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Where does the Relevance of Corporate Governance lie?

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Opinion Article

The term, corporate governance as a relatively new term has been in popular use for the past two decades to describe the general codes by which businesses are steered and controlled. Despite its newness, there is however, no single or universally accepted definition of this term by academic scholars or practicing managers. Corporate governance is multi-faceted with its debate raising more issues than have been resolved [1]. However, two distinctive features can be noted among the various definitions of corporate governance. Firstly, the term is defined either too narrowly or broadly in its scope. Secondly, the various definitions reflect the two main perspectives of corporate governance: the shareholder perspective, which fits into the narrower scope of the definition of corporate governance; and the stakeholder perspective, which also corresponds to the wider scope of the definition of corporate governance. These two perspectives compete to define and determine the objective of a corporate business, whose interest the firm should serve, and the corporate governance structure.

The shareholder theory traces its origin to the works of Adam Smith, Berle and Means [2] and also the seminal paper by Jensen and Meckling [3]. This theory considers an organization as a device for shareholders to maximize their investment returns, on the basis that theoretically, shareholders are residual risk bearers [3]. This means the objective task of a corporate business ought to focus only on those who have monetary share of the corporation. Other stakeholders such as employees, suppliers, creditors and so on, who provide resources to the company do so on the basis of contracts that define the relation between their contributions to the firm's productive processes and the returns they get from those contributions [4]. The implication is that shareholders' returns depend on the revenue (if any) that are left after the payment of all contractual claims.

Stakeholder theory, on the other hand, has gradually developed since the 1970s [5]. One of the first demystifications of the stakeholder theory was exhibited by Freeman [6], who proposed the general theory of the firm, integrating corporate accountability to a wider range of stakeholders. The fundamental issue of the stakeholder theory is that companies are too large, and their influence on society is ubiquitous that they should discharge accountability to many more sectors of society than just their shareholders [5,7,8]. In other words, an objective function of corporate businesses should not only be economically inclined, but also be socially accountable and efficient [7]. This is because stakeholders are not only impacted or influenced by corporate businesses, but they in turn influence firms in some ways. In simple terms, they have a 'stake' rather than a 'share' in corporate businesses.

The discussion above leads the study to the debate between the shareholder and stakeholder perspectives. For the purpose of this analysis, the shareholder perspective is defined as the maximization of a long-term market value of the firm, as characterized by its stock price, whereas the stakeholder context is described as the maximization of the total value of the firm, as distributed amongst all stakeholders such as shareholders, employees, customers, creditors, communities in the vicinity of the corporate businesses' operations, and the general public [9].

In the early days of the Great depression, a debate emanated between Professor Adolf Berle of Columbia Law School and Professor Merrick Dodd of Harvard University on the role of corporate directors as fiduciaries. Berle [10] contends that since powers of management are drawn from shareholders, it is the duty of managers to maximize the corporate business' value for the sole benefit of its equity holders. Dodd [11] in response argues that opinions on the role and responsibilities of corporate entities would eventually get their way into the law books. His argument was that it is not only the duty of managers to maximize firm value to benefit its shareholders, but also to provide social benefits to other stakeholders. In the preface to the 1968 edition of his seminal work The Modern Corporation and Private Property, Berle interestingly accepted that successive events had confirmed Dodd's argument.

Jensen [9] posits that even though stakeholder theory (that has its source from sociology and organizational behavior) is considered the major contender of shareholder theory, it is characterized by politics of special interest and managerial self-interest. The stakeholder theory has been popular and greatly acknowledged by numerous professional organizations, special interest groups and other organizational bodies, but it cannot be regarded as an appropriate competitor to value maximization since it fails to offer complete specification of the corporate objective function. Jensen [9] argues that in addition to its incompleteness, the stakeholder theory serves the private interests of those who promote it, including outside managers, inside managers as well as directors of corporate businesses.

Danielson et al. [12] opine that if a corporate business is pressured to apportion some of its economic surplus to employees (ie. Paying wages in excess of the employees' marginal productivity) or by reducing prices to customers, they would benefit in the short-run. However, these policies might restrain future innovation, hurting shareholders and other stakeholders in the long-run. Hosmer [13] suggests that in order to be considered as a stakeholder, it should be subject to how the individual or group at some point in the future can influence the achievements of the corporate business. This assertion has been buttressed by the Delaware Court, which ruled that the interest of other stakeholders ought to have thoughtful associations to

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the general interest of the shareholder [14]. Without this limitation, the stakeholder theory will become irreconcilable with corporate governance practice when the people who are considered as stakeholders increase significantly to the point where the concept "stakeholder" is of no importance for scrutiny. Stenberg [15] argues that:

Stakeholder theory provides no effective standard against which corporate agents can be judged. Balancing stakeholder interests is an ill-defined notion, which cannot serve as an objective performance measure; managers responsible for interpreting as well as implementing it are effectively left free to pursue their own arbitrary ends.

