

# Review of Corporate Governance Theories

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## ABSTRACT

Corporate governance is a mechanism in which conflict of interest between managers and shareholders is managed and controlled. From the perspective of stakeholders' numerous theories have been proposed and emerged from different perspectives to offer solutions to these conflicts and reduce conflicts among the stakeholders. This paper talk about corporate governance theories to improve the mechanism of corporate governance understanding from different stakeholders' perspectives.

**Keywords:** Agency Theory, Resource Dependence Theory, Stakeholders' Theory, Shareholders Theory.

**Submitted:** September 15, 2022

**Published:** November 09, 2022

**ISSN:** 2507-1076

**DOI:** 10.24018/ejbmr.2022.7.6.1668

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## I. INTRODUCTION

Generally, corporate governance refers to the system by which companies are directed and controlled (Cadbury Report, 1992). This definition emphasizes that all stakeholders are responsible for an effective and smooth interest alignment of stakeholders. The corporate governance mechanism is established to protect the interests of investors, shareholders, and all stakeholders (Yusoff & Alhaji, 2014). According to the Cadbury report (1992), corporate governance outlines the responsibilities and duties of an organization's board of directors to lead the organization successfully. The board of directors is responsible for the smooth implementation of corporate governance. The role of a shareholder in governance is to appoint directors, and auditors, and ensure that directors are appropriately running the structure.

Corporate governance is a set of relationships between a company's management, its board, its shareholders, and other stakeholders (OECD, 2004). There is no single model of good corporate governance, however, the principles proposed by Organization for Economic Co-Operation and Development (OECD 2004) for good corporate governance that is based on common elements and different models that already exist. Corporate governance is about what the board of a company does and how it sets the values of the company, and it is to be distinguished from the day-to-day operational management of the company by full-time executives (Gyamerah & Agyei, 2016). Thus, this system supports the financial and capital market of a country.

The UK Corporate Governance Code (July 2018) defines the concept of corporate governance as "The purpose of corporate governance is to facilitate effective, entrepreneurial and prudent management that can deliver the long-term success of the company". There is no specific definition of corporate governance which defines the scope. There are

various authors and organizations, which define the terminology 'corporate governance' the holistic meaning of which sums up as the set of codes and rules that controls the conflict of interests and strengthen the relationship between the firm's management, the board of directors, shareholders, or any other interested stakeholder. Corporate governance encompasses those rules and regulations which eventually lead to a more responsible organization, as a result, it led to the company's leverage.

Under the corporate governance system, the interest of different stakeholders is aligned and matched. Accordingly, several theories have contributed to improve the governance of firms with the aim of maximizing shareholders' and stakeholders' wealth.

## II. BACKGROUND OF CORPORATE GOVERNANCE

The concept of corporate governance has a wider scope and the area of business that incorporates managerial accountability, board structure, and rights of shareholders. The issue of governance began with the beginning of corporations and the concept existed for centuries, but the name didn't come in a clear manner until the 1960s. The concept of Corporate Governance was first highlighted in 1960 by Richard Eells in his paper "The Structure and Functioning of Corporate Polity" where he discussed how agency cost affects financial resources and how this negative effect can be reduced. Till 1970 the concept of Corporate Governance was confusing but within 25 years this system gained a lot of attraction and now the topic is much debated in business as well as the literary environment (Cheffins, 2011).

The term corporate governance was first used in the United States, where the balance between power and interest became the main topic under discussion. After the Second World War, the United States experienced strong economic growth,

corporations were growing and rising, managers were highly influenced by the selection of board directors and things began to change. In 1976, the term “corporate governance” first appeared in the business environment where the Securities and Exchange Commission (SEC) imposed that each corporation to have an audit committee composed of all independent board directors (Cheffins, 2011).

In the 1980s the focus was imposed on Principles of Corporate Governance, the focus on these initial principles was on the board of directors, where they were given more rights and power in governance matters. The principles were first criticized by the majority of law regulatory bodies and economic scholars but later the principles were approved and published in 1994 (Khan, 2011).

