Corporate Social Responsibility
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Lecture - 34
Theories of Corporate Governance

Welcome back to the MOOC course on Corporate Social Responsibility. My name is Aradhna Malik and I am helping you with this course and in the previous class we talked about what corporate governance is now in this class we are going to discuss some theories of corporate governance we are going to talk about how the concept of corporate governance has evolved and how people have discussed it in various contexts.

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Some theories of corporate governance

- Agency theory
- Resource dependence theory
- Stewardship theory
- Class hegemony theory
- Social comparison theory
- Signalling theory
- Stakeholder approach

So, let us see what we have for you. Some theories of corporate governance in the previous class we talked about the beginning of all of this.

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Where does all this begin (Klein, 1999)

- "In the production-function approach, money capital is treated as a factor of production. The manager's objective is to maximize the difference between total revenues & total costs, with the cost of capital treated simply as another cost (& typically assumed to be exogenous). The residual, 'profit', is retained by the manager."

So, you know we talked about money making, we talked about money capital as a factor of production, we talked about the objectives of the manager and the owners. Now, in this class we are going to define that concept and we will talk about various theories of corporate governance. So, some of the theories under which corporate governance has been discussed is the are the agency theory, resource dependence theory, stewardship theory, class hegemony theory, social comparison theory, signaling theory and stakeholder approach. But we are not going to go to, going to all of these we will be dealing only with four approaches which are the agency theory, the resource dependence theory the stewardship theory and the stakeholder approach and some more are listed here and I would encourage you to go online and try and find out what the other theories are all about.

So, that is your homework for this particular class. Find out what the class hegemony theory is and which part of corporate governance it deals with find out what the social comparison theory is and how does it relate to corporate governance and how does it relate to your lives as managers. Find out what the signaling theory is and maybe you can come up with some more theories about of corporate governance or you know through which corporate governance has been discussed and described, all right.

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Resource dependence theory
(Daly, Dalton & Cannella, 1992)

- "... provides a theoretical foundation for directors' resource role. Proponents of this theory address board members' contributions as boundary spanners of the organization & its environment.[...] In this role, outside directors provide access to resources needed by the firm."
- Board's responsibility is to garner resources from outside the organization & help build outside relations to maximize this.

So, resource dependence theory is the first one that we will talk about and so this is from a paper by Daly, Dalton and Cannella this is not 1992, I am sorry there was a mistake here this is from a paper from 2003. So, I am going to make this correction while talking to you I realized this after I started speaking, but that is absolutely all right, if I were in class I would be doing the exact same thing. So, that is yeah all right. So, resource dependence theory and I think I will have to do that for the others also anyway. Resource dependence theory provides a theoretical foundation for directors resource role. The proponents of this theory sorry yeah, the proponents of this theory addressed board members contributions as boundary spanners of the organization and its environment in this role outside directors provide access to resources needed by the firm.

So, the boards responsibility in according to resource dependence theory is to garner resources from outside the organization and help build outside relations for the organization to the maximum, to maximize this. So, in order to do this the board members are selected among people who have the maximum number of contacts who can finance the organization or bring in more capital or bring in more human resource or form a network or help get more clients. So, that is the resource dependence theory. That corporate governance you know it shows how the organization can be governed using resources from outside and the roles of the director, the roles of the board of directors are defined in light of this belief that resources can be generated from outside the organization in and through contracts or personal efforts of the board of directors. And

the responsibility of the board of directors is to find people to find resources to find money from outside, the organization to bring in financers to bring in peer experts to bring in people who will support the organization to you know to help them get connected to the organization. So, any kind of resource they can find from outside is contracted is brought in is connected with the organization and that is the resource dependence theory.

And that is then and these resources are then connected with the organization and then they are amalgamated with the organization they become extensions of the organization then they may not be brought in, but they are connected in such a way so that the organization can draw upon these resources as and when required. And the board of directors facilitates this transfer of resources from outside the organization to inside the organization. So, that is the resource dependence theory.

