Corporate governance theories and their application to
BOARDS OF DIRECTORS
A critical literature review

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Review

Corporate governance theories and their application to boards of directors: A critical literature review

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The ongoing debate on the theories of corporate governance is yet to settle on a specific perspective between agency, resource dependence, stakeholders and stewardship theories. While promoters and supporters of each group attempt to rationalize the superiority, and universality of each model in theory, they rarely pay attention to the long-standing notions, norms and premises underpinning their perspectives which are less credible and valid in matching the continually changing practice of corporate governance. This paper critically reviews the literature on corporate governance theories and relates them to the board of directors’ characteristics. In so doing, it reveals the lack of conventional approaches employed in corporate governance theories. The paper finally, calls for an integration of all the theories in the field and suggests five areas of future study on corporate governance in Africa.

Key words: Agency theory, corporate governance, board of directors, resource dependence theory, stakeholders’ theory, stewardship theory.

INTRODUCTION

The current mainstream schools of corporate governance rest their ideas and assumptions on theory of the firm and associated ideologies which were created and constructed by company law theory and classical economics in the 18th and 19th centuries (Letza et al., 2004). In recent years, the corporate scandals, some of which are still unfolding, involving high incidence of improper activities of managers expropriating the resources of a firm at the ultimate expense of shareholders have prompted the intense re-examination and scrutiny of some of the existing corporate governance practices and also considerable interest in empirical research on the effectiveness of various corporate governance institutions and mechanisms (Fan, 2004).

A number of agency problems resulting from the separation of ownership from control (Berle and Means, 1932; Jensen and Meckling, 1976) still prevail in firms globally. Nonetheless, agency problems are the necessary evils of “efficient form of economic organization” called firms (Fama and Jensen, 1983) where the various resource owners are pooled together in order to produce goods or services demanded by customers at the lowest cost. Therefore, firms must be convinced of the importance of grappling with and managing corporate governance for their long-term survival and growth. This paper attempts to review extensively the literature on corporate governance and how the various corporate governance theories interact with board of directors characteristics to influence corporate performance.

Corporate Governance Theories

Various scholars have developed a number of theories on corporate governance with respect to boards of directors. The scholars have carried out the studies
spanning a period of about thirty years. The theoretical frameworks upon which this review is based are the agency, stakeholder, resource dependence and stewardship theories, which give varied views on the presence of information asymmetry that the agent (in this case, the directors and managers) is likely to pursue interests that may hurt the principal, or shareholder among others (Fama and Jensen, 1983). The theories form the foundation of the role and effectiveness of boards of directors in strategic decision-making.

The Agency theory is based on the principal-agent framework. Jehnsen and Meckling (1976) viewed organizations as sets of explicit and implicit contracts with associated rights. Separation between ownership and control of corporations characterizes the existence of agency relationship between the board who represent the shareholders and the management who represent the board and other stakeholders.

In the context of corporations and issues of corporate control, agency theory views corporate governance mechanisms especially the board of directors, as being an essential monitoring device to try to ensure that problems that may be brought about by the principal-agent relationships are minimized (Moldoveanu and Martin, 2001; Mallin, 2007). According to Blair (1996), managers as agents must be monitored and institutional arrangements made to assure checks and balances are in place to avoid abuse of power.

Agency theory suggests that boards should consist of outside and independent directors. It also proposes that the position of the board chairman and chief executive officer should be separate (Daily and Dalton, 1992; Balta, 2008). When the separation of those two roles is violated, mainly when the chairman is under the influence of the chief executive officer, the agency cost becomes great and the firm will suffer in the financial and control market (Dalton et al., 1999; Balta, 2008). Although Agency Theory is the dominant perspective in corporate governance studies, it has been criticized in recent years (Blair, 1996; Hoskisson et al., 2000; Fan, 2004) because of its limited ability to explain sociological and psychological mechanisms inherent of the principal-agent interactions (Davis, 1991).