After the major financial scandals in 2002 of large organizations like Enron and WorldCom, the attention towards Corporate Governance became much higher (Ali, 2018). The attention moves toward corporate governance extensively among professionals and academicians. Many regulatory bodies issued and revised the principles and codes of corporate governance. The basics of such rules and principles result in the positive effect of corporate governance on the organization (Claessens & Yurtoglu, 2012; Shouvik, 2018).

As a result of high-profile corporate scandals, major steps have been taken by governments and professional bodies to strengthen the oversight of company performance by external agencies such as the Securities and Exchange Commission (SEC) in the USA. The USA also passed the legislation called Sarbanes-Oxley Act (SOX) in 2002. In the UK, since the early 1990s, a similar corporate governance system has evolved, known as Cadbury Report (1992). Many member countries of the Organisation of Economic Cooperation and Development (OECD) also produced their own country-specific corporate governance codes. There is also a private voluntary body sponsored by several professional accounting bodies called the Committee of Sponsoring Organizations of the Treadway Commission (COSO), which provides guidance on corporate governance and business ethics (Braendle & Kostyuk, 2007; Devendra Kodwani, n.d.; Shouvik, 2018).

The OECD was the first organization to offer an international code of corporate governance principles, issued in May 1999 and was revised in 2004 and 2014. The principles developed by OCED have been endorsed by World Bank and IMF (International Monetary Fund) (Leipziger & Leipziger, 2019). The OECD principles provide guidelines on corporate governance practices without imposing any obligations on the member's organizations. The OECD principles enrich the scope of corporate governance by acknowledging the rights of all stakeholders. These principles focus on the separation of ownership from control.

### III. THEORIES OF CORPORATE GOVERNANCE

The theories of corporate governance are important to study when highlighting the relationship of corporate governance variables with the capital structure of companies. These are primarily agency theory, stakeholder theory, stewardship theory, and resource dependency theory.

#### A. Agency Theory

This theory is regarded as the fundamental base for all other theories related to corporate governance. This theory focuses on the contractual relationship nature between shareholders and management. According to this theory, the shareholder's work as principals and management are considered as the agent of owners (Khan, 2011). Shareholders are interested in increasing their wealth whereas managers are working for shareholders, but their priority is an increase in their compensation not only shareholders' wealth. Thus, a conflict of interest arises, and this cause agency problem under the principal and agent relationship.

Agency theory has its origins in the economic theory, which is presented by Adam Smith (1776). First-time separation of ownership to control was discussed by Adam Smith, who proposed that a manager who controls all activities of the firm will not have a keen interest in business as he would invest his own money and pointed out some negligence (Smith *et al.*, 1977). Later, the agency theory was further developed by Jensen and Meckling (1976) who defined agency theory as a contract between owners and management. Moreover, ensuring whether the agent is acting in the principal's best interest or not. This is based on the grounds of an inherent conflict of interest between the agent and principal (Fama & Jensen, 1983). Moreover, the conflict between management and shareholders may also take place due to the issue of information asymmetry. Fig. 1 elaborates on the agency model.

Different researchers and economists categorized agency problems into three types. The first type of problem is identified as Principal-Agent Problem, this problem started with the operation of a large corporation. Where the shareholders assign the administration of business to managers, but managers are more interested in maximizing their compensation rather than the interest of owners. The type 2 problem is named as Principal-Principal problem. This problem exists between the major and minor shareholders of large corporations. Since the major owners have high voting power so they can take participate in the decision-making process in their favor. The type 3 problem is the Principal – Creditor Problem, this problem, and conflict exists between owners and creditors due to the financing decision of risky projects (Panda & Leepsa, 2017; Yusoff & Alhaji, 2014).

Generally, agency theory focuses on the opportunistic behavior of managers where they try to put their interests first by sacrificing shareholders' interests. As a result, the cost of solving agency problems is increased because under the corporate governance mechanism several measures need to be taken by the board of directors such as the establishment of numerous committees (Yusoff & Alhaji, 2014).

