Deshbandhu Journal of Social Sciences, Volume II, 94 - 114, December 2024 2583-7974 (Online)

The Evolution of Corporate Governance: Underlying Theoretical Foundations and Adaptations over time

Dr. DEEPTI SINGH[1]; Dr. JYOTI PAUL[2]; DR. SUCHETA GAUBA[3]

[1] Ph.D , M. Phil, M. Com, Motilal Nehru College; [2] Ph.D, M.phil, M.Com, Dyal Singh College; [3] Ph. D, M. Phil, M. Com, Lakshmibai College

Abstract

The paper highlights the corporate governance mechanism followed under various theories which have developed over time with the changes in structure and size of corporations. The different theories have developed in the backdrop of changes in economy, markets, need for governance and control of management and shareholders. One theory is not sufficient to meet the requirement of corporate governance but the combination of mechanisms and codes from various theories may be a better approach. The paper considers the evolution of corporate governance theories as businesses face complexities and challenges. The modern-day businesses have come a long way and are significantly concerned about sustainability being aligned to their organisations. The present paper tries to overview the evolution of corporate governance theories over time.

Keywords: Corporate Governance, Stewardship theory, Agency theory

JEL Classification

G30, G40

1. Introduction

Corporate governance reforms have become a global issue over the last two decades because of globalisation and varied governance scams. It has emerged as a widely debatable issue among scholars. Countries around the world are developing new codes of best practices and amending them in the light of successive developments in the financial markets as well as on their economic front. There have been continuous amendments in laws and listing requirements of the stock exchanges in a quest to reform corporate governance. However, this issue of corporate governance is not so nascent; its roots can be traced centuries back when Adam Smith documented the principal- agent conflict.

With the expansion of economic activities, size of business started increasing making it beyond the scope of a single owner to manage it, the advent of partnership infused the concept of mutual dependence and binding among owners. This, to me, seems like the first playground for good governance whereby each supplier of funds was not involved in each decision of firm and agency relationships started. With the introduction of the concept of joint stock company, separation of control and ownership was emphasised and hence greater manifestations of agency theory. The firms that succeeded and survived the test of time were the ones that had strong governance imbedded in their functioning.

"Corporate governance has been defined by Cadbury report (1992) as the system by which companies are directed and controlled". The inception and development of the concept of corporate governance has been affected by theories from several disciplines including economics, finance, law, organisational theory and behaviour, accounting, management and sociology. Among the new economic theories of the firm, agency theory, which propounds protecting the interest of shareholders from self-serving managers became significant and prominent theory for corporate governance. However, the position of stakeholder theory increased as companies cannot operate only for shareholders, in isolation from other stakeholders and therefore, they need to identify and protect the interests of and provide some benefits to wider stakeholder groups. Stewardship theory on the other hand is a stark contrast of agency theory stressing on involvement rather than control of management. Another theory contributing to the area is resource dependence theory, which talks about establishing certain links among organisations to make efficient use of resources. With Sustainable Development Goals given by United Nations, corporate governance theories have also enlarged their scope and Environmental, social and governance aspects have been taken up by authors. The concept of corporate governance and the underlying environment, social and governance factors in theories has been studied by the authors and reviewed here.

2. Objectives of the Paper

- Corporate governance as a concept has been studied in the past, but the present paper aims to relate the underlying approaches related to these theories.
- The newer aspect of corporate governance that not only includes stakeholders but also how the concept of corporate governance and sustainability have been aligned is seen in this paper.
- The aim of the paper is to assess various theories of corporate governance and their adaptations over time.

3. Review of Literature

Corporate governance has become imperative since its evolution due to major corporate scandals but newer complexities like environmental catastrophes have changed the perspective and corporate governance has evolved (Aziz et al., 2015). The area of corporate governance can be studied from the perspective of three periods. The initial era which is managerial capitalism (1932-1976) which focuses on separation of managers and owners and has its roots in agency theory. In 1976, next era came of shareholder value where senior management interests were aligned with shareholders. In 1984, the era of stakeholders became prominent (Jaimes-Valdez & Jacobo-Hernandez, 2016). When UN gave us Sustainable Development Goals in 2015, the authors have studied interlinkages between sustainability and governance. (Darus et al., 2016) has explored the impact of corporate governance on sustainability disclosure. Authors studied corporate governance parameters like size of the board with their impact on disclosure of sustainability factors.

(Afza & Nazir, 2014) describe the theories of corporate governance, their mechanisms for understanding the conflicts and problems among stakeholders along with views and solutions to the conflicts. Abdullah & Valentine, 2009 discussed the concept based on social relationship rather than processes and its ever evolving with changes in business environment. Corporate governance can be defined from various perspectives by different theories. (Yusoff & Alhaji, 2012) reiterate that accountability, transparency and honesty are the crucial components of good corporate governance and sustainability of the business. Further the present theories are not competent enough to explain the heterogeneity of the business as governance differs on basis of many factors like culture, level of economic development, culture, politics, and social circumstances. An attempt has been made in this paper to study the mechanism and codes explained by various theories and understand the various factors which can be integrated for good corporate governance.

