Literature Review on Corporate Governance Models

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ABSTRACT: ***There is the growing acknowledgement that improved corporate governance is crucial for economic growth and development. However, debates and issues on corporate governance have mainly focused on the two competing perspectives: the shareholder and the stakeholder perspectives and which of the two is best for management. This paper reviews the theoretical and empirical literature on the nature and consequences of corporate governance problems. The study present the nature and purpose of corporations and the need for regulations as a governance tool based on the literature. The study presents the nature, arguments, basic assumptions and limitations of the corporate governance models and its implications for effective corporate governance system.***

KEY WORDS: ***Corporations, Governance, Corporate Governance***

I. INTRODUCTION

Much has been written and debated on what corporate governance actually is or involves and why it is important over the recent past. The concept of corporate governance is based on ideas relating to corporation and governance. It is therefore appropriate that these two concepts are adequately elaborated in order to appreciate the issue of Corporate Governance. What is clear when assessing issues regarding corporate governance is that much of the literature has focused on shareholder and stakeholder perspectives. Based on a theoretical review of literature on the nature and purpose of a corporation and governance, the paper provides a conceptualization of corporate governance.

A. UNDERSTANDING CORPORATE GOVERNANCE

Corporate governance is based on ideas relating to corporations and governance. The concept can be viewed as a framework that determines whom the organization is there to serve and how the purposes of the organization should be decided and upon whose interest should the corporate serve [22]. However, theoretical work on corporations can be viewed from four main perspectives: "concession or fiction, aggregate, nexus of contracts, and real entity theories" [28][22][31]. Firstly, the concession theory views a corporation as artificial, invisible, intangible, and existing only in a legal context. Corporate law was used to protect the financial interest of shareholders from any special restrictions on their property rights. Thus, a corporation is regarded as "an extension of the state" rather than the private initiative of individual incorporators [1][5]. Secondly, fiction theory was based on concession theory and perceived the corporation as a fictitious entity [26][1]. A corporation is created by specific charters which usually limited them to public purposes, and became less important when new statutes made incorporation routine and mechanical. From this perspective, the concession and fiction theories are merely formal doctrines [31][3]. Indeed, corporate law focuses on governance problems that arise inside the corporation to give an internal perspective of a corporation. This theory may have its applicability in state owned enterprises which are established by specific Statue or Legislative instrument.

Thirdly, aggregate theory, the corporation can be created *de facto* through an association of those people who agree to undertake an enterprise and can be perceived as the sum of their human, and sometimes non-human, components [3][15]. The aggregate entity theory clarifies the distinction between what corporations are, from how they are established, in order to determine how best to regulate them. Unlike the artificial entity theory which considers the corporation as an extension of the state, the aggregate theory argues that the corporation is an extension of its shareholders. Some Scholars argued that:

> *"… behind the corporation as a legal group lie the individual members of which the corporation is composed, and the unity of such a group is purely a pretense or fiction constructed by the state. Hence, a corporation is simply a collective name for its members and their aggregate rights. Individuals are not genuinely united when they act as a*

> *group, but are an aggregate, united legally by contract." [22].*

Aggregate theory separates the entity's liability from the personal liability of shareholders. Shareholders provide the capital for the company with the expectation of financial returns, but they are not liable for illegal acts committed by the company or their employees [4][15][28]. Thus, corporate entities have lives of their own. Additionally, the "nexus-of-contracts" theory is a form of aggregate theory which asserts that a corporation is a set of contracts among the firm's participants [31][15]. The term 'contract' is used broadly to include not only explicit and implicit agreements, but also legislative statutes and judicial interpretations. Using the corporation as the common signatory of these contracts, the entity connects them to form a "nexus". This theory supports a stockholder-centered conception of the corporation in which the duty of managers is to serve the interests of shareholders alone [2].