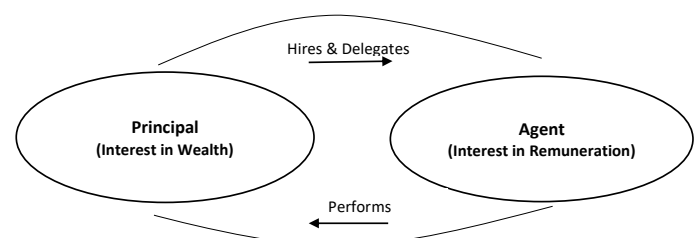


Fig. 1. Agency theory model.

The Board of directors plays an essential role in monitoring performance managers and aligning both parties' interests. The audit committee as a proxy of the board of directors works as a monitoring mechanism to control the management activities and match with the shareholders' needs. In addition, agency theory claims that the appointment of independent directors is the key to the effective and efficient performance of management (Fama & Jensen, 1983).

Further, researchers suggest that performance-based incentive schemes will help to motivate managers to maximize wealth and decrease the chances of managers' opportunistic behavior (Khan, 2011). However confounding views also exist on this suggestion. Compensation-based managers' performance may highly empower to shareholders and minimizes the importance and role of managers (Afza & Nazir, 2014). Whereas the suggested solution to remove all these issues is to create a relationship between compensation and performance and create a healthy environment relationship.

### B. Stakeholder Theory

Stakeholder theory is the further extension of agency theory. It is argued that agency theory has limited scope because it identifies the interest of only shareholders only. The stakeholder theory suggests that a firm should create value for all stakeholders, not just shareholders (Freeman *et al.*, 1984). However, the stakeholder theory scope is considered broader because it covers the role of corporate governance (Yusoff & Alhaji, 2014). This theory is based on the belief that managers should work in the best interest of all stakeholders and the board of directors should monitor the performance of managers. The notion of the theory is widened in today's scenario where business needs to take care the interest of all stakeholders (Schmid, 2006).

Freeman (1984), argued that a stakeholder is considered as an organization or any individual who can affect or affected by the organization decisions. As time passes, different views and amendments came under the stakeholders theory and scope of the theory becomes widened, thus all the members of society where business is operating, workers of firms, suppliers of raw materials, local community and competitors become an important element of stakeholders theory (Freeman *et al.*, 2004).

Stakeholder theory stipulates that a firm works to improve and balance the interests of its several stakeholders in such a way that each stakeholder receives some level of compensation. It is suggested that a firm is no longer sole responsibility but also a firm needs to take care of the interest of society at large. Thus, stakeholder theory provides much wider scope of corporate governance. However, the stakeholders of the company consist of its employees, customers, lenders, suppliers, competitors, shareholders, investors, governments, banks, and society at large.

Initially, stakeholder theory was embedded in the management discipline while with the passage of time different amendments and views came under stakeholder theory and now considered an important theory under corporate governance system. One of the main advantage of stakeholder theory is to consider and develop strategy for the entrepreneurial risks (Barney & Harrison, 2020).

In the current business environment not only owners or shareholders are more interested in the success of the business but also the suppliers, creditors, employees, potential investors, government & regulatory organizations, local community, lenders, trade associations, and the general public have a direct or indirect interest in business activities. This notion brings stakeholders theory to a more prominent position, where all stakeholders' interest has been considered and acknowledged. This theory refers to dealing with all stakeholders on a more fair basis (Harrison *et al.*, 2015; Klepczarek, 2017). Fig. 2 explains the different stakeholders which can affect and affected by organization's decisions.

Later on, the stakeholder theory was criticized because the performance of a firm is not and should not be measured only by gains to its stakeholders (Jensen, 2002). While deeply studying corporate governance theories, the stakeholder theory occupies a prominent position because it claims to satisfy the interest of all stakeholders in its governance process.