4. Evolution of Theories: A theoretical analysis

4.1 Agency Theory

Jensen & Meckling (1976) defined "an agency relationship as a contract under which one or more persons (the principal) engage another person (the agent) to perform some service on their behalf which involves delegating some decision-making authority to the agent".

Here for a firm, manager is considered as an agent who acts on behalf of the shareholders (principal) and the relationship is contractual in nature, governed by the terms and conditions of contract between both the parties. This theory tries to find answers to two problems. One, the agent might not be behaving appropriately (in the best interest of the principal) because his desires and goals may not align with those of the principal. The managers may have opportunistic behaviour and try to emphasise on their interest at the cost of owners' interest. This increases the cost of resolving the conflict by following various corporate governance mechanisms and monitoring systems including monetary and non-monetary incentives (Afza & Nazir, 2014). And the other problem is related to risk attitude of agent and that of the principal being different and may not align, and both may prefer different actions to given risk assumptions. Therefore, agency theory seeks to align the interest of owners and managers presuming an inherent conflict of interest between the owners of the firm and its managers. Another form of agency problem that has become prevalent is oppression of minority rights whereby majority shareholders are able to take any decision irrespective of the views of minority shareholders.

The basic problems inherent in agency relationships are:

- *Information Asymmetry*
- *Risk Asymmetry*
- *Goal Asymmetry*

Information Asymmetry

"The problem long accepted as fundamental to finance and corporate governance is information asymmetry. In finance it is between receivers and providers of finance and in corporate governance it is between agent and principal." (Cai & Tylecote, 2008). The problem is that principal and agent have access to different levels of information. Managers (agents), who are running the firm are assumed to know much more about the firm than the owners (principal) and can use this advantage of having better access to information to serve their self-interest, which may be pecuniary, or any other advantage. "According to agency theory rooted in economics and finance, agents are opportunistic and are strongly motivated to profit from information asymmetry between them and their principals." (Fama & Jensen, 1983) "Moreover it is difficult or costly for owners to observe or infer the amount of effort exerted by managers to fulfil their responsibility and therefore managers have an inevitable temptation to shirk work and take advantage of the unobservability of their actions to enhance their personal goals as owners can't assess the true picture. Managers can also conceal true picture by misrepresenting actual outcome to owners (Crowther & Aras, 2010)". So, owners cannot assess decisions made properly.

Risk asymmetry

Another problem is that there may be non-alignment in the attitude towards risk between manager and principal; manager might not be taking appropriate risk in pursuance of maximisation of the benefit of the principal because he might think that those risks are not appropriate. The asymmetry is because, for a shareholder, the stake in the firm is an investment and he can diversify his risk by making an appropriate portfolio of such investments and dilute it; but managers don't have any such portfolio and hence cannot diversify risk that easily. Therefore, they try to mitigate risk even at the cost of maximising shareholders wealth.

Goal asymmetry

Both information and risk asymmetry become even more harmful if there is goal asymmetry between the owners and managers whereby managers are tempted to take actions to increase their own utility and not necessarily to maximise the returns on capital invested by financers. They could be interested in consumption of perquisites, diversion of resources for their own consumption, empire building etc.Moreover, there may be a differential time horizon between the managers and owners, which may lead to managers resorting to short-termism rather than long term wealth maximization. Managers might also pursue growth over wealth maximisation. As their interests do not match, strict monitoring and certain costs like monitoring, bonding costs etc are incurred (Jensen & Meckling, 1976).

According to the agency theory, corporate governance procedures can provide assurance to shareholders that management would try to accomplish results that are in their best interests (Shleifer & Vishny, 1997). Corporate governance mechanisms try to limit agency costs by checking managerial discretion and aligning manager and owner interest.

Two propositions that capture the governance mechanisms have been identified. Firstly, outcome-based contracts with management aligning preferences of agent with those of principal reduce conflict in self-interest between them. Secondly, clear and complete disclosure through well devised information systems also curb agent opportunism as deceiving the principal becomes impossible.

4.1.1 Corporate governance mechanisms and Agency theory

Effectively structured boards with greater proportions of independent directors

According to various scholars, board of directors actively regulate the decisions of top management to ensure shareholder wealth maximisation. Agency theory suggests greater proportion of independent directors on board. The widespread adoption of normative corporate governance guidelines emphasising on the need of independent directors on the boards by the business communities around the world clearly indicate the acceptance of this model.

Separation of the role of CEO and chairman

As per this theory, unitary leadership structure can impact board’s functions like monitoring, compensation of board etc. (Barako et al., 2006). Therefore, this theory proposes separation of roles of CEO and chairman of the board. Non- duality would permit the board to effectively scrutinise and monitor the behaviour of the executives. The rationale behind separating the two responsibilities is that if the person who chairs board meetings and controls the information provided to the board simultaneously runs the company, it is doubtful that the boards will be able to adequately assess and challenge such a CEO. As a result, separation reduces the CEO's influence and increases the board's ability to monitor executives.