Donaldson and Preston justify the stakeholder theory in the management literature, both explicitly and implicitly, on the basis of its descriptive accuracy, normative validity and its instrumental power. The authors recapitulate that even though these three justifications are mutually supportive, the normative base of the theory (i.e. why some claims, whether moral, property-based, and some associations are legitimate and worthy) attracts the attention of management professionals. Mcvea and Freeman [16] contend that the structure of the stakeholder theory which developed out of a series of clinical studies of management practitioners over a period of ten years by Freeman [6] has recently been spotted that, it has more influence on theorists and academics than corporate managers and entrepreneurs. The stakeholder theory perspective which was originally suggested as a strategic management apparatus, has since been 'hijacked' by management scholars to serve as a channel/conduit to make corporate businesses more ethical in the current debate of corporate governance. Therefore, it must be well-noted that to deal with situations that encompass business ethics and matters of conflict of interest that are more likely to raise public views, it would be more appropriate for boards of listed corporate organizations to accept the stakeholder point of view.

Nevertheless, the traditional shareholder perspective (ie. the finance model) of corporate governance is still attracting attention from management scholars as well as practitioners in the present corporate governance discourse. Shareholder value is very important in terms of a country's economic development. In this line of argument, countries that apply the finance model in their corporate governance practices stand to benefit in terms of competition than countries that apply or adopt the stakeholder perspective [17]. Jensen [9] claims the main objective function of a corporate business in the finance model, as entrusted to its board of directors, is to maximize long term market value, which is primarily reflected in the company's stock price. Charkman [18] however, asserts that the fundamental flaw of the shareholder model is its excessive attention on short-term market value. The performance of a corporate business is attentively monitored on three-monthly basis and thus exerting pressure on corporate managers to only concentrate on the current stock price, which subsequently leads to a rejection of the long-term market value of the corporate business. Therefore, for corporate business managers to overcome this flaw there ought to be "a structure that will help them resist the temptation to maximize the short term financial performance (usually profits, or sometimes even more silly, earnings per share) of the organization" [9].

The bone of contention between the shareholder and stakeholder perspectives is also reflected in the current discourse on Corporate Social Responsibility (CSR). The major question that arises is: What role should a corporate business play in terms of social responsibilities? Friedman [19] states the only social responsibility of a corporate business is to use its resources to partake in activities that are purposely designed to increase or maximize its profits as much as it resides within the rules of the game. This means corporate businesses have to engage in activities that maximize shareholders' wealth. Therefore, the only objective of a corporate business is to meet shareholders' interests by maximizing their value, leaving the various social responsibilities to the government and other institutions. In simple terms, any corporate governance reforms ought to align management's interests with that of shareholders, for example by aligning management's incentive packages closely with firm profitability. This profit would benefit the entire corporation in that reinvested profits will assist in building up the corporation's economic resources, thus allowing future capital investment and expenditure on valuable long-run ventures like research and development [20]. These activities will eventually help other stakeholders. For instance, the workforce will experience job security enhancement and the environment in which the firm situates will gain via huge efficient investment and a lesser amount of harmful industrial activities.

However, a corporate business focusing only on maximizing shareholders' value without considering CSR role may weaken or undermine its shareholders' long term interest [21]. The environment of a business brings out numerous possible ethical conflicts. For instance: a) A corporate entity's attempts to meet its goals may crash with workers efforts to accomplish their own goals; b) wishes of consumers for quality and safe produce may collide with a corporate entity's goal to make sufficient returns, and c) top management's aim to obtain considerable increases in remuneration may have a collision with shareholders' desires to minimize costs and at the same time maximize the value of the firm [21]. Collins and Porras [22] in their study suggest that shareholder value maximization has not been a major objective of corporate businesses that make more money. The authors conclude that corporate businesses that concentrate only on maximizing shareholder value are more inclined to perform badly than their counterparts that focus differently (ie. not only concentrating on maximizing shareholder value).

