The Theoretical Framework for Corporate Governance

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Corporate Governance is an old problem!

"The directors of such [joint-stock] companies, however, being the managers rather of other people's money than of their own, it cannot well be expected, that they should watch over it with the same anxious vigilance with which the partners in a private co-partnery frequently watch over their own. Like the stewards of a rich man, they are apt to consider attention to small matters as not for their master's honor, and very easily give themselves a dispensation from having it. Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company".

- ***Adam Smith**, quoted by Jensen and Meckling (1976).*

Essence of the Corporate Governance issue

Needs a clear answer to the following questions;

On what basis should key decisions be taken in an organization?

In an organization, 'whose' interests are paramount and should guide decision making?

What is required:
A theoretical framework to clearly guide the Board of Directors (BoD) in an organization so that they can take the 'right' decisions.

Alternative Frameworks for Corporate Governance

Serial No.	Theoretical Framework	Basic Discipline	Year of Origin
1	Agency Theory	Economics	from 1930's onwards
2	Stakeholder Theory	Management	from 1970's onwards
3	Stewardship Theory	Psychology & Sociology	from 1990's onwards

Agency Theory

- The essence of the agency problem is the separation of management and finance or, as defined in more standard terminology, the separation of ownership and control, Shleifer and Vishny (1997).

- Historically, corporate governance evolved as a mechanism to deal with the consequences of the agency problem. The largely popular Anglo Saxon Model of corporate governance is based on this theory.

- CG has a very narrow focus under agency theory, *"… how to assure financiers that they get a return on their investment".* Shleifer et al (1997).

Stakeholder Theory

- Its origins in the theory of corporate governance can be traced to Freeman (1994) who defines stakeholders as *"any group or individual who can affect, or is affected by, the achievement of a corporation's purpose".*

- The focus of the stakeholder theory is articulated in two core questions formulated by Freeman (1994).
  - Firstly, what is the purpose of the firm?
  - Secondly, what responsibility does management have to stakeholders?

- Examples of this approach range from Ansoff's (1987) thinking in the 1960s to Michael Porter's (1980) conceptions of industry analysis in the 1980s and the work of Kaplan and Norton (1992) on balanced scorecards in the 1990s.

Stewardship Theory

- Stewardship Theory has its roots in psychology and sociology.
- Davis, Schoorman &Donaldson (1997) *"a steward protects and maximizes shareholders wealth through firm performance, because by so doing, the steward's utility functions are maximized".*
- In this perspective, stewards are company executives and managers who work for the shareholders and protect and make profits for them.
- The stewardship perspective suggests that stewards are satisfied and motivated only when organizational success is attained.

Trusteeship-an ideal goal !

- The Gandhian concept of Trusteeship is not only in perfect sync with, but goes much farther than, the modern expectations of corporate stewardship; it stands for caring for other peoples' money and resources entrusted to the care of corporate directors and executive management and is also sensitive to the broader needs of the society.

- Increasing evidence of migration towards a more inclusive model of governance based on Trusteeship ; Balasubramanin (2008) .

- *The primary challenge with the Trusteeship Model is that it cannot be implemented by prescriptions alone but, to succeed, needs to be accompanied by transformational change of the hearts and minds.*

Complexities of the modern organization

- Bain & Company, (1999) reported a churn rate of 76% among shareholders in US companies- a rate six times greater than in 1960.
- With short shareholder longevity, the dilemma before the board members in modern organization is to decide for whom the strategy should be set - i.e. is the strategy aimed to benefit the investor who holds the shares today, or the one who is likely to hold them tomorrow? Or, one who may hold the shares in three years' time?
- 'Executive Churn', coined by Bennis and O'Toole (2000), has been increasingly used to describes the brevity of CEO tenure and the realization that an incoming CEO usually has a two year period to get it right before there is either voluntary or involuntary churn at the top.
- Increasingly and, perhaps influenced by their own concerns regarding their survival, CEOs are taking decisions which are guided by their own survival instincts rather than taking decisions that would be beneficial for the organization in the long run.
- Collins, Jim (2001) has suggested that whenever we consider the return on a stock in anything less than a five-year horizon, we are confusing the concepts of price and value and a shortsighted focus on price would inevitably lead to the decline of great companies.