Compensation contracts that encourage shareholding orientation

Agent opportunism can be effectively curbed by outcome-based contracts with the executives, whereby, rewards for both the principal and agent depend upon the same actions hence reducing conflicting interests between the two parties. Providing equity incentive schemes, commissions to managers, golden parachutes, can align the interest of the managers with those of shareholders and provide incentive to managers to maximise shareholders wealth.

Concentrated shareholdings leading to active monitoring of the executives

Large outside investors are in a position to protect their interest in a much better way than a large number of small, disbursed investors by investing in information required to vote more consistently in accordance with stockholder’s economic interest, as they can efficiently organize themselves to influence management. Dispersed shareholders, given their low stakes in the company, generally do not have the incentive and at times even the resources to gather sufficient information to monitor management or use their voting power collectively to influence management. That is why the role of institutional investors as a check on management is gaining importance.

External mechanism of corporate control

In the agency context, external market for corporate control is an important device, which is stimulated when internal mechanisms for controlling managerial opportunism have failed. Corporate performance of a firm is adversely affected if its management pursues inefficient and ineffective strategies for a prolonged period, making it a soft target for takeover bids. Takeover results in management changes and hence, is a threat for self-indulgent managers; therefore, it acts as a monitoring device and reduces agency problems.

Greater disclosures and transparency in operations

To keep a check on the agents, agency theory favours greater disclosures and high level of transparency in operations by the management. Given that the management has an informational edge over the shareholders, and it is practically not possible for investors to gather all information about functioning of organisation on their own account, hence there is a need for an information system enabling the owners to verify managers' behaviour, at least covering important areas of concern. This takes care of information asymmetry to some extent and acts as a barrier towards indulging in self-serving behaviour by managers. There is a widespread acceptance of this mechanism, and all the norms of governance world over prescribe the minimal level of mandatory disclosures by the management in the annual report. Voluntary disclosures are a step ahead in this direction whereby mangers provide credible and reliable information to market to enhance the value of the firm; this involves monitoring cost while providing information about investment opportunities, financing policies and other general information about the firm but such monitoring costs do help in reducing agency cost.

Thus, according to agency theory managers are only custodians who are working on behalf of the owners of the business. This theory overemphasises the role of shareholders and ignores other stakeholders who are coincidental to running of a business. Many viewpoints have questioned this emphasis on shareholders as the sole intended benefactors of a corporation, arguing that it does not reflect the way a firm is conducted (Crowther & Aras, 2010). This limitation of agency theory has led to the evolution of stakeholder theory.

4.2 Stakeholder theory

A stakeholder is any group or individual who can affect or is affected by the achievement of an organization's objectives. Edward Freeman’s perspective on stakeholder theory revolutionized the way businesses and organizations approach their relationships with various groups. In his landmark work “Strategic Management: A Stakeholder Approach” (1984), Freeman proposed that companies should not focus solely on maximizing profits for shareholders, as suggested by traditional economic theories. Instead, he argued that businesses must consider the interests and well-being of all stakeholders involved, including employees, customers, suppliers, communities, and shareholders. This broad definition moved the focus from the narrow interests of shareholders alone especially under agency theory discussed above to a wider, more inclusive view of organizational responsibility. (Friedman, 1970; Jensen, 2002).

Stakeholder theory views organizations as complex networks of relationships between the enterprise and its diverse stakeholders. These stakeholders can be internal, such as employees, managers, and owners, or external, including customers, suppliers, competitors, government entities, special interest groups or organisations, and society as a whole. The company, to succeed must try to maintain cohesiveness in relationship with all these groups. According to stakeholder theory, a business maximizes its value when its management operates in the best interests of all stakeholders. Returns should be distributed fairly among these stakeholders in a way that is mutually acceptable to everyone involved (Crowther & Aras, 2010). This theory stresses the importance of broadening the organization's purpose to go beyond maximizing shareholder wealth, incorporating the interests of other stakeholders as well namely, the creditors, the customers, the employees etc. The theory argues that the stake holders also include government authorities, trade unions and associations, communities and at sometimes competitors and prospective employees (Yusoff & Alhaji, 2012). Again, to maximize shareholders’ welfare, there should be a sense of fairness in the way the firms interact and conduct exchange with other stakeholders. Such fairness is necessary for social efficiency.

4.2.1 Corporate governance mechanisms and Stakeholder theory

Stakeholder representative on board

Corporate governance codes in the line of participation and representation of different stakeholders in the board of directors can be viewed as a natural derivation from this theory.(Gupta & Parua, 2006) Their presence on the board is one way of protecting the interest of the concerned group. That is why it is advocated to have employee nominee on the board, there may be nominees of other stakeholder groups like government, financial institutions etc also. In the current scenario, even the small shareholders might be considered as an independent stakeholder group different from the majority group, having their representative on board, as there may be chances of opportunism by majority shareholders.