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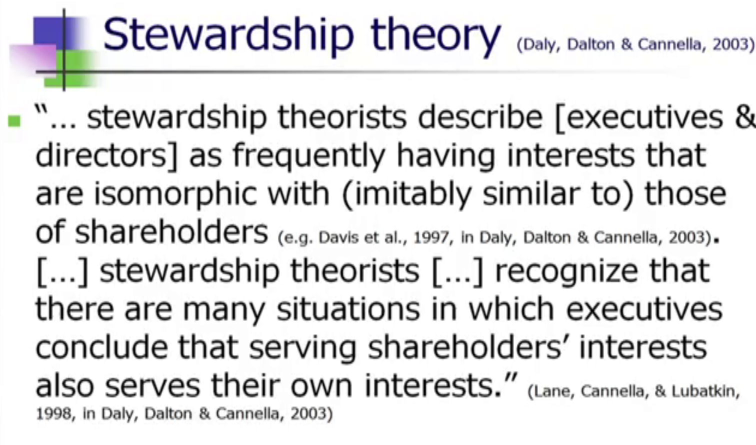

So, stewardship theory, the next theory in this context is the stewardship theory. Now stewardship theorists describe executives and directors as frequently having interests that are isomorphic with or imitably similar to those of shareholders. Stewardship theorists recognized that there are many situations in which executives conclude that serving shareholders interests also serves their own interests now this means that stewardship theory if we look at corporate governance through the stewardship lens we are assuming we are understanding that the stewardship that that if the shareholders if the people who

are connected with the organization because they have invested in it, they have invested money in it they have a money stake in it. Then the if we see corporate governance through this lens we assume we understand that if the shareholders of the organization look after the interests of those who have not invested in the organization or who do not have a financial stake in the organization then the organization will still continue to profit, if they do there if they conduct their activities in a manner that it benefits the people who are connected to the organization who are being affected by the organization.

But may or may not have a financial stake in the organization then through that the interests of the people who have a financial stake in the organization will also be taken care of. So, we serve those who are connected to the organization then the way the organizations activities will shape up will also end up benefiting those who have a financial stake in the organization that is what be stewardship theory suggests. So, if we look at CSR from the stewardship lens or sorry if we look at the corporate governance from the lens of the stewardship theory then we understand that stewardship or that serving others interests will also help serve our own interests.

And this is the theory that forms the basis for the connection between corporate governance and corporate social responsibility. Why is corporate governance necessary, why do we need to look after the organization, why do we need to ensure that the organizations administration is effective and the shareholders interests are looked after? If both are looking after each other if we put a system in place to look after the interests of the shareholders and the shareholders in turn institute a system to look after the interests of the stakeholders then everybody is interest will be taken care of. So, we have a system of governance we have systems and procedures and a structure in place to look after the interests of both.

But the work is being done keeping the interests of the stakeholders who may or may not have a financial stake in the organization and then everybody is interests will be served and we will discuss this more when we discuss the link between corporate governance and corporate social responsibility which is why this module has been included.

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Stakeholder approach (Mason & Simmons, 2014)

- "... facilitates consideration of a wider range of corporate governance issues, contributes to stakeholder management decisions on who & what really counts (Mitchell et al., 1997, in Mason & Simmons, 2014), & extends company director duties to include formal consideration of stakeholder perspectives & agendas."

The stakeholder approach suggests it facilitates consideration of a wider range of corporate governance issues contributes to stakeholder management decisions on who and what really counts and extends company director duties to include formal consideration of stakeholder perspectives and agendas.

So, it facilitates the, it looks at a wider range of corporate governance issues it finds out it this approach is totally concentrated on the stakeholder. It contributes to the stakeholder management decisions on who and what really counts and extends company director duties to include formal consideration of stakeholder perspectives and agendas. It becomes the duty of the through this approach if we view corporate governance through this approach then it becomes the responsibility of the board of directors to identify stakeholders who is important, who is not important, who can be considered a stakeholder which stakeholders the interests of which stakeholders should we keep in mind the interests of which stakeholders should we put on the backburner all that has to be decided.