Therefore, the question that can be asked is: Is there any other way or approach to resolve the current debate between the shareholder perspective and the stakeholder viewpoint? Gamble and Kelly [23] contend that changes are happening that will possibly make the traditional shareholder theory worthy of being accepted. They referred to these changes as "enlightened managerialism". This is where corporations adopt non-legal binding codes in order to propagate best practice. Also, Gamble and Kelly observe the likelihood of an increasingly strong shareholder movement or 'shareholder activism', for example shareholder advisory group PIRC of Britain, CalPERS of US, l'Association pour la Defense des Actionnaires Minoritaires (ADAM) of France, TIA of Thailand and TIAA-CREF. These movements will serve to empower shareholders to act vehemently and efficiently in monitoring firm performance. This can be achieved through the modification of existing laws of governments to ensure greater shareholder democracy and greater accountability of corporations' boards of directors to shareholders. Nevertheless, they admitted that increasing share ownership via privatization has not instituted a wider share-owning culture. Also, the authors support corporate pluralism and a more proper acknowledgement in firm governance of the risks incurred by all stakeholders- including shareholders, employees, suppliers, customers and so on.

The corporate pluralism position on the company in the stake holding debate proposes to acknowledge the pluralistic structure of the modern company by changing the legal framework to accommodate it. The strength of this perspective is that it offers a way to make the company both more efficient and more legitimate [23].

Jensen [6] argues for an adjusted approach to shareholder theory and emphasizes the significance of firm value maximization; "two hundred years of work in economics and finance implies that in the absence of externalities and monopoly (and when all goods are priced), social welfare is maximized when each firm in an economy maximizes its total market value" [24]. He admits that a corporate organization cannot maximize its value if it disregards other stakeholders' interests. Therefore, he proposed an "Enlightened Value Maximization", which he considers as identical to "Enlightened Stakeholder theory" to fuse the two theoretical perspectives. With this, there is "no doubt advocates of stakeholder theory would find it hard to accept the mechanism whereby focusing on firm market-value maximization leads inevitably to social welfare maximization" [20]. However, leaving this pressing issue to one side, it appears logical to admit that maximizing more than one objective at the same time means 'the absence of objective'.

Telling a manager to maximize current profits, market share, future growth in profits, and anything else one pleases will leave that manager with no objective. The result will be confusion and lack of purpose that will fundamentally handicap the firm in its competition for survival [24].

Jensen [24] further argues that stakeholder theory does not provide any criterion for what is better or otherwise, leaving corporate directors and managers with no criterion to solve corporate problems. He continues that if this is the case, why do corporate executives and directors accept stakeholder theory? He interestingly, states that the answer lies in the self-centered motive of managers of corporations.

Because stakeholder theory provides no definition of 'better', it leaves managers and directors unaccountable for their stewardship of the firm's resources. With no criteria for performance, managers cannot be evaluated in any principled way. Therefore, stakeholder theory plays into the hands of self-interested managers allowing them to pursue their own interests at the expense of society and the firm's financial claimants........By expanding the power of managers in this unproductive way, stakeholder theory therefore increases agency costs in the economic system. Viewed in this way it is not surprising that many managers like it [24].

This argument leads Jensen to agree on enlightened value maximization and enlightened stakeholder theory. By ignoring or mistreating any important constituency, firms should not expect to maximize their long-run market value [24]. In simple terms, for a corporate organization to succeed in the competitive market, it has to address the concerns of all stakeholders.

Jensen proposes this theory on a basis of finding a lasting solution to the bone of contention between the shareholder and stakeholder perspectives, but it is surprising to note that the term Enlightened Value Maximization can be changed into Enlightened Self-interest. This is because:

Findings on attitudes of stake holding suggest that boards consider the embracing of the idea of stakeholders as one of the enlightened self-interest, rather than adopting a stronger version of the principle. Details of how the boards factored in stakeholders to decision-making remained hazy, leaving a sense of ad-hoc, case by case assessment, rather than any considered approach to stakeholder groups [25].

So far, we have discussed shareholder and stakeholder perspectives of corporate governance. However, the question is; is it possible for corporate governance to be enhanced by attempting to make some adjustments with regards to corporate ethical behavior? Many large corporate organizations have drafted a business code, but the presence of a business code does not essentially mean that a corporate organization will stick to it, even though its contents at least, direct the corporate organization to the sort of business ethics it claims to endorse [26]. However, there are individuals who think corporate governance can be improved via extensive disclosure of a company's ethical programs [20].

In summary, it is obvious that the practical importance of shareholder and stakeholder perspectives of corporate governance will continue to be discussed for a very long period of time to come. Even though theoretically, it is important to highlight these two differing perspectives of corporate governance, it is worth noting that, in reality, the importance of corporate governance lies between these two distinctive standpoints.

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