Concept of corporate social responsibility

Carroll introduced the "Pyramid of CSR," categorizing CSR into four levels: economic, legal, ethical, and philanthropic responsibilities. It provides a framework for understanding the multifaceted nature of corporate responsibility (Carroll, 1991). This framework helps define and shape the nature of an enterprise's obligations to the society in which it functions. Corporate social responsibility, according to Epstein, “relates primarily to achieving outcomes from organizational decisions concerning specific issues or problems which (by some normative standard) have beneficial rather than adverse effects upon pertinent corporate stakeholders” (Epstein, 1987). This concept itself has evolved from stakeholder theory whereby each company seeks to contribute something towards society as a stakeholder group. Various endeavours in the field of education, environment protection, and health facilities etc. by companies is a bid to satisfy or rather contribute to the welfare of these stakeholder groups. The growing importance of CSR initiatives taken by companies’ world over shows the wider acceptance of stakeholder theory.

Carroll, A. B. (1991). The pyramid of corporate social responsibility: toward the moral management of organizational stakeholders. Business Horizons, 34(4), 39–48.

Whistle blower policy

In the wake varied corporate scandals like Enron, Vivendi, Lehman Brothers, Satyam where top management and board overlooked their responsibility towards shareholders and stakeholders, the idea of whistleblowing began to gain prominence, emphasizing the need for companies to establish clear procedures for stakeholders to report legitimate concerns about unethical behaviour that could violate the organization's Code of Conduct. These policies are designed to provide assurance that individuals can voice their concerns with confidence, free from the risk of retaliation or victimization. Companies may designate an Ombudsperson to oversee a structured process for reviewing and investigating reported concerns and taking appropriate actions to address the issues. Cases involving serious misconduct handled by the Ombudsperson may also be escalated to the Audit Committee for further review.

However, a universally accepted mechanism for fairly distributing returns among all stakeholders has not yet been developed, and stakeholder theory notably falls short of providing concrete suggestions in this regard.

Nevertheless, the theory is widely recognized and operates on the principle that prioritizing the interests of all stakeholders inherently leads to the maximization of shareholder returns. As a result, the role of management is to optimize the long-term performance of the business to achieve this objective, ensuring that all stakeholders, including themselves as part of the stakeholder group, are rewarded appropriately (Crowther & Aras, 2010).

4.3 Stewardship theory

Stewardship theory recognizes that managers often pursue a diverse range of goals beyond just monetary rewards, such as personal achievement, altruism, growth, and dedication to meaningful work. Unlike agency theory, it argues that there is no inherent conflict of interest between managers and owners. Instead, it suggests that managers are inherently trustworthy and work in the organization's best interests, acting as responsible stewards of the resources entrusted to them (Donaldson & Davis, 1991). According to this theory, the role played by the board of directors should be confined to reviewing the plan of action of the management to achieve the overall goals and cultivate a framework of synchronization with managerial cadres. The theory puts greater stress on reliance on inside directors because of the technical expertise, involvement with the affairs and informational edge they have over the outsiders. This theory places the argument in favour of managers and internal directors that they can act in best manner for company and shareholders because they have intrinsic knowledge of company affairs as compared to independent directors who are outsiders (Afza & Nazir, 2014). The theory snubs any non-alignment of interest of owners and managers and encompasses a long-term horizon, putting a greater reliance on involvement rather than control of insiders on the board. In terms of the renowned motivational theory by Mc Gregor (1960), stewardship theory undertakes a “Theory Y” stance of managers contravening the “Theory X” stance taken by agency theory and undermines the prominence of monitoring the board to improve performance as suggested by the agency theory.

4.3.1 The practices that find their roots in this theory are:

Minimum number of board meetings

Some codes specify a minimum number of board meetings that must be conducted within a certain period whereby plans may be reviewed by directors and inside directors may brief the outsiders with regard to conduct of business and performance against various parameters set. However, the theory does not propound too many meetings of the board as it may hamper the speed of decisions and over involvement of outsiders in conduct of business.

Attendance of directors in meetings

Board meetings serve as an interface between the insiders and outsiders on the board and hence some minimum prescribed attendance is necessary to ensure participation. Outside directors can be acquainted to the functioning of the organisation through these meeting at the same time insiders can gain from the expertise of outsiders through the interaction while deciding on strategic matters.

However, many of the prepositions of stewardship have not been integrated into corporate governance codes, largely due to the lack of robust empirical evidence, unlike in the case of agency theory, which supports the claim that a greater presence of inside directors leads to improved corporate performance. Some of such views promulgated by the stewardship theory are:

Greater proportion of inside directors on board

*T*he theory contends that majority inside directors' results in better performance as these directors expend their working life in the company they manage and are close to actual performance of the company. Thus, they have a better understanding of its functioning, greater access to both formal and informal channels of information, can look at the organisation from an overall perspective including the operational aspects and hence, are in a position to take more informed decisions. Whereas an outside-dominated board is more reliant on the information provided by the management and at times may not be well equipped in terms of knowledge, time and resources to take timely and better decisions.

