to be held by worker representatives.

The origin of the stakeholder theory of corporate governance can be traced to Freeman (1994) who defined stakeholders as "*any group or individual who can affect, or is affected by, the achievement of a corporation's purpose".* This framework evolved as s realization that organizations created value through interaction between diverse interest groups, all of whom had a stake in the growth and well being of the organization and organizations do not exist to fulfill the economic interest of only one group. The essence of the stakeholder theory has been well captured in two key questions formulated by Freeman (1994). The first question was what is the purpose of the firm? Secondly, what is the responsibility of the management of the firm to its stakeholders?

Consequently, the earlier view, based on a narrow, legal interpretation, which held that the directors were solely responsible to their shareholders, is now rapidly giving way to a broader interpretation of their role and responsibilities.

However, a contrary view, to the stakeholder view on corporate governance, is held by several thinkers like Ansoff (1987) who has argued forcefully against the stakeholder approach. As per his argument, shareholders in an organization have their entire investment at risk and therefore need to be the primary (if not the sole) recipient of any benefits arising from the performance of the organization.

Trusteeship Theory

The scale and magnitude of corporate frauds and scams, across the world, in the 21st century have also made it profusely evident that corporations, in pursuit of profits, can ill afford to ignore the impact of their interactions with the environment and the society in which they operate.

Balasubramanian (2009) has pointed out, there is a large measure of knowledge available in Indian tradition which provides the framework for migration towards an integrated model of governance. He emphasizes the imperatives of shareholder wealth creation while being sensitive to the need of the society and fair and equitable distribution of wealth.

Giving example from corporations, Balasubramanian (2009) has suggested that, increasingly, there seems to be a growing approval that the board's role was to steer a path, while protecting and enhancing shareholders' wealth, should also ensure that the stakeholders' aspirations are taken care of and organizations fulfill their responsibility towards society.

Objectives of the study:

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The relevance of corporate governance theories in Modern Organizations:

In today's world, the responsibility to shareholders and creating long term shareholder value is increasingly becoming less relevant in defining the goal of corporate action, not because responsibility to shareholders is an out dated concept but because of the fact that the concept of shareholder longevity has significantly changed over the years on account of the increased churn in shareholding that is so common today.

According to a study in the late 1990's by Bain & Company, (Business Week Online, September 13, 1999) in the USA, at a churn rate of 76%, shares turn over at a rate six times greater than in 1960. In such an environment, the phrase "*building enduring shareholder value"* takes on a different connotation and really means "*maximizing share price for realizing capital gains"* on the sale of the shares by investors who do not have any long term interest in the organization.

With an increased focus on looking at short term gains as opposed to certain long term value, increasing market valuation of shares is now the driver for most business and is not an outcome of the process of creating shareholder value. Today, investors often evaluate their portfolio company by looking at the stock price in the short run and quickly move on to other companies that offer a better potential for near-term appreciation. Furthermore, with the proliferation of stock options with relatively short vesting and holding requirements, increasingly larger numbers of people, in management, have also started aligning with this view of focusing on short term share price gain rather that looking towards long term value creation.

Other writers have even argued that in today's complex business environment, it is not enough to balance the "*shareholder wealth maximization"* with "*long-term commitment"* in corporate governance and that the model must include a third dimension which focuses on growth and value creation for the organization (McCahery, Vermeulen, and Hisatake 2013), and go on to suggest that one of the advantages of such a three dimensional model of corporate governance is that the responsibility for implementing structures that limit agency costs, encourage long term commitments and promote entrepreneurship and innovation, lies within the company itself.

Another organizational complexity of recent origins is the significant decrease in the tenure of the CEOs at the top. Ever since the concept of "executive churn" was coined by Bennis and O'Toole (2000), this label has been increasingly used to describe the brevity of CEO tenure and the realization that an incoming CEO usually has a two year period to perform before there is either voluntary or involuntary churn at the top. Bennis. Et al (2000) found that the "churn-time" markedly less than what was afforded to incoming CEOs 10 to 15 years ago and according to them this CEO churn factor is a part of the dangerous hubris that leads CEOs towards making dramatic and high profile strategic changes (mergers, take-over, acquisitions and revolutionary change) during his tenure that at times, cause more harm than good to the organization.

Executive churn at the top is now a global phenomenon and is not confined to the USA alone. As reported in the online edition of Financial Express, (October 22, 2006), a study done by the HR consulting firm EMA Partners International found that in the past 5 years 66% of the companies in India had changed their CEOs with MNCs having the highest percentage at 86%.

To summarize, today's complex business environment is characterized by extreme turbulence, internal and external and is in a constant state of churn with neither the principal (owners) or the agent (managers) having a long term permanent interest in the organization, their interest is purely guided by their short or medium term interest. Such a situation presents a major challenge for the members on the board of the company when they have to take decisions on issues that come up for discussion before the board and which have long term implications for the business.

