



Corporate Governance and Agency Theory: An Analysis of Literature

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ABSTRACT

For long term sustainability as well as organized functioning of corporate, a strong and effective corporate governance policy is necessary. The research aim is review of literature of corporate governance in Indian context. The review is based on the themes of agency theory, governance policies and norms, degree of corporate disclosure and governance effectiveness. The review examines the efficacy of governance mechanism towards organizational accomplishment. The paper also highlights the principal-agent problem in corporate governance mechanism. This study can provide insights to policy makers towards strengthening the quality of corporate governance for the progress of corporates within nation. It provides information to the executive of multinational firms who take decision to investment in Indian market as well as outlines the knowledge gaps and future research directions to the researcher.

Keywords: *Corporate Governance; Governance mechanism; Agency theory; Corporate disclosure.*

1.0 Introduction

Today corporate governance is one of the most debatable topics and it has been discussed a lot across the globe. In 1999, the concept of corporate governance was first introduced by the Organization for Economic Co-operation and Development (OECD). Due to the happening of various frauds and failures in the corporate sector and prevalent unfairness in the conduct of business, corporate governance has become a subject of serious thought.

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The high-profile collapses of large number of U.S. firms such as the MCI Industries formerly WorldCom and the famous Enron fraud has put a question mark towards corporate governance practices in the corporations. In 2002, the Sarbanes-Oxley Act (SOX) was enacted to restore investors' confidence in the financial markets and the act had a subtle effect on corporate governance in the US. The Act strengthens audit committees, perform internal controls tests, strengthen disclosure etc. to control over companies. The former President of World Bank-James D. Wolfensohn, highlights the significance of corporate governance as follows - "The governance of the corporation is now as important to the world economy as the government of countries". Thus, corporate governance provides a roadmap for company which enhances the confidence among the stakeholders and allows it a company to set realistic goals for accomplishment.

Charreaux and Desbrières (2006) point out that the vital points between stakeholder value and shareholder value. Due to the increase in financial and managerial scams, the corporate outline for transparency and professional management in handling the company's business which make confidence among shareholders. In board term, corporate governance describes as the processes, customs, policies, and laws. Corporate governance act as an administer to control the operational activities of the firms as well as strengthen the relationship among the stakeholders, board of directors and the shareholders. Good corporate governance is an essential standard for establishing the salient investment environment which is needed by competitive companies to gain strong position in efficient financial markets. It is fundamental to the economies with extensive business background and also facilitates the success for entrepreneurship.

Haldar and Rao (2013) point out that the board of directors and the upper management play a vital role in passing on the chain of command and rules to the lower half of the organization. The size and composition of the board also play an important role in the issues raised by corporate governance. According to Arora and Bodhanwala, (2018) corporate governance aims at facilitating effective monitoring and efficient control of business. Perjury in fairness and transparency in operations enhance disclosures for protecting curiosity of stakeholders. In other word corporate governance is a structure based principles which provides best governance in the interest of all stakeholders. It is also promoting corporate fairness, transparency, accountability and directed to control the management. In simply say that a good corporate governance is a good patron.

This paper presents the broad view of corporate governance in Indian context with agency theory from rigorously revision of literature. It gives an overview that the

factors effecting corporate governance effectiveness and mechanism of effective corporate governance how help to solve the agency problems in the organizations.

2.0 Review of Literature

Research on corporate governance has escalated reformist over the years. Corporate Governance in India plays a key role in protecting valuations of a company because the ultimate goal of good governance is to maximize the interest of all stakeholders. Donaldson and Davis (1919) advocated various theories of corporate governance. The development of corporate governance is perplexing which including cultural, legal, ownership, structural differences etc. Some theories may be more pertinent to some countries than others or more relevant at different times depending on an individual country. The key insight of Jensen and Meckling (1976) was to agency relationship and identifies agency costs. Agency relationship is a contract under which the principal engage another person i.e. agent to perform services on behalf of principal and the principal delegate some authorities for deed. The author's point out that there is a tradeoff in the form of agency costs between having more or less insider ownership. Agency costs typically arise in the wake of disruptions such as fundamental conflicts of interest between shareholders and management. Lewellen *et al.*, (1985), advocate that negative returns are most common for bidders in which their managers hold little equity, suggesting that agency problems can be mitigated with incentives. Kaur (2018) point out that corporate governance has been existing from a long time and discuss the history of the corporate governance. The paper highlights the various theories which leads to develop the concept of corporate governance and approaches different models in corporate governance.

La Porta *et al.* (2002) point out that corporate governance as a set of mechanisms through which outside shareholders protect themselves from top management. The Organization for Economic Cooperation and Development (OECD) provides another perspective by stating that corporate governance is the system by which business corporations are directed and controlled and also specifies the rights and responsibilities of managers, shareholders and other stakeholders for making decisions on corporate affairs. Corporate governance provides a frame work to monitor performance and set a objectives for smooth functioning of the operations.

Dhar *et al.*, (2018) in their research paper examine the relationship between the extent of related party transactions (RPTs) and the firm performance and found out the income from related parties are found to be negatively associated with firm performance. Bhasa (2004) defines information asymmetries created by the managerial