Because we cannot keep everybody is interests in mind we have to somehow create a balance between the interests of those who are going to directly affect, the profits the interests of those who are putting in the money into the organization and the interests of those who may not have invested financially in the organization who may not be directly affected by the organization, who may not have the power to directly affect the

organization, but who are still being affected or who are still connected with the organization. So, various categories of stakeholders are there we have already talked about this. So, it becomes the responsibility of the board to identify the stakeholders whose needs need to be considered and decide how different stakeholders will be identified and how issues brought up by those stakeholders will be you know prioritized and then how keeping all this in mind the management structure will be created.

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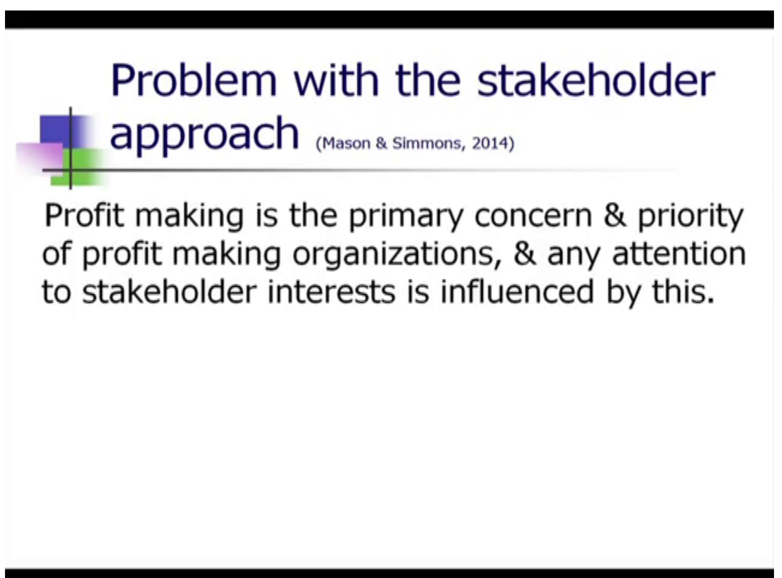

The problem with the stakeholder approach is that profit making is the primary concern and priority of profit making organizations and any attention to stakeholder interests is influenced by this. So, when the board identify stakeholders they have to be very cautious they cannot identify only those stakeholders who are in you know who are only who you know whose presence is only money related. They have to also like I said create a balance between the stakeholders, who are affected financially by the organization, who have the power to influence the organization and who are not in a position to influence the organization, but who are being directly affected by the organization.

And the interests of those who are really like wallflowers who are there, but may or may not have the power to influence decisions may or may not be directly affected by the organization, may or may not be investing in the organization, but are still being affected in some way shape or form. So, many times the interests of these different categories of stakeholders can be in conflict with each other and that is the biggest problem in this

approach. Now the difference between stewardship and stakeholder approach is that when we talk about stewardship we are talking about serving the interests of the stakeholders, stakeholder theory is about identifying stakeholders. So, which of these is function related, which of these is board related, which of these theories becomes board related theory you have to think about that and maybe answer this question on the forum.

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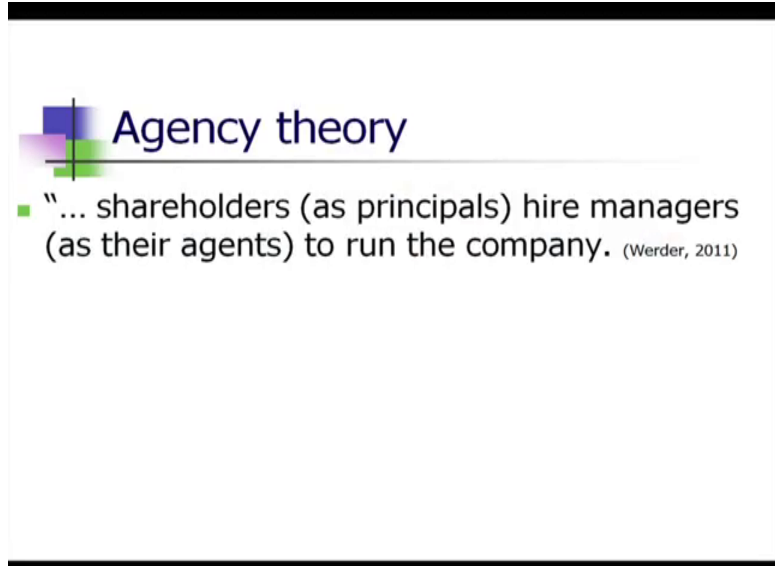