Finally, the real entity theory claims that corporations are social entities, comprised and represented by its different elements [31][28]. Though, a corporation has its own mind or will and capacity to act, it does so through agents, who are not acting as individuals but as organs of the corporate personality [27][22]. Thus, the corporation can be punished for illegal or unethical acts of certain crimes, e.g. that of omission and in some cases of commission, but not others, e.g. murder and other acts of violence [1]. According to Machen,

> *"When a company is formed by the union of natural persons, a new real person, a real corporate "organism," is brought into being… The corporate organism is an animal: it possesses organs like a human being. It is endowed with a will and with senses." [26].*

Corporate law focuses on the relationship between the corporation and the rest of society to provide an external perspective of a corporation. Thus, the law does not create corporations but merely recognizes their independent existence. This approach maintains that corporations are real, naturally occurring beings with characteristics not present in their human members [1]. Unlike the artificial entity theory, the real or nature entity theory asserts that a corporation is the sum of its human constituents whose existence was separate from the state. In relation to the theories a corporation is viewed through the legal and not the social relations perspective. Though, the real or nature entity theory seems to recognize that the corporation can behave as an "organism" of different individuals, it does not fully consider the relations between the corporation and the civil society. The normative form of the contractual theory maintains that corporations ought to be managed for the benefit of all stakeholder groups [11]. The assumption is that the stockholder-centered conception has been replaced by the stakeholder theory since it is ethically unjustifiable to neglect the interests of non-shareholder groups. It can be argued that both the stockholder and stakeholder conceptions of the firm are compatible with the contractual theory [2]. The significance of the theories focuses primarily on the determinate normative implications of particular legal theories and their role in the legitimation of legal doctrine and social practice [23]. Phillips argued that "none of these theories is sufficiently well-grounded to be a solid basis for legal or policy implications" [31]. Particular theories of the corporation can be considered to legitimize appropriate approaches to regulation of corporate activity. These legal theories define the corporation's attributes; establish dynamic and interdependence relationship between legal theories of the corporation and corporate doctrine.

Governance is seen as synonymous with government; governance describes something broader than government. Government signifies the formal institutions of the state and their monopoly of the legitimate coercive power" while "governance is conceived as *"...the rules and forms that guide collective decision-making not about one individual but rather about groups of individuals or organizations or systems of organisations making decisions"* [38]. Governance refers to: *"a new process of governing including: self-organizing, inter-organizational networks characterized by interdependence, resource exchange, rules of the game and significant autonomy from the state' [33].*

Governance as structure refers to the architecture of formal and informal institutions [25][35]. Governance is regarded as: *"the regimes, laws, rules, judicial decisions, and administrative practices that constrain, prescribe, and enable the provision of publicly supported goals and services," holds strong interest for public administration scholars [25].* Governance as a process lies in the interplay between structure and agency in which the state interacts with society in general. That is, how one gets to act, through different types of interactions in the form of deliberation, negotiation or self-regulation and the extent to which actors adhere to collective decisions [24]. No single actor, public or private, has all the knowledge and resource capacity to tackle problems unilaterally. Under this conceptualization, the dynamics and steering functions are involved in lengthy never ending activity of policy making. This arrangement may be well suited to address key challenges facing developing countries, especially the provision of services to society in a context of weak institutions of state. Governance as a mechanism signifies institutional procedures of decision-making [24] of compliance and of control (or instruments) [37][38]. The fundamental themes of governance involve not only the transformation in the role, direction, power, and the activities of state, but also the enhancement of institutional (formal and informal) capacity [37][38] and networks [33]. This way of defining governance creates the interaction between the decision making body (formal institutions publicly and privately) and the stakeholders (civil society) and how decision-makers are held accountable. Indeed the responsibility and function of the state has gone beyond the provision of services to establishing the mechanisms and processes that are conducive to organizations to meet the specific needs of their societies.