The Stakeholder theory takes account of a wider group of constituents rather than focusing on shareholders (Mallin, 2007). It examines the firm in the context of a wider range of implicit and explicit stakeholders having legitimate expectations, urgent claims, and/or power regarding the firm (Jones and Politt, 2002a; Jones and Politt, 2002b). Stakeholder theorists suggest that managers in organizations have a network of relationships to serve that include the suppliers, employees and business partners (Clarkson, 1995; Abdullah and Valentine, 2009). This theory focuses on managerial or strategic decision-making and suggests that the interests of all stakeholders have intrinsic value, and no sets of interests are assumed to dominate others (Clarkson, 1995; Abdullah and Valentine, 2009).

According to Stewardship theory, Directors are regarded as the stewards of the company assets and are pre-disposed to act in the best interest of the shareholders (Mallin, 2007). Stewardship theory relates to the board’s task of providing support and advice to management (Davis, 1991). The stewardship theory has its roots from psychology and sociology. According to Abdullah and Valentine (2009), stewards are company executives and managers working for the shareholders. The stewards protect and make profits for shareholders and are satisfied and motivated when organizational success is attained. Stewardship theory argues that the effective control held by professional managers empowers them to maximize firm performance and corporate profits. Regarding the leadership structure, stewards maximise their utility because they achieve organisational rather than self-serving objectives (Davis, 1991; Balta, 2008).

Stewardship theorists contend that superior corporate performance is associated with the majority of inside directors because; first, they ensure more effective and efficient decision-making and second, they contribute to maximise profits for shareholders (Kiel and Nicholson, 2003). Consequently, insider-dominated boards are favoured for their depth of knowledge, access to current operating information, technical expertise and commitment to the firm.

Proponents of resource dependency theory have attempted to explain organisations in terms of their interdependence with the environment (Pugh and Hickson, 1997, p. 62; Pfeffer and Salancik, 1978). Some scholars have argued that the provision of resources enhances organizational functioning, a firm’s performance and its survival (Daily et al., 2003). This theory concentrates on the role of Board of Directors in providing access to resources needed by the firm (Abdullah and Valentine, 2009). Hillman et al. (2000) contend that resource dependency theory focuses on the role that directors play in providing or securing essential resources to an organization through their linkages to their external environment. This theory states that organizations are interdependent with their environment and or other organizations for their survival since they are not self-dependent (Pugh and Hickson, 1997).

The theory thus proposes that corporate board is a mechanism for managing external dependencies (Pfeffer and Salancik, 1978), reducing environmental uncertainty (Pfeffer, 1972) and environmental interdependency. Resource dependency theory also views outside directors as a critical link to the external environment (Pfeffer and Salancik, 1978). The theory predicts a relationship between the extent of uncertainty and dependence and the composition of the board with respect to boards’ size and proportion of outside board
Table 1: Theories of corporate governance

<table>
<thead>
<tr>
<th>Board role</th>
<th>Theoretical basis</th>
<th>Effective Boards</th>
<th>Representative studies</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agency theory</td>
<td>Control and supervision</td>
<td>Economics and finance</td>
<td>Independent (outsider dominated board, no social, personal, or professional ties between board and CEO/management)</td>
</tr>
<tr>
<td>Stakeholders</td>
<td>Uphold interest of all stakeholders</td>
<td>Management</td>
<td>Maximizing the shareholder returns is not the sole objective. Interests of all stakeholders should be equally honoured</td>
</tr>
<tr>
<td>Resource dependence</td>
<td>Links the firm to the resources required to maximize performance</td>
<td>Organizational theory and sociology</td>
<td>Large board Board member diversity</td>
</tr>
</tbody>
</table>

Source: Adapted from Castro et al., (2009)

members.

The foregoing theories of corporate governance that affect boards of directors roles are summarized in table 1.

Integration of the theories of corporate governance

Hendry and Kiel (2004) explain that the choice of a particular theoretical perspective depends on contextual factors such as board power, environmental uncertainty and information asymmetry. To gain a greater understanding of the board's role in strategic decision-making, there is need to integrate different theories rather than consider a single theory alone. All the theories assume that the board and management formulate strategy through a partnership approach (Hendry and Kiel, 2004). These perspectives arise from the three main roles identified by the literature within boards of directors – control, service, and resource dependence (Johnson et al., 1996).