One-man leadership

The theory favours the argument that company can achieve higher performance if it operates under the leadership of a single individual serving as both chairman of the board and the CEO of the company. A dependable steadfast leadership can avoid a deadlock in boardroom, which may arise in case of diluted leadership where board chair and CEO are different people. As per the theory, fear of jeopardising their own reputation, makes it improbable for senior executives and CEO to act against the interest of shareholders. Hence dual leadership is not required which can in fact slowdown decision-making process.

Stewardship theory assumes that inside directors naturally work for long-term profit maximisation of the firm, and they are reliable individuals. Trust and performance get priority over monitoring and cost control.

4.4 Resource dependence theory

Resource dependence theory emphasizes the board's role in connecting with the external environment to secure critical resources necessary for the organization's success.. The board plays a critical role in arranging the significant resources for the organisation through their links with the external environment and define the interdependencies with other organisations. These interdependencies are the result of uncertainties in availability of resources because of their scarcity. Board composition can be viewed as a response to the external challenges faced by the organization, reflecting the need for diverse expertise and resources to navigate those challenges effectively (Madhani, 2017). Organisations have continuous interface with the environment and are affected by the same in various ways. The basic premise of Resource Dependence Theory is that organisations seek to influence their environment by acquiring and controlling the resources needed to address external challenges. In order to gain such control, organisations try to inculcate links amongst themselves through the channel of board members from other organisations and institutions. Co-opting boards from other companies, social & legal bodies, educational institutions etc. open channels of information and expertise beyond the core competencies of the organisation.

Interconnected boards enable the organization to better navigate environmental uncertainty, improve access to finance and capital, and establish stronger connections with all key stakeholders. This theory supports the appointment of directors on various boards as it provides the opportunity to get the information and develop network in many ways (Yusoff & Alhaji, 2012)

4.4.1 The practices that find their roots in this theory are:

Appointment of directors from other organisations

The codes for best practices encourage corporations to appoint outside specialist on their board. Business experts can add to performance by providing their expert suggestions on competition, problem solving, strategic decision making etc. Specialists on the board can offer valuable expertise in areas such as law, banking, taxation, insurance, and public relations, while educationists can contribute non-business perspectives, helping to address issues, challenges, and generate new ideas.

Allowing directors to hold certain number of directorships in other companies

Directors holding multiple appointments can bring significant benefits to the organization by leveraging their extensive networks, which can be utilized to enhance the firm's value. Most of the codes allow directors to hold directorships in other companies and committee memberships as it is recognised that inter-firm directorships add to the pool of resources of a corporation. A caveat in this regard is that too many directorships may hinder the efficiency of the concerned director.

Intensity of board activity

Board activity is measured by number of board and other committee meetings. It is generally believed that boards respond to poor results with greater level of activity, which in turn is associated with improved operating performance in later years (Jackling and Johl, 2009). Resource dependence theorists believe that increased activity levels of boards lead to greater interaction between board members and free flow of ideas enhancing the effectiveness of the board. At the same time the quality of these meetings in terms of time spent on routine tasks etc. should also be point of consideration.

4.5 Legitimacy theory

Suchman (1995) considers that “Legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions”. The Legitimacy Theory posits that organizations, including corporations, engage in activities and practices that are perceived as legitimate by their stakeholders to maintain their acceptance and support within their environment. This theory is rooted in the idea that organizations need to conform to societal norms, values, and expectations.

4.5.1 Corporate governance practices that find root in this theory:

In the context of sustainability, the Legitimacy Theory implies that organizations engage in sustainable practices not only because they are legally required or economically beneficial, but also to maintain their legitimacy in the eyes of stakeholders.

Legitimacy and CSR/Sustainability Reporting

Companies now a days engage in Corporate Social Responsibility (CSR) and sustainability reporting to demonstrate their commitment to sustainable practices. This reporting is a way of signalling to stakeholders, including investors, customers, and the wider community, that the company is adhering to widely accepted norms related to sustainability.

Stakeholder Influence

Sustainability constructs are often influenced by stakeholders who have an interest in environmental, social, and economic aspects of a company's operations. These stakeholders include shareholders, regulatory bodies, customers, employees, local communities, and advocacy groups.

Proactive Approach to Sustainability

Companies adopting a Legitimacy Theory perspective take a proactive approach to sustainability, going beyond mere compliance with regulations. They aim to shape and influence sustainability norms and expectations in their industry and society.

Transparency and Accountability

Transparent reporting on sustainability initiatives and performance is crucial for demonstrating a company's legitimacy in this regard. It allows stakeholders to assess whether the company's sustainability efforts align with societal expectations.

4.6 Transaction cost Theory

Williamson developed this theory which focuses on the costs associated with organizing economic activities. It suggests that firms exist to minimize transaction costs, which include the costs of negotiating, contracting, monitoring, and enforcing agreements. TCT suggests that firms adopt specific governance mechanisms to structure relationships and reduce transaction costs.

4.6.1 The theory has following postulates:

Bounded Rationality and Opportunism

TCT recognizes that decision-makers have limited information and cognitive resources. It assumes that individuals act opportunistically to maximize their own interests. Governance mechanisms are designed to manage these behavioural realities.