Agency theory, this is this theory is where it all started, but I took this up last because there is a lot more to agency theory than the other approaches that we have discussed. So, according to agency theory the shareholders are principals they hire managers as their agents to run the company. So, the owners hire people who are trained qualified, who have the time, who have the physical capacity to run the organization for them, but these are the people who have who really own the company according to the agency theory someone owns and someone controls somebody owns the company, somebody controls the way the company is being run shareholders own the company they appoint managers as their agents they hire managers right from the CEO to the frontline worker to control what the company does or to make the company run.

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Someone owns, someone controls

- "… a variety of incentive mechanisms to control the behavior of managers, focusing mostly on compensation, the composition of the board of directors, & the market for corporate control as the three primary control issues"

Now, according to the agency theory it includes a variety of incentive corporate governance includes a variety of incentive mechanisms to control the behavior of managers focusing mostly on compensation, the composition of the board of directors and the market for corporate control as the three primary control issues.

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Agency Theory (Contd.)

- "Principal-agent theory postulates that by delegating the management of companies to managers (agents), the owners (principals) have to create mechanisms to align the agents' interests with their own." (Machold, Ahmad & Faquhar, 2008)

Principal agent theory postulates that by delegating the management of companies to managers the owners have to create mechanisms to align the agents interests with their own biggest problem here - the owners are the shareholders, they appoint managers who

run the company. So, the control lies with the managers the shareholders own the organization. So, they have to create a mechanism if they leave it all to the managers they are not going to get anything. I am not saying that people will be unethical that would be the natural tendency.

But if they really want to maximize profits and they want management run their way then they have to because they are after all they own the company. So, they have to put a mechanism in place by which the interests of the managers align with the interests of the board. So, that they are all on the same page and they are all serving the interests of the organization and in turn being benefited by the output of the organization in a similar manner.

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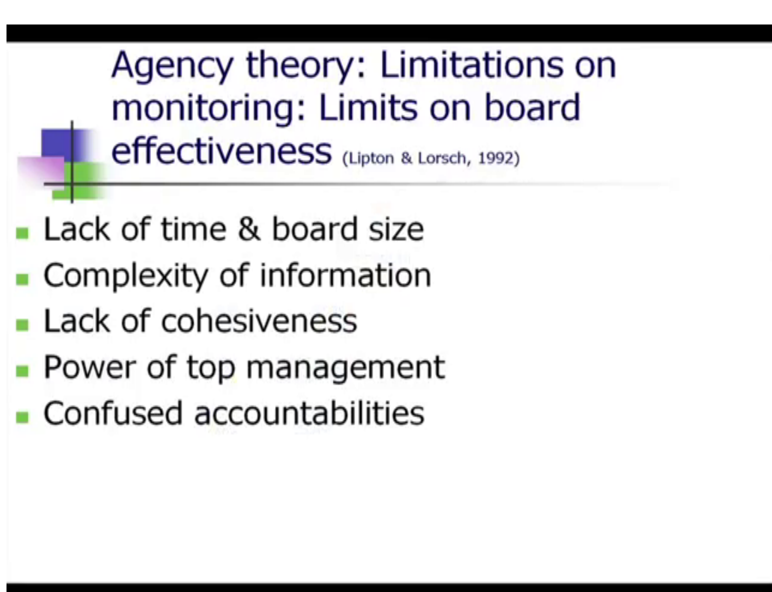

Now, the limitations on monitoring are or you know the boards job is to monitor, but there are some limitations on board effectiveness and these limitations are lack of time and board size the board is people who have you know they meet say maybe 8 times in a year that is what was mentioned you know in this paper sometimes more, but approximately research has suggested that they meet 8 to 10 times a year.