Drawing from the discussions, corporate governance can be viewed from the perspective of corporation's as ways of ensuring that corporate actions, assets and agents are directed to achieve the corporate objectives established by the corporation's shareholders. To Shleifer and Vishny:

> *"corporate governance deals with the ways in which suppliers of finance to corporations assure them of getting a return on their investment. How do the suppliers of finance get managers to return some of the profits to them? How do they make sure that managers do not steal the capital they supply or invest in bad projects? How do suppliers of finance control managers?" [37].*

Corporate governance is concerned with how suppliers of capital get managers to return profits, ensure that managers do not misuse the capital by investing in risky projects, and how shareholders and creditors monitor managers. The definitions focus on economic efficiency objectives of maximizing shareholders wealth which might as well encompass the relationship of the corporation to stakeholders and society. Corporate governance encompasses set of relationships between a company's management, its board, its shareholders and other stakeholders and provides the structure through which objectives of the company are set, and the means of attaining those objectives and monitoring performance determined.

In relation to governance, corporate governance refers to the set of formal and informal institutions including the internal and external corporate structures, system of laws and regulations by which corporations are directed and controlled. Corporate governance mechanisms refer to set of customs, policies, guidelines and controls to manage an organization and reduce inefficiencies. John and Senbet assert that: *"corporate governance deals with mechanisms by which stakeholders of a corporation exercise control over corporate insiders and management such that their interests are protected" [16]*. In this regard, the concept is concerned with the relationship between the internal governance mechanisms of corporations and society's conception of the scope of corporate accountability. Corporate governance addresses the fundamental questions concerning networks and promoting ethical behavior. To control behavior and give opportunities and incentives to actors, network relationships need to be governed using regulations.

Regulation is characterized as rules, state intervention in the economy, accountability and compliance. In other words, regulation signifies actions of the state or local government designed to restrict or influence a change of behavior in activities of the various social and economic groups in the community. Governance regulations operate in two main legal traditions: common law and civil law systems [30]. The common law tradition has its root in corporate law and correlated with better shareholder protection and more developed financial markets [30][19]. On the other hand, the civil law is a legal tradition concerned with the private relations between members of a community and predominantly practiced in Continental Europe and most former colonies of continental European countries. Though, there are universal codes for regulating the practice of corporate governance, there exist other national codes based on local needs and the unique characteristics of each country. Regardless, regulatory framework of corporate governance can be viewed from two perspectives, namely: voluntary and mandatory. Developments in corporate governance are taking place in three areas: legal, self-regulatory and in-company [18]. Corporate governance involves the interplay of legal norms (Company Law), self-regulations (including corporate governance codes of best practices and instructions for listed firms) and in-company (range of corporate level guidelines) grounded in the disciplinary forces of the market.

II. ASSESSING CORPORATE GOVERNANCE MODELS

Current extensive analysis of corporate governance studies has generated different assumptions and insights, creating diverse theoretical models. There are: the principal-agent (finance model), the myopic market model, the abuse of the executive power model, the stewardship model, the stakeholder model and the political model [17]. However, the theoretical models identified in the current literature on corporate governance can be categorized into two competing perspectives: the traditional shareholder model and the stakeholder theory [29][14]. The following section discusses the different corporate governance models under the two main competing perspectives: shareholder and stakeholder.

A. SHAREHOLDER PERSPECTIVE

The traditional shareholder perspective has its roots in the principle of private property rights and considers the corporation as a legal instrument for shareholders to maximize value for its equity. The assumption is that a shareholder's value objective is important to the economic development of a nation [23]. From this perspective, private ownership is considered fundamental to social order as well as economic efficiency. Shareholders own the company and managers must act in the best interest of the shareholders. The shareholder perspective is categorized into three main models: the Principal-agent or finance model, the myopic market model and the stewardship model with the common assumption that the purpose of the corporation is the maximization of shareholders' wealth.

B. PRINCIPAL-AGENT/FINANCE MODEL

As corporations become larger and ownership dispersed, shareholders can no longer be active in controlling and monitoring the company activities. As a result, the Principals engage the agent to perform services on their behalf. This shifts the controlling role of shareholders to managers who are considered to be in an agency relationship with shareholders, referred to as the Principal - agent problem [16][7][8]. The Principal –agent or finance model view is the most dominant theoretical model of corporate governance [23]. This model recognizes the agency costs arising from the separation of ownership and control to ensure that managers act to maximize shareholders' wealth [21][16].