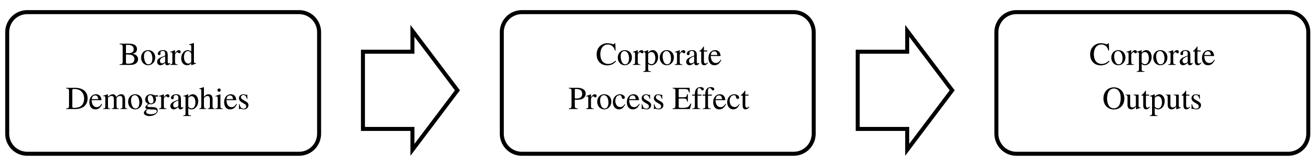
Long term contracts

TCT often emphasizes the importance of long-term relationships and contracts to reduce transaction costs. For instance, investing in sustainable supply chain practices can lead to stable and reliable supplier relationships over time.

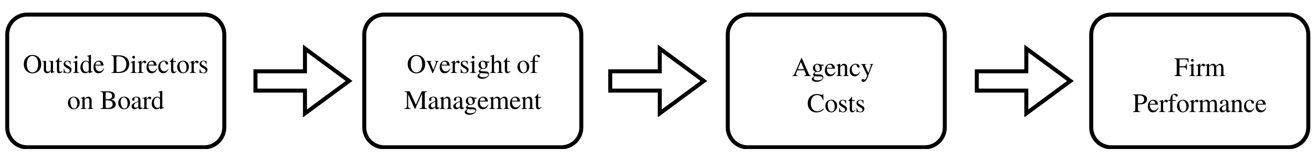
Governance Mechanisms

TCT suggests that firms use various governance mechanisms leading to efficient structures and processes to align interests and reduce transaction costs.

The processes described by various corporate governance theories can be represented visually as follows:



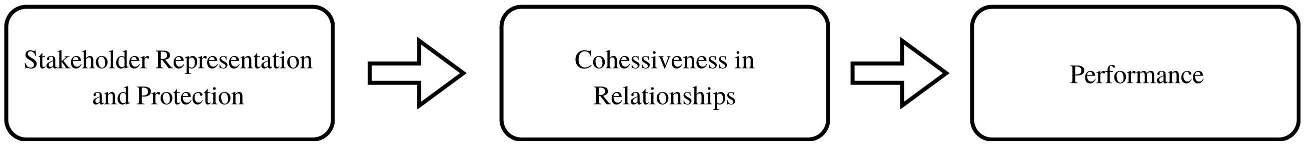
Agency Theory



Pattern

High ▼	High ▼	Low ▼	High
Low ▼	Low ▼	High ▼	Low

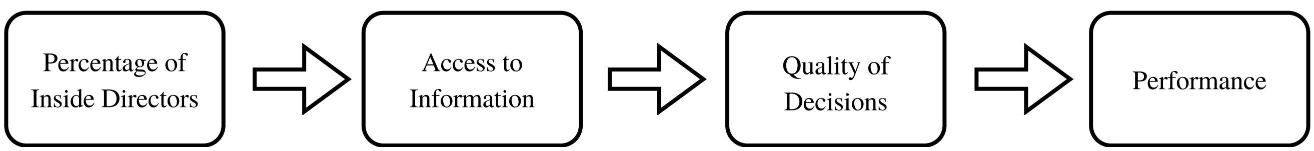
Stakeholder Theory



Pattern

High ▼	High ▼	High
Low ▼	Low ▼	Low

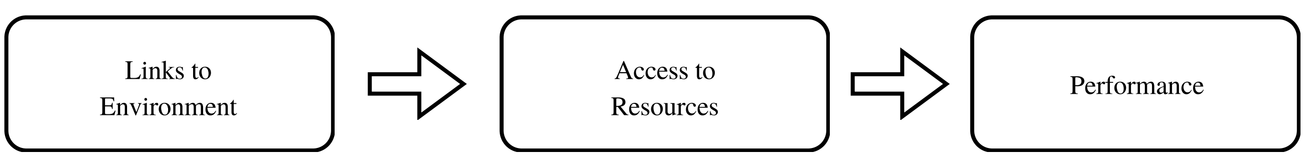
Stewardship Theory



Pattern

High ▼	High ▼	High ▼	High
Low ▼	Low ▼	Low ▼	Low

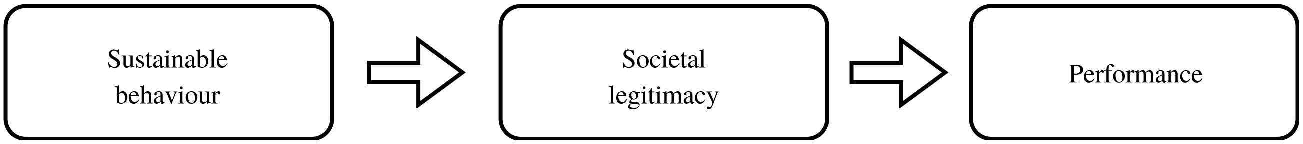
Resource Dependence Theory



Pattern

High ▼	High ▼	High
Low ▼	Low ▼	Low

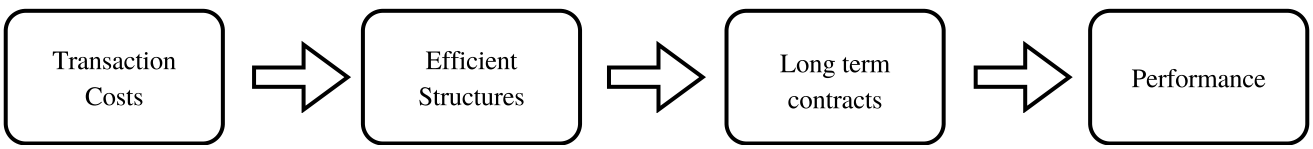
Legitimacy Theory



Pattern

High ▼	High ▼	High
Low ▼	Low ▼	Low

Transaction Cost Theory



Pattern

High ▼	Low ▼	Low ▼	Low
Low ▼	High ▼	High ▼	High

Figure 1 Processes predicted by the Theories of Corporate Governance: Adapted from Nicholson & Kiel (2007)

5. Conclusion

From the above discussion, it is understood that agency theory favours the separation of ownership from the management while stewardship theory emphasises on the non-duality of the functions of CEO for better managerial harmony and prefers appointment of internal directors over external because of the better knowledge and insight of the company. On the other hand, stakeholder theory considers all-inclusive model for the community, agency theory prefers shareholders over other stake holders. Finally, the resource dependence theory necessitates the inclusion of directors with experience and expertise to be treated as resource for the board of the company (Islam, 2022). Boards in today's time are increasingly looking into expertise in sustainability matters.

The Legitimacy theory suggests that organisations are adhering to societal norms and expectations to gain trust of stakeholders and remain legitimate in their environment. The theory posits that the organisations are influenced by the external environment, and they have to engage in activities perceived legitimate by stakeholders. The Transaction cost theory (TCT) starts with the premise that economic agents (individuals, firms) are motivated by self-interest and operate in an environment of bounded rationality, uncertainty, and opportunism. It highlights the economic rationale behind governance choices and how they relate to minimizing transaction costs in complex organizational settings.

Thus, after discussing the contribution of various theories, it is evident that corporate governance has evolved over a period from what was seen as protection of shareholders from managers to a more wholesome system with delicate balances between insiders and outsiders, with a broader perspective than that limited to shareholders only. But this does not diminish the contribution of agency theory which is still the corner stone of all the codes and practices. The theories that have influenced the evolution of corporate governance should also be observed in the light of other environmental systems that affect the functioning of the corporations like the legal system wherein countries with common law system have better framework for shareholder protection and might need less stringent codes than countries with civil law system leading to weaker protection of shareholders and hence stringent codes of compliance to protect them and other stakeholders. Capital market development has its own role in this area therefore corporations operating in a developed and efficient market may need lesser spoon feeding on governance as the external market for corporate control is an important means to restrain self-indulgent behaviour of managers. Long term inefficient behaviour is penalised by undervaluation of the firm in capital market, making it a soft takeover target and this behaviour acts as a deterrent for managers to be overtly self-centred. On the other hand, countries with weaker market mechanisms need stronger governance codes and practices. Ownership pattern is also an important influence as same rules of governance may not be suitable for all. Managerial behaviour differs from a family-owned firm to a large, disbursed ownership to a public sector enterprise. Hence the degrees of applicability of various theories depend upon the ownership concentration and pattern. However, there seems to be a common understanding on core aspects of corporate governance where all theories convey the same message such as role played by independent and non-executive directors and importance of transparency and disclosures.

The above theories contributed to development of various codes and practices in the field of corporate governance. In the current business landscape, the demands from stakeholders for ESG, concerns about gender diversity on boards and newer regulations in wake of shareholder activism for board compensation and board composition is pushing up reforms in corporate governance. Corporate governance is not a one size fits all solution to various problems in governance nor is it a one-time phenomenon, it is rather a continuous endeavour to improve fairness, transparency and responsibility in corporate actions. Governance structures are also evolving, and the boards are becoming more inclusive. Moreover, with sustainability being embedded into organisation's structure to achieve sustainable development goals the role of agents of corporate governance becomes even more important keeping in view the stakeholders and protection of environment and social wellbeing. Different theories though have different constructs, but governance in this era has undergone significant transformations to environmental, social and ethical considerations.