So, and the number of people on the board that is one issue, how much time do they have for the company, how much time are they willing to invest, how the how much time are they able to invest complexity of information after all they are not dealing with issues day in and day out, they are not dealing with things day in and day out. So, the big

problem here becomes what you know the big problem here is how they are going to manage the issues or their understanding of the issues the company is facing. Then the complexity of information lack of cohesiveness, they could have different interests, they could have different agendas, they could have different ideas about different things, they could have different priorities.

So, the issue here is where do they actually bond with each other or do they just come there and talk and then go, after all their company they own a stake in the company. So, everything that the company does influences that stick. But their importance or their attention to that stake how much how important do they think that stake in the organization is and do their interests match or not. Power of the top management how much power have they given to the top management is another issue here. The confused accountabilities who becomes accountable to whom that becomes another issue with the monitoring.

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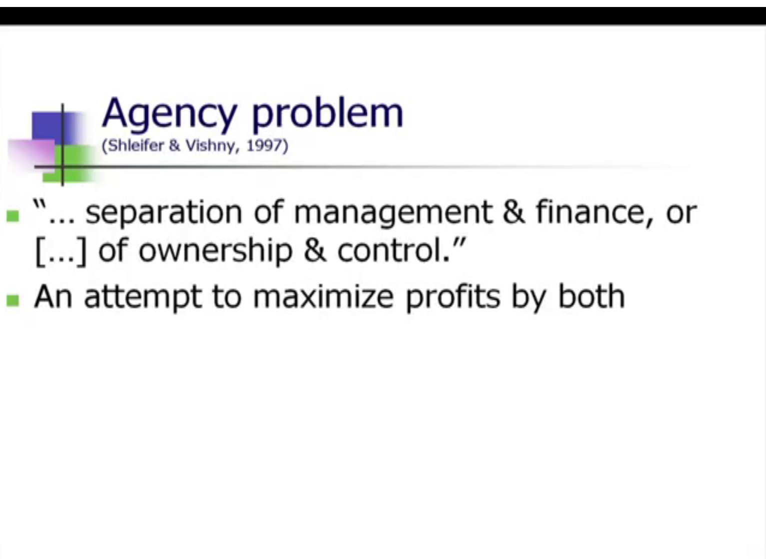

Agency problem is the separation of management and finance or of ownership and control. The problem arises where both the ownership the board and the managers try to maximize their own profits.

So, if the board has to maximize its own profits then the managers do not get very much, but the managers will not want to communicate how much or what is left for the board to the board if their interests are not aligned. So, both are trying to maximize the what they

make out of their or out of the company which means the board wants definitely wants a share of the pie and the managers are being paid salaries and the board gets what a share of whatever is left after the salaries of the management are paid and the other expenses are paid. So, both are trying to maximize their profits and that is where the agency problem starts coming up.

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- People who own the company are not the same as people who run the company. People who own the company (shareholders) have different priorities and different stakes than people who run the company on a salary (executives).

Why does the agency problem arise? People who own the company are not the same as the people who run the company. People who own the company have different priorities and different stakes than people who run the company people who own the company have different priorities and different stakes than people who run the company on a salary and that is how this problem arises.

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How does the agency problem influence CG? (O'Connor & Rafferty, 2012)

- "Shareholders have the ability to diversify away firm specific risk because they can hold a broad portfolio of assets. In contrast, much of an executive's wealth in the form of salary, perquisites, & professional reputation is directly tied to the firm. Hence, executives are usually more risk averse than shareholders, so executives will usually prefer a strategy that emphasizes low-risk/ low-return assets over high-risk/ high-return assets. When agency problems exist, the set of customs, rules & institutions known as corporate governance will determine the relative importance of these 2 different sets of preferences in determining corporate policy. If the agency problem is severe enough, then executives may reduce risky investment strategies (like innovative activity) in favor of much less risky investment."