There two main problems associated with the agency relationship and agency theory [7]. Firstly, the interests of the Principal and agent conflict and the Principal have difficulties controlling what the agent is doing. This possibility of opportunistic behavior on the part of the agent has the potential to work against the interest of the Principal [7]. As such, the Principals cannot be certain that the agents, who make the decisions, will act in the shareholders' interests. Thus, the fundamental supposition of agency theory is that, manager's act out of self-interest and are self-centered, thereby, giving less attention to shareholder interests [8][9]. Shareholder interests could be compromised, should managers pursue their self-interest to the detriment of maximizing the wealth of the shareholder. The relationship of agency is one of the oldest and commonest codified modes of social interaction,…essentially all contractual arrangements, as between employer and employee or the state and the governed contain important elements of agency" [36]. Secondly, the Principal and agent have different attitudes towards risks due to the differences in their risk preferences and differing goals.

Agents may seek to avoid investment decisions which increase the risk of their company, and pursue diversifying investments which will reduce risk. Managers may seek to minimize the risk of their company's stock. Risk averse managers will prefer equity financing because debt increases the risk of bankruptcy and default. It is argued that agency costs will be minimized whenever managers hold an equity stake in a company [9][15].

Agency cost refers to an internal cost that arises from, or must be paid to, an agent acting on behalf of the Principal to cause the agent to act in the Principal's interest [15]. These costs include: the costs of monitoring the behavior of the agents, bonding costs and residual loss [4][15][7]. The cost of monitoring and controlling the behavior of agents are expenditures paid by the Principal to measure, observe and control an agent's behavior. For example, the costs of monitoring agent's behavior through information systems, such as reporting procedures and to establish a contract based on the loss of the agent outcome [37][15]. Though, these costs are paid initially by the Principal, they will ultimately be borne by an agent as their compensation is adjusted to cover these costs. Thus, there is the need for appropriate structures to be put in place to control the behavior of agents. Additionally, costs are incurred in ensuring that agents adhere to these systems, known as the bonding costs. This notwithstanding, the effectiveness of this mechanism is at best questionable since investment policies are at the discretion of company management. This leads in a residual loss arising from the conflict of interest between the managers and shareholders as the interest of managers and shareholders are still unlikely to be fully aligned, regardless of the monitoring costs and bonding costs. In sum, it is imperative that adequate governance mechanisms are put in place to monitor the behavior of managers and protect the shareholder's interest.

Corporate governance defines how agency can be minimized in order to maximize the returns of the shareholder. There are two effective solutions to agency problem, including: concentrated ownership and legal protection [37]. The effects of ownership concentration on firm performance are motivated by the separation of ownership and control [4] and agency theory [9]. Thus, outside shareholders should be encouraged to own larger stakes and to assume a more active and constructive role in companies [32]. Ownership concentration implies a higher level of monitoring commitment, thus, the need for expanded ownership to include directors, managers, employees and even customers and suppliers in order to ensure maximization of the value of the firm, a reduction in agency costs as well as higher profits and share prices. Additionally, the legal system of a country is a key determining factor to its corporate governance structures, arrangements and practices such as: ownership structures, capital markets and shareholder protection laws and regulations [19]. It is argued that governance mechanisms limit managerial opportunistic behavior [9][37] to constrain manager's ability to deviate from investors' interest.

The efficient working of the agency model is to determine the most appropriate contract governing the relationship between the agent and the Principal and the mechanisms to align the behavior of the managers with the interest of shareholders. The adoption of an optimal incentive scheme to align the behavior of the mangers with the interest of the owners is contingent on the availability of information. One critical question agency theory seeks to answer is whether behavior oriented contract (i.e., salaries) is more efficient and effective than an outcome-oriented contract (i.e., commissions, stock options) [7]. The behavior-based contract is optimal when agent behavior is easily observable [21]. In situations where the agent's behavior is not fully observable, the Principal may acquire the information about the agent's behavior and reward those behaviors, and to reward the agent based on outcomes (e.g., profitability). Consequently, the optimal contract is the trade-off between the cost of measuring behavior and the cost of measuring outcomes and transferring risk to the agent.