References

1. Abdullah, H., & Valentine, B. (2009). *Fundamental and Ethics Theories of Corporate Governance*. Middle Eastern Finance and Economics, 4. http://www.eurojournals.com/MEFE.htm

2. Afza, T., & Nazir, M. S. (2014). *Theoretical Perspective of Corporate Governance: A Review.* European Journal of Scientific Research, 119(2), 255–264. https://www.researchgate.net/publication/287890145

3. Aziz, N. A. A., Othman, S. N., & Manab, N. A. (2015). *Exploring the Perspectives of Corporate Governance and Theories on Sustainability Risk Management (SRM).* Asian Economic and Financial Review, 5(10), 1148–1158. https://doi.org/10.18488/journal.aefr/2015.5.10/102.10.1148.1158

4. Barako, D. G., Hancock, P., & Izan, H. Y. (2006). *Factors Influencing Voluntary Corporate Disclosure by Kenyan Companies*. Corporate Governance: An International Review, 14(2), 107–125. https://doi.org/10.1111/J.1467-8683.2006.00491.X

5. Cai, J., & Tylecote, A. (2008). *Corporate governance and technological dynamism of Chinese firms in mobile telecommunications: A quantitative study*. Research Policy, 37(10), 1790–1811. https://doi.org/10.1016/J.RESPOL.2008.07.004

7. Carroll, A. B. (1991). *The pyramid of corporate social responsibility: Toward the moral management of organizational stakeholders.* Business Horizons, 34(4), 39-48. https://doi.org/10.1016/0007-6813(91)90005-G.

8. Crowther, D., & Aras, G. (2010). *The Agency Problem and Corporate Governance.* In A handbook and Book of Ccorporate governance and Social responsibility. Gower publishing. https://papers.ssrn.com/abstract=1910547

9. Darus, F., Janggu, T., Alam, S., & Malaysia, S. (2016). *Board Characteristics and the Extent of Social and Environmental Risks Disclosure*. Journal of Accounting and Auditing: Research & Practice, 2016. https://doi.org/10.5171/2016.150257

10. Donaldson, L., & Davis, J. H. (1991). *Stewardship theory or agency theory: CEO governance and shareholder returns*. Australian Journal of Management, 16(1), 49-64. https://doi.org/10.1177/031289629101600103

11. Epstein, E. M. (1987). *The Corporate Social Policy Process: Beyond Business Ethics, Corporate Social Responsibility, and Corporate Social Responsiveness.* California Management Review, 29(3), 99–114. https://doi.org/10.2307/41165254/ASSET/41165254.FP.PNG_V03

12. Fama, E. F., & Jensen, M. C. (1983). *Separation of Ownership and Control*. The Journal of Law and Economics, 26(2), 301–325. https://doi.org/10.1086/467037

13. Freeman RE, Harrison JS, Wicks AC, et al. (2010) *Stakeholder Theory: The State of the Art*. New York: Cambridge University Press.

14. Friedman M (1970) *The social responsibility of business is to increase its profits*. New York Times Magazine, 13 September, pp. 26–32.

15. Jensen MC (2002) *Value maximization, stakeholder theory, and the corporate objective function*. Business Ethics Quarterly 12(2): 235–256.

16. Gupta, A., & Parua, A. (2006). *An Enquiry into Compliance of Corporate Governance Codes by the Private Sector Indian Companies*. SSRN Electronic Journal. https://doi.org/10.2139/SSRN.962001

17. Islam, T. (2022). *Revisiting the Fundamental Theories of Corporate Governance: Do the Westernized Models Fit Emerging Economies?* International Journal of Scientific and Management Research, 5(9). https://doi.org/10.37502/IJSMR.2022.5902

18. Jackling, B., & Johl, S. (2009). *Board structure and firm performance: Evidence from India*. Corporate Governance: An International Review, 17(4), 492-509. https://doi.org/10.1111/j.1467-8683.2009.00760.x

19. Jaimes-Valdez, M. A., & Jacobo-Hernandez, C. A. (2016). *Sustainability and Corporate Governance: Theoretical Development and Perspectives*. Journal of Management and Sustainability, 6(3), 44. https://doi.org/10.5539/JMS.V6N3P44

20. Jensen, M. C., & Meckling, W. H. (1976). *Theory of the Firm: Managerial Behavior, Agency Costs and Ownership Structure*. Journal of Financial Economics, 3, 305–360.

21. Madhani, P. M. (2017). *Diverse Roles of Corporate Board: Review of Various Corporate Governance Theories*. The IUP Journal of Corporate Governance, 16(2), 7–28. https://ssrn.com/abstract=2981605

22. Nicholson, G. J., & Kiel, G. C. (2007). *Can Directors Impact Performance? A case-based test of three theories of corporate governance*. Corporate Governance: An International Review, 15(4), 585–608. https://doi.org/10.1111/J.1467-8683.2007.00590.X

23. Shleifer, A., & Vishny, R. W. (1997). *A Survey of Corporate Governance*. The Journal of Finance*,* 52(2), 737–783. https://doi.org/10.1111/J.1540-6261.1997.TB04820.X

24. Suchman, M. C. (1995). *Managing Legitimacy: Strategic and Institutional Approaches*. The Academy of Management Review*,* 20(3), 571. https://doi.org/10.2307/258788

25. Yusoff, W. F. W., & Alhaji, I. A. (2012). *Insight of Corporate Governance Theories*. Journal of Business & Management*,* 1(1), 52–63. www.todayscience.org/jbm