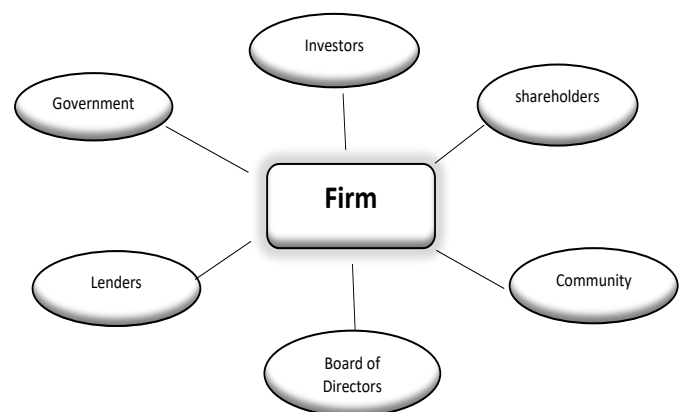


Fig. 2. Stakeholder theory model.

### C. Resource Dependence Theory

Both stakeholder and agency theory focused on the managers and different groups of people's relationships while resource dependence theory introduces accessibility to resources are a crucial aspect of corporate governance discussion. This theory was developed by Pfeffer and Salancik in 1978. Resource dependence theory is the study of how the external environmental resources of organizations affect the behavior of the organization. The basic proposition of this theory is based on creating links between the firm and the external environment, directors are responsible to match the changing environment trends with the firm capabilities (Klepczarek, 2017; Yusoff & Alhaji, 2014).

Resource dependence theory highlights the role of the board of directors that they play in acquiring and securing critical resources of the firm by their linkage to the external environment. Thus, board of directors brings different types of resources such as skills, information, raw materials, and uses their expertise to connect business with the resources. Based on this notion board is directors is considered as a key source that connects an organization to the external environment and provide resources to the firm. As a result, a business performance is highly dependent on the power of a board of directors to acquire and secure scarce resources.

Resource dependence theory focuses on the role of

directors that they play in providing essential resources to an organization through their linkages to the external environment. Resources refer to information, skills, and access to key constituents. Directors can be classified into four categories of insiders, business experts, support specialists, and community influential. First, insiders are the current and former executives of the firm, and they provide expertise on the overall and general direction of the firm. Second, the business experts are current and former directors of large firms, they provide expertise on business strategy and decision-making. Third, the support specialists are the lawyers, bankers, and other firms' representatives, these provide support in their area of specialization. Finally, the community's influential are the political leader, academicians, and representatives from social and community organizations (Abdullah & Benedict, 2009). Fig. 3 depicts the resource dependence theory.

Based on discussed categories of directors, the board may therefore offer the four primary benefits to the firm, first, advice and counsel services, second legitimacy, third channels for communicating information between external organizations and the firm and fourth access to commitments or support from outside elements (Callaghan *et al.*, 2016). Thus, the diversity of board members is seen as the critical element which leads to the board's ability to connect the firm with the best resources and further high financial performance of the business.

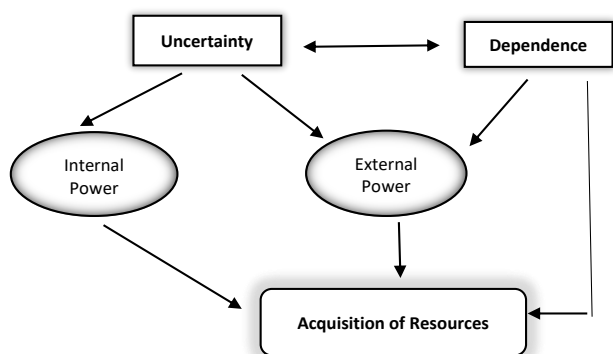


Fig. 3. Resource dependence theory model.