- **The Myopic Market Model**

The Myopic market model is similar to the agency theory and the finance model that the firm's purpose is to maximize the wealth of shareholders. This model criticizes the Anglo-American corporate governance system as being fundamentally flawed by an excessive concern for short-term gains (return on investment, corporate profits, management performance, stock market prices, and expenditures) due to huge market pressures [21]. The focus of the short term market value tends to be the basis for measuring corporate performance and managerial efforts. In effect, current corporate governance systems force managers to concentrate on short-term earning data and forecasts (current share prices and short term performance) without taking into account the long term investments of the firm such as research and development [39]. Share prices do not *"reflect the true value of the firm as changes in the market share prices may arise from guesses about the behavior and psychology of market participants and the changing moods and prejudices of investors, rather than from the estimations of corporate fundamental values"[21]*

Consequently, share prices should not be used as a basis for decision making, or otherwise risk the company to hostile take-overs by institutional investors as the price of shares may drop at any time allowing investors to buy company stocks at a lower price [17]. Advocates of Myopic model suggest that firms should focus on long term investments and call for increased shareholder loyalty. Both managers and shareholders are encouraged to develop long-term interests. However, it is argued that this measure may increase shareholders' exit cost, thereby making them more vulnerable to poor corporate governance and impede the market efficiency by preventing takeover attempts.

- **Stewardship Model**

The stewardship model rejects self-interest and seeks other ends beyond financial interest such as: a sense of worth, a good reputation, a job well done, a feeling of satisfaction and a sense of purpose. A steward is a person who "essentially wants to do a good job, to be a good steward of the corporate assets" [6]. Letza *et al* claim that:

> *"based on the traditional legal view of the corporation as a legal entity in which directors have a fiduciary duty to the shareholders, the stewardship theory argues that managers are actually behaving just like stewards to serve the shareholders' interests and diligently work to attain a high level of corporate profit and shareholder returns."[23]*

This approach suggests that managers have great responsibility and will act in the public interest through the effective use of resources for both shareholders and society as a whole. In particular, stewardship theory describes situations in which managers are not motivated by individual goals, but rather are stewards whose motives are aligned with the objectives of their Principals. Thus, Executives and board of directors are more motivated to act in the best interests of the firm rather than for their own selfish interests. Corporations' are social entities that affect and are affected by the welfare of its larger stakeholder groups and thus, judged by their ability to add value to all their corporate stakeholders. The stewardship model believes that a positive relationship between corporations and their stakeholders provide a mutual benefit for all. It is important for corporate managers to consider being socially responsible to their stakeholders.

- **Stakeholder Perspective**

Stakeholder perspective clearly rejects the view that shareholders have a privileged place in the business enterprise and argues in favor of giving more voice to stakeholders [10][11][32]. The traditional definition of stakeholders as "any group or individual who can affect or is affected by the achievement of the organization objectives" [11] acknowledges that stakeholders can influence the organization, but also are affected by the organization. However, one of the primary challenges in stakeholder analysis has been the construction of a universally accepted definition of the term *stake*. Though, Freeman's definition is one of the most frequently cited in the literature, it lacks clarity in terms of both the scope of stakeholder and the stake. There are three interrelated but distinctive approaches to examine stakeholder issues based on their underlying theoretical dimensions, namely: descriptive, instrumental and normative approaches. The descriptive and instrumental approaches are considered analytical which attempt to understand how managers deal with stakeholders and represent their interest in the achievement of various corporate goals. The approaches offer managerial and practical scope which constitutes a base for the development of stakeholder theory.

The analytical stakeholder approach is based on the identification of stakeholders and analysis of specific stakeholder perspectives. It describes the value-free of what firms do or what they are able to do and determines how firms interact with their multiple stakeholders. However, seem to be simply descriptive and lacking clear objective.