Board of directors

Board of directors as an area of study has generated a lot of interest among researchers (Tricker, 2009). Scholars and practitioners as well as policy makers have for the last two decades debated on the role of boards of directors as one of the key pillars of corporate governance (Mallin, 2007; Tricker, 2009). They have asserted that boards of directors’ attributes may influence strategic decision-making and subsequently firm performance (Cutting and Kouzmin, 2002; Van den Berghe and Baelden, 2005). The increasing interest in the influence of board of directors’ attributes is because of the board’s roles in creating linkages to other resource dependencies (Balta, 2008; Bathula, 2008). Many studies have attempted to identify the attributes or mechanisms of the boards of directors that lead to improved strategic decision-making and corporate performance (Van den Berghe and Baelden, 2005; Barako et al, 2006; Balta, 2008; Kajola, 2008; Maharaj, 2009). However, the results of these studies have been inconclusive in terms of decision-making processes and board involvement.

The composition and demographic characteristics of the board have been examined in numerous studies as the key attributes of the board of directors (Westphal, 1999). Board composition subsumes the individual director’s potential to solve the various tasks (Daily et al., 1999) and has generally been analyzed by examining the demographic characteristics of the board (Rindova, 1999). Board size and board composition have long been regarded as important components of the governance process for firms in business as it defines the affiliation of each director as either inside or outside board member (Lawrence and Stapledon, 1999; Boone et al, 2007; Tricker, 2009).

Resource dependency theory suggests that boards with interlocking directorships are intended to link the companies with the external environment and resources to maximize their performance (Kiel and Nicholson, 2003; Hendry and Kiel, 2004; Balta, 2008). Some researchers believe that interlocking directors serve as a source of information on business (Davis, 1991). The theory of interlocking directors suggests that interlocks exist for class integration and high strategic interdependence of organizations (Penning, 1981). Researchers have found contradictory results regarding the impact of interlocking directors on firm performance.

Boards of Directors have been known to influence the strategy of their firms in two main ways: through “decision control” activities such as evaluating past decisions made by top management, performing high-level reviews of strategic plans, and monitoring executive and firm performance (Fama and Jensen, 1983) and through “decision management” activities such as ratifying strategic proposals, asking probing questions about important issues, and helping to formulate, assess, and decide upon strategic alternatives (Judge and Zeithaml, 1992). Decision control is the board’s most fundamental responsibility, but decision management is not traditionally considered a necessary board role (Fama and Jensen, 1983). Indeed, the results of past surveys of corporate directors affirm that while most boards review

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strategy and executive performance (Harrison, 1987), few boards play a significant role in strategic decisions (Mace, 1986). However, as relatively few studies have targeted board strategic involvement, our awareness of its antecedents and consequences is limited (Finkelstein and Mooney, 2003).

**Corporate governance and firm performance**

Corporate performance relates to the way and manner in which financial resources available to an organization are judiciously used to achieve the overall corporate objective of an organization. Organizations have different ways of measuring their success. The level of success is generally based on organizational performance.

Moseng and Bredrup (1993) asserted that organizational performance is the integration of three broad dimensions: effectiveness, efficiency and adaptability. The measure of firm performance can be evaluated from the perspective of various stakeholders (Kaplan and Norton, 1992). The various measures of performance are either quantitative or qualitative. Quantitative measures include return on investments (ROI), return on assets (ROA) and dividend yield (DY) (Ongore, 2008). Qualitative measures, on the other hand, include market share, employee and customer satisfaction and corporate image or reputation. Firm performance is therefore a complex and multidimensional phenomenon in strategic management literature (Balta, 2008).

Many scholars, such as (Leng, 2004) have sought to establish whether various corporate governance mechanisms affect corporate performance. Thus far, research on Boards of Directors has been limited in terms of scale and scope and it is considered to be at an early stage of development (Melyoki, 2005; Kajola, 2008). Abdullah and Page (2009) studied the effect of corporate governance on corporate performance in the United Kingdom’s (UK) 350 listed companies. They found no consistent relationship between governance structure (board and ownership structure) and companies’ market book value.