Now I am going to read this I am sorry there is too much on this slide, but this is really really important. So, I just took it as it is from the paper by Oconnor and Rafferty. Now how does the agency problem influence corporate governance? Shareholders have the ability to diversify away from specific risk because they can hold a broad portfolio of assets in contrast much of an executives wealth in the form of salary perquisites and professional reputation is directly tied to the firm hence executives are usually more risk averse than shareholders. So, executives will usually prefer a strategy that emphasizes low risk low return assets over high risk high return assets, when agency problems exist the set of customs rules and institutions known as corporate governance will determine the relative importance of these two different sets of preferences in determining corporate policy.

If the agency problem is severe enough then the executives may reduce risky investment strategies like innovative activity in favor of much less risky investment. Now what does all this mean I wanted to give you all of this and I wanted to read out all of this for your benefit. So, what does all of this mean we come to the comparison later? Now all of this means that the shareholders have you know shareholders have a lower risk in the organization they hold a broad portfolio of assets they have a lot of assets there and that is why they are on the board of directors. So, behold a broader portfolio they have much more to gain from the company than do the executives, but the executives are at a higher risk.

So, they have in contrast much of an executives wealth in the form of salary perquisites and professional reputation is directly tied to the firm. Something goes wrong with the firm the people running the firm will be affected directly by it their salaries could be affected their professional reputation is affected that perquisites could be affected that you know so anything that the firm faces will have an impact directly on the executives and the senior you are the more risk you have if you are a paid salaried employee of the organization including the CEO very very stressful job. So, everything that the company does reflects on what the CEO makes, what the management makes, what they get out of the company.

So, that is what happens here anyway. So, their reputation is at stake when we talk about the company when we talk about the performance of the company and that is why the executives the management is much more risk averse they are not willing to take higher risks as far as innovations in the organization are concerned in as far as the work of the organization is concerned. As compared to this the shareholders are you know they are open to taking risks they are open to they have lesser at stake.

So, they say at the most we will not get this much profit, but they are not the ones who are directly running the company. So, if something goes wrong the blame goes directly to the person who has taken those decisions with the result the stakeholders or the shareholders are willing to take higher risks because they know that if their risk is beneficial if the outcome of the risk they have taken is positive then they stand to gain a lot more. So, they are not as risk averse as the executives are and that in turn influences what the company does the decisions that they make etcetera. So, this it really comes up because the people who own the company and the people who are running the company are two different sets of people whose interests are different who are only tied together by way of profits or by way of money. So, that is how this shapes up.

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Comparison of various theories of CG
(Chambers et. Al., 2013)

	Agency	Stewardship	Resource Dependency	Stakeholder
Composition	•Representatives of owners •Tendency to homogeneity •Tendency to small boards	•Unitary •Tendency to homogeneity •Tendency to small boards	•Experts, boundary spanners •Balance between homogeneity & heterogeneity •Board size varies	•Representatives •Tendency to heterogeneity •Tendency to large boards

Now, comparison of the theories that we have discussed with reference to composition. The agency theory includes representatives of owners or it talks about representatives of owners the tendency to homogeneity there is a tendency to small boards. So, the board of directors includes the, you know either the owners themselves or people who are their representatives the boards could be homogeneous and there is a tendency to have smaller boards. As far as stewardship is concerned the composition of the board of directors could be unitary the tendency is again towards homogeneity.

Because the interests are the same or they need to be on the same level and there is a tendency to again have smaller boards. So, they can feed in the interests of the or they can connect with the interests of the stakeholders as far as resource dependency theory is concerned the board is composed of experts boundary spanners people who can actually go out and find people who can bring in resources. So, the board of directors would comprise of people who are able to do that who have that kind of network. There needs to be a balance between homogeneity and heterogeneity because the higher the diversity in the board the higher the chances of getting a diverse pool of resources that can be fed into the organization and help the organization to grow.