Limitations of the existing Corporate Governance Theories:

As a guide to board members for taking decisions the traditional agency theory, which is the basis of most of the current framework for corporate governance, is fundamentally flawed. The agency theory is based on the relationship between the two parties—principal(s) and agent(s), and a shared understanding of the context in which agreements are made between them.

However, identifying what is in the interests of shareholders is not an easy task. Company promoters and their families, who relatively have a long term orientation, have a different interest from venture capitalist that, typically, look for an early exit and both of them may have different interests from an institutional investor who may have purchased shares during an initial public offering. The dilemma before the board members in modern organization is lack of clarity on who is the real owner of the company for whom the strategy should be set—i.e., is the strategy aimed to benefit the investor who holds the shares today, or the one who is likely to hold them tomorrow? Or, should the board members aim to protect the interest of the future investor, who may hold the shares in three years time?

Furthermore, in the 21st century, the proliferation of new instruments and trading platforms like derivative markets, short-selling, hedge funds and cross-border trading have made the already difficult task of understanding the interests of shareholders almost impossible and even perverse. As an illustration, consider investment tools like mutual funds whose growth has accelerated the concentration of corporate share ownership in the hands of institutional investors. Some of these mutual funds passively track a broader market index, where the interest of the fund is linked to the overall performance of the market. The owner's (holders of the mutual funds which in turn hold shares in the organization) economic interests are, therefore, different from those of the company in a very competitive marketplace.

The proliferation of leveraged hedge funds has added further complexity and could lead to a possible situation where a hedge fund trading on a short selling strategy (on the back of shares temporarily acquired for executing the trade from another passive fund) actually benefits from the company doing badly with worsening performance of the company leading to improved performance of the fund and the owner of the hedge fund would actually gain from the company doing poorly!

Consequently, in the real world where principals are equated with the shareholders of the company and the agents to its managers, reliance on the agency theory as the bedrock for corporate governance poses a major challenge since, in today's world, the shareholders are an amorphous mass of people who are not known to the mangers and whose requirements may even be at cross purpose to the objective of "*long term shareholder value".* Indeed, in the modern context there is no requirement, or even expectation, that anyone will remain a shareholder for an extended period of time and, hence, the basic assumption of a principal-agent relationship between the shareholders and managers, around which the agency theory is based, fails.

Likewise, given the very high level of executive churn seen in organizations today, the interest of other party to the principal-agent contract in an organization i.e., the managers of the organization is also transitory. Furthermore, the senior most managers in an organization are likely to be the board of directors and given the increase in the number of directors who are also shareholders, their role in the agent-principal relationship is likely to be partly one (shareholder) and partly the other (manager), so there is no clear divide between the two roles as far as the managers are concerned. The increasing reliance of managerial remuneration schemes on share option plans further accentuates this problem.

With the lines between agent(s) and principal(s) getting blurred in the present context, the governance model based on the agency theory runs into severe limitations in providing a suitable framework to the theory of corporate governance. Nonetheless, the agency theory does help the board of directors in finding solutions to a narrower problem of corporate governance i.e., how to keep managers from diverting corporate funds for private purposes.

Stakeholder theory is flawed as well but for different reasons. On one hand it fails in determining the difference between means and ends, while on the other hand it fails, at a practical level, because, when everything (the different objectives of the various stakeholders, which at times may even be contradictory) is a goal then nothing really is the goal.

Stewardship theory may help to explain why people might still want to serve on boards of director of public companies, despite the risk of prosecution under local acts or costly shareholder lawsuits so common in the litigious western world. However, some directors see their roles as being stewards of particular interest groups only, it is quite common to observe that when a major shareholder secures a seat on the board, its appointed director will understandably be tied to that shareholder's aims, whatever company law might say or company interest may warrant.

The primary challenge with the Gandhian trusteeship model is that it cannot be implemented by prescriptions alone but, to succeed, it needs to be accompanied by a transformational change in the hearts and minds of all concerned.

What is, therefore, currently missing is a sound theoretical framework for corporate governance that would be of help to the board of directors in managing the big picture and serve as a unifying theory to guide them in taking strategic decisions such as those involving a substantial commitment of shareholder funds or the opportunity costs of abandoning one line of business for the sake of entering another.

Organization as an organism – The evolved and relevant corporate governance theory:

The focus of any robust theoretical basis for corporate governance needs to shift from one that aims to balance between the interests for the various focuses on the organization and in creating stakeholders, to one that enduring benefit for the organization.