Balha (2008) suggested that internal governance structures are substitutable and the firms can choose appropriate governance options based on what is right for them. Ongore (2008) conducted a study on the effect of ownership structure, board effectiveness and managerial discretion on corporate performance among the listed firms in Kenya. He concluded that there was no statistically significant relationship between board effectiveness and firm performance. Kajola (2008) in a study conducted in Nigeria of twenty listed firms concluded that there is a positive and significant relationship between return on equity (ROE) and board effectiveness.

Numerous studies (Balta, 2008; Kajola, 2008) have revealed significant association between the Board of Directors’ demographic characteristics and strategic decision-making. According to Pfeffer (1983) demography refers to the composition in terms of basic attributes such as age, educational level, race, length of service and social entity. In a study that examined the effect of corporate governance on the performance of firms in Africa by using both market and accounting based performance measures Kyereboah-Coleman (2007) found that large and independent boards enhance firm value and that combining the positions of chief executive officer and board chair has a negative impact on corporate performance. Boards and indeed top managers have a critical role in the strategic direction and success of organizations. However, their characteristics including age, gender and other characteristics coupled with heterogeneity of the composition of TMTs will affect organizational performance (Kinuu et al., 2012).

**SUMMARY AND CONCLUSIONS**

Corporate governance issues have gained worldwide attention in the last decade with the spectacular collapse of Enron, when the boards of directors of many underperforming firms were reluctantly thrust into the spotlight (Tricker, 2009). In this paper, we have reviewed the relevant theoretical and empirical literature on corporate governance and related them to board of directors’ and corporate performance. The theoretical perspectives of corporate governance in general and boards in particular such as agency, resource dependence, stakeholder and stewardship theories were critically reviewed.

The literature on corporate governance examines the efficacy of firm performance and relates it to boards of directors and various other governance structures. While there is increasing evidence of the failure of certain governance structures to control and motivate managers to increase firm performance, the empirical evidence to date is mixed and gives little coherent evidence for the shape of an optimal governance structure. One explanation is that existing theories have not been sufficiently complete to include all major determinants of good corporate governance. Perhaps there will never be one optimal governance structure because there are differences between two firms, markets, legal regimes or cultures, resulting in highly complex issue of corporate governance. Ultimately governance structure is determined by a combination of the foregoing issues and their dynamics.

A more likely and useful outcome of the on-going debate and research, may be the increasing focus on shareholder interest and concerns, and identification of some widely accepted guiding principles, rather than trying to find some specific mechanisms which are universally applicable, for effective corporate governance. Each organization remains unique in its structure, product, ownership and so governance issues will continue being
as diverse as organizations are. Structuring organizations and indeed applicability of the theories in designing and composing boards will therefore be dependent on the unique position of the firm.

Suggestions for future research
Generally, there is excessively large amount of research among developed countries such as the Europe, America and Asia. Given corporate governance concerns human behaviors and business practices, and the different impact of different institutional environments and culture on corporate governance, there is an urgent need for workable corporate governance model for Africa. In the context of Africa, some areas are worth being further researched into:
- How unique institutional environments in Africa whereby high shareholders and government ownership, weak legal investor protection and lack of active market for corporate control exist have affected corporate governance structures such as board characteristics; and explore alternative models where the roles of foreign institutional investors, fund managers, firm reputation, proxy contest and other voluntary mechanisms may be emphasized.
- There are successful family owned or controlled companies in Africa. More in-depth empirical study on the merits and demerits of family ownership structure and how has it impacted firm value. May be the resource dependency theory can better explain the success of these companies. If so, how corporate governance may evolve in these companies and what can be done to better align the interest of controlling family ownership, continuity in family owned businesses and other shareholders.
- Despite the presumed importance of the director demographic characteristics and board composition as board attributes, very little rigorous research has examined the extent to which independent and outside board members actually monitor and advise top management team (TMT) in strategic decision making processes (Tricker, 2009).
- The degree to which board independence or multiple appointments play a role in monitoring and advising the management team towards sustainable corporate performance requires examination (Carpenter and Westphal, 1999).

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