The board size could vary depending on what is required by the organization. As far as the stakeholder theory is concerned excuse me again the composition of the board is representatives of the owners there is a tendency to heterogeneity because they need to

look after the interests of stakeholders. So, they need to find out what you know who needs to be kept in mind then there is a tendency to have larger boards who you want representation from different aspects or different facets of the organization.

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Comparison of various theories of CG (Contd.) (Chambers et al., 2013)

	Agency	Stewardship	Resource Dependency	Stakeholder
Focus	•Supervision of management •More focus on compliance •Type of fiduciary governance (Guarding resources & their use) •Monitoring of performance against targets & objectives •Conformance of board task	•Strategic thinking as task •More focus on improvements in performance •Type 2 strategic governance (Focus on performance as opposed to conformance) •Use of resources	•Policy formulation as board task •Type 3 Generative governance (Leadership & development)	•Supervision of management •Focus on compliance •Type 1 fiduciary governance •Monitoring of performance against targets & objectives •Conformance as board task

The next one is the focus of board activities or corporate governance. If we look at corporate governance from the agency lens, then the board is required to supervise the management there is more focus on compliance by the management than running the organization the management is expected to comply with the decisions taken by the board. There is a type of fiduciary governance which includes guarding resources and their use. So, it is the boards responsibility to guard resources and they are used by putting a very strict monitoring mechanism in place. Their job is to monitor the performance against performance of management against targets and objectives and they require conformance of board tasks. Now when we look at stewardship theory the focus of the board becomes strategic thinking, the task of the board is to think strategically then there is more focus on improvement in performance type two strategic governance the focus on performance as opposed to conformance.

So, they are not looking so much towards compliance as the quality of performance of the management, they are focusing on improvements in performance, they are thinking strategically they are trying to find out how they can serve the interests of the stakeholders and how that can serve their own interests also. Then resource dependency

theory then as for as resource dependency theory is concerned the policy formulation becomes a task that is the board task they need to formulate policies, so that in order to find out what resources they can get and the governance is type three generative governance which is leadership and development they needs to or they want to find out how to constitute the board - how to constitute the management in such a way that leadership evolves or the managerial work the organization they focus on the development of the organization.

Then stakeholder theory the focus is on supervision of management, focus is on compliance by the management. They again have type one fiduciary governance which is guarding resources and their use because they want to take make sure that the interests of the stakeholders are looked after and stakeholders also want some accountability they again monitor performance against targets and objectives and the board task is conformance here.

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Comparison of various theories of CG (Contd.) (Chambers et al., 2013)

	Agency	Stewardship	Resource Dependency	Stakeholder
Dynamics	•High challenge •Controlling •Critical style to achieve goals	•Appreciative style to achieve goals •Collaborative •Well-functioning board committees	•Predominantly external focus	•Predominantly external focus •Tendency to be active in relation to sectional or political interests

As for as dynamics are concerned and if we look at corporate governance through the agency perspective it is a high challenge type of task, their job is to control and critical style of governance to achieve goals they need to, they want to find out where things are going wrong so they can fix them.

As far as stewardship is concerned the style is appreciative to achieve goals, they are trying to be collaborative and they have well functioning board committees not very high

challenge and not very laid back also. Resource dependency the focus is primarily external they are looking outside the organization to get their resources and then as far as stakeholders stakeholder theory is concerned the focus is again predominantly external to find out who can be affected by the organization and how their interests can be taken in mind or they their interest can be kept in mind and looked after through the governance of the organization. The tendency is to be active in relation to sectional or political interests. So, that is how these three, these four theories compare as far as the tasks of the tasks of various boards are concerned.

Now that is all we have time for in this lecture, we will continue with some more discussion on corporate governance in the next class.

Thank you very much for listening.