D. Stewardship Theory

Stewardship theory is an important theory of corporate governance which assumes that managers should work as a steward. Stewardship theory is developed by Donaldson and Davis (1991) and Donaldson and Davis (1993). In contrast to agency theory, the stewardship theory presents a different perspective of management, where managers are considered stewards who will act in the best interest of the shareholders (Chrisman, 2019). The fundamentals of stewardship theory are based on psychology and sociology. This theory assumes that the managers will be always work in the best interest of the firm, they will protect and make profits for shareholders. The success of the firm tightly encompasses management commitment and when the shareholder's wealth will be maximized, the stewards will be also benefited in terms of remunerations (Abdullah & Benedict, 2009; Klepczarek, 2017; Yusoff & Alhaji, 2014).

The unique feature of stewardship theory is to enrich trust in managers which is lacking in the perspective of agency

theory. Stakeholder theory assumes that insider directors have more information about the business performance and operations as compared to outsider directors (van Puyvelde *et al.*, 2012). In addition, stakeholder theory assumes that managers safeguard and protect shareholders' interests by taking the right decision to increase the wealth of the shareholders. In contrast to agency theory, stewardship theory considers that managers and inside directors are best to work in favor of shareholders (Schillemans & Bjurström, 2020).

Stewardship theory is based on the assumption that shareholders give more power and trust to managers (stewards) and in return managers will maximize their wealth (Yusoff & Alhaji, 2014). As a result of this theory, shareholders enjoy more profits and returns on their investments and managers will be able to achieve intrinsic and extrinsic rewards (Abdullah & Benedict, 2009). This theory depicts the positive relationship between shareholders and management, which is one of the requirements of good corporate governance practice. The primary emphasis of stewardship theory is to understand how managers can be motivated to contribute to the achievement of business goals. Thus, the theory is based to align the interest of managers (agents) and shareholders (principals) (Chrisman, 2019). Fig. 4 describes the stakeholder theory model.

While studying corporate governance all the above theories are important and have their own arguments and validity. All the theories considered the relationship between shareholders and managers in different decisions especially financing decisions. The summary of corporate governance theories is given in Table I.

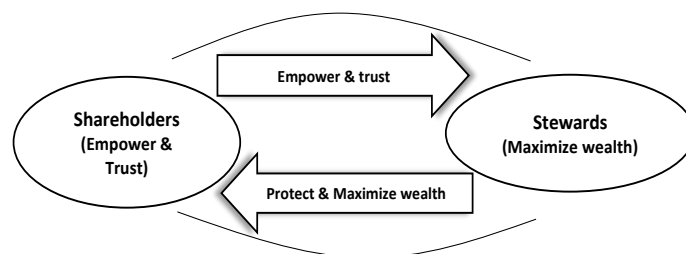


Fig. 4. Stakeholder theory model.

TABLE I: SUMMARY OF CORPORATE GOVERNANCE THEORIES

Theories	Year	Author	Summary
Agency Theory	1776 & 1976	Smith, Jensen, & Meckling	A contract between shareholders and managers to resolve all conflicts
Stakeholder Theory	1984	Freeman	A firm should create value for all stakeholders
Resource Dependency Theory	1978	Pfeffer & Salancik	A business must create value by utilizing the resources from the external environment
Stewardship Theory	1991	Donaldson & Davis	Managers work as a steward on behalf of owners' best interest

IV. CONCLUSION

This paper explains the basic four theories which are used under the study of corporate governance system. These theories provide the base for understanding of the literature which is highly relevant while examining the corporate

governance mechanism. Agency theory highlights the relationship between principal and agent while introducing the several aspects to minimize or resolve agency problem. Further, stakeholder theory broadens the discussion by adding all stakeholders in the corporate governance mechanism. The theory assumes that managers actions not only affect shareholders but also all types of stakeholders are affected by managers actions. Whereas resource dependence theory explains that business needs several resources to complete its operational activities which are not possible without the support of board of directors. In addition, stewardship theory provides explanation and basis in favour of management and focus that managers works in the best interest of shareholders to increase their wealth. The research on corporate governance needs to be viewed from a different perspective to understand its applicability and influences. Thus, the need to explore and study corporate governance theories is always needed to examine the developments in the field of study.

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