One such framework is based on the concept of viewing the 'organization as an organism' which has been developed by de Geus, Arie (1997). Accordingly, companies are living organisms that are influenced by their past history and experiences and the learning, skill and commitment of the people who work in them and have a purpose of their own. This holistic view of organizations is completely overlooked by most investors and they see the organizations as mere financial assets and as instruments to derive short term gain for them. In developing his framework, de Geus has followed work of evolutionary biologists who have defined an organism as an entity that is made up of different parts that cooperate well, but for an overall common purpose, and do so with minimal conflict (Rice University Press Release, November 9, 2009).

Based on a study of long living organizations, de Geus (1997) identified the following four characteristics that increase the longevity of organizations:

1. *Sensitivity to the environment*, representing a company's ability to learn and adapt.
2. *Cohesion and identity*, which are aspects of a company's innate ability to build a community and a persona for itself.
3. *Tolerance* and its corollary, decentralization that are both symptoms of a company's awareness of ecology and its ability to build constructive relationships with other entities, within and outside itself.
4. *Conservative financing* as a key attribute that enables an organization to govern its own growth and evolution effectively.

Viewing the 'organization as an organism' provides us with the framework that would help in guide the board members of a company in taking the right decisions.

Under the corporate governance reforms of the previous decades, the decision of the board would, in all probability, rest in the hands of the independent, non-executive, outside directors. They are now, supposedly, in a majority and control all the key board committees.

Worldwide, independent directors on the board of a listed company are now seen as an integral element of a company's corporate governance process with board independence taking on a pivotal status in the design of board structure, for instance in the USA, between 1950 and 2005, the composition of the boards of listed companies increased from having approximately 20% of the board members as independent directors to roughly 75% of the board comprising of independent directors (Gordon, 2007). Also globally, the post Enron regulatory reforms have increasingly pinned hope, as well as responsibility, on independent directors to bring about higher standards of governance in organizations.

In USA a series of regulatory changes now ensure that the independent directors have a critical role to play in the governance of organization, "…..by virtue of the Dodd-Franking Act of 2011 (DF), the Sarbanes-Oxley Act of 2002 (SOX) and exchange listing requirements at the NYSE.

In India, with an overwhelming majority of companies being family-owned, independent directors are increasingly expected to play a stronger role in ensuring good corporate governance. The recently enacted Companies Act, 2013 confers greater say in governance to the independent directors and, at the same time, places a much higher demand on them in terms of involvement, commitment levels and technical and industry knowledge. Despite the positive changes in statute that have considerably strengthened the position of independent directors on the board of organizations, the absence of a robust framework to guide them in their decision making remains a significant shortcoming.The existing available corporate governance frameworks are of little help to the independent directors in taking the right decision on strategic issues when they come up for discussions before the board of directors.

The framework of de Geus (1997) can help to create the basis that would guide the independent board members in making the right choice in such cases. Instead of aiming for creating/enhancing shareholder or stakeholder value, the board members need to only look at improving the strategic value for the organization, which should become the guiding force for their decisions. As defined by de Geus (1997), the increase in the strategic value of the organization leads to an increase in the organization's longevity (its strategic objective), hence all the strategic decisions taken by the board of directors must aim to increase the organization's strategic value.

Basing decisions on enhancing the strategic value of the organization involved requires the orientation of the independent directors to be on the long term, regardless of what the shareholders might say. At the end of the day, while the shareholders and managers may be here today and gone tomorrow, the organization will remain forever!

Since the assessment of the strategic value of an organization requires projecting into the future, the utility of this approach would be limited by the unpredictability of the future, the utility of this approach would be limited by the unpredictability of the future. Nonetheless, this does not diminish the usefulness of this approach as it would apply to all other theoretical frameworks.

Conclusions:

The corporate governance function is based on Agency Theory which involves a Board of Directors controlling separate management which executes the decisions and policies of the firm; this conceptual framework derives its input from corporate governance theories.

The goal of Agency Theory is to maximize shareholders value in long term, but this goal is not always valid particularly when the interest and decisions of Board of Directors are in conflict, in that situation Stakeholders Theory and Stewardship Theory becomes valid which ensures alignment of interests.

The complexities of working of modern organizations where short term investors are members of Board of Directors and CEOs managing the organizations are also for short tenures and further representatives of Mutual Funds, Hedge Funds also working as Independent Directors and continuous increase in the numbers of Independent Directors; renders alignment of conflicting interest a difficult task. The Trusteeship Theory due its insistence on transformation of the minds of Board of Directors and management is also difficult to implement.

For modern organization the concept of organization as organic entity is the valid theoretical framework for decision making function of Board of Directors, this concept is based on growth and longevity of the organization as the prime goal of organizations. The decisions of Board of Directors are taken to create strategic values for the whole of organization, keeping in view the interest of all stakeholders like managers, employees, suppliers, customers and society, these strategic values are in alignment of interest of all shareholders.

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