Normative stakeholder theory provides solutions to the fundamental questions: "what are the responsibilities of the company in respect of stakeholders?" and "why should companies take care of other interests than shareholders' interests?" In this approach, stakeholders have legitimate interests in the "procedural and/or substantive aspects of the firm," and all stakeholder interests have intrinsic value [6][11]. This viewpoint identifies moral values and philosophical principles for managers to perform their role. Freeman suggests a separation between economics and ethics spheres which presupposes that every organization should define fundamental moral principles, and use these principles as a basis for decision making [13]. Managers are expected to make corporate decisions respecting stakeholders' well-being rather than treating them as means to a corporate end. The purpose of the firm is to serve as a vehicle for co-ordination of stakeholders' interests. However, the challenge of this model to effective corporate governance arrangement is the definition of stakeholders which virtually includes everyone, everything and everywhere. This implies that organizations may be faced with a bewilderingly complex set of claims that cannot reasonably be accommodated. However, the approach has its critics in the private sector domain and that the concern for the intrinsic interests of all legitimate stakeholders sometimes dictate that a firm should go out of business.

- **Stakeholder Model**

The stakeholder model is the most fundamental challenge to the Principal-agent model and believes in a broad sense of stake holding welfare as the purpose of the corporation. This model assumes that values are a part of doing business and that ethics and economics are not mutually exclusive. As the core of stakeholder theory, the normative theory is communicated in two main questions: "what is the purpose of the firm?" and "what responsibility does management has to stakeholders?". While the first question encourages managers to articulate the shared value created and what brings its stakeholders together, the second question induces the managers to formulate what relationships they need to cultivate with the stakeholders to accomplish their purpose. In general, the assertions that:

> *"managers must develop relationships, inspire stakeholders and create communities where people strive to give their best to make good the firm's promises" are fundamental to the stakeholder theory [12].*

This approach describes how managers and organizations treat the interest of stakeholders in a moral and responsible way. However, the stakeholder theory of the firm focuses on economic analysis, including: agency problems, transaction costs, and property rights [16]. Theories of the firm view the corporation as a nexus of contracts to alleviate incentive conflicts between shareholders and managers as well as among different members within the firm. Hence, stakeholder theory views the firm as an entity through which "diverse participants" achieve multiple goals.

In relation to the two competing perspectives of corporate governance, current analyses draw more attention to evaluating and judging the superiority, rationality and universality of either the shareholder model or stakeholder model [23]. To minimize the one-sided arguments, corporate governance needs to focus on reflexive thinking through critical examination of the main theories, approaches and assumptions of the two perspectives. From this standpoint, the authors suggest the analyses step beyond the narrow confines of the respective interests of the shareholder and stakeholder perspectives; and to investigate their underpinning theoretical genealogy, ideology, presuppositions and value systems. In reality, there seems to be a paradigm shift with both perspectives increasingly drawing attention worldwide in recent times. Stoney and Winstanley contend that countries such as Germany and Japan, which had traditionally stakeholder-committed model, have moved closer towards a more shareholder valued and market-based model due to globalization competition. Corporate governance is flexible and dynamic and the claim of superiority of both perspectives is neither permanent nor universal but contextual.

III. CONCLUSION

This paper addressed the mainstream conceptualization of corporate governance based on the nature and purpose of corporations and governance reviewed and their approaches examined. A corporation is viewed as a solid and enduring entity or the aggregation of individual entities, with a clear division between inside and outside, the corporation and its environment, and with a fixable identity of shareholders and stakeholders. In situations where the evolution of a corporation is characterized by individual contributions to the firm's capital for the pursuance of their economic interests, an instrumental view of the corporation tends to evolve. In this perspective, it becomes the right of those who contributed capital to own the corporation, and society protects this right by means of laws. In the context in which the development of a corporation is characterized by contributions to its capital by a number of different constituencies (stakeholder groups), they acquire rights which society protects by means of laws.

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