Limitations of the existing theoretical frameworks.

- With the lines between agent(s) and principal(s) getting blurred the governance model based on the Agency Theory runs into severe limitations.
- However, the Agency Theory does help the Board of Directors in finding solutions to a narrower problem of corporate governance of how to keep managers from diverting corporate funds for private purposes.
- Stakeholder Theory fails in determining the difference between means and ends – when everything (the objectives of all the stakeholders) is a goal then nothing really is the goal !
- Under Stewardship Theory, directors see their roles as being stewards of particular interest groups only; for example when a major shareholder secures a seat on the board, its appointed director will understandably be tied to that shareholder's aims, whatever company law might say.
- These frameworks address the 'why' of Corporate Governance but do not provide an answer to the 'what' (to do) of Corporate Governance and provide limited guidance to the BoD in taking key decisions.

We lack an encompassing and unifying theory of corporate governance that would guide the Board of Directors in taking key decisions.

Organization as a organism

- There is an opportunity and need to evolve formal structures which are not focused on transitory shareholders and managers and are not aimed at creating short term gains for them.

- Instead, the energies within the organization need to be re-focused on creating great companies that build lasting value.

- The focus of any robust theoretical basis for corporate governance needs to shift from one that aims to balance between the interests of the various stakeholders to one that focuses on the organization and on creating enduring benefit for the organization.

- Using the framework of viewing an 'organization as an organism' - developed by de Geus, Arie (1997) –provides the appropriate theoretical basis for Corporate Governance in an organization.

Organization as a organism .....continued.

- According to de Geus (1997), companies are living organisms that are animated by their histories and the learning, skill and commitment of the people who work in them.

- de Geus (1997) starts from the premise that an organization's first loyalty is not *to any individual stakeholder(s),* but to itself and its continued existence and growth and emphasizes on the need of organizations to focus on the factors that would ensure its longevity.

- In developing his framework, de Geus has drawn up the work of evolutionary biologists who have defined an organism as an entity that is made up of different parts that cooperate well, but for an overall common purpose, and do so with minimal conflict.

Organization as a organism …..continued.

Based on a study of long living organizations, carried out while he was at Royal Dutch Shell, de Geus (1997) identified the following four characteristics that increase the longevity of organizations;

- ***Sensitivity to the environment***, representing a company's ability to learn and adapt.
- ***Cohesion and identity***, which are aspects of a company's innate ability to build a community and a persona for itself.
- ***Tolerance*** and its corollary, ***decentralization*** that are both symptoms of a company's awareness of ecology and its ability to build constructive relationships with other entities, within and outside itself.
- ***Conservative financing*** as a key component in the attribute that enables an organization to govern its own growth and evolution effectively.

A new framework to guide the BoD in Corporate Governance

- The framework of de Geus (1997) helps to create the framework that would guide the independent board members in making the right choice.

- Instead of aiming for creating/enhancing shareholder or stakeholder value, the BoD Members need to only look at improving the longevity of the organization which should become the guiding force for their decisions. Since creating strategic value in an organization leads to increasing its longevity, all strategic decisions must aim to increase an organization's strategic value.

- The concept of strategic value incorporates the aims of all socially responsible investors and the stakeholders as well as the collective aims of all interest groups who are not stakeholders.

- ***It follows as a natural corollary, that any stakeholder objective that is not consistent with growth and longevity of the organization would not add to the strategic value of the organization and the BoD would REJECT the same while taking its decision.***

Summarizing – the question that the BoD Members need to ask.

The ONLY QUESTION to be asked by the BoD members before taking a key decision:

- How does my decision affect the Strategic Value of the organization?
- Does it help to increase the longevity of the organization and ensure its growth?

DISCUSSIONS & QUESTIONS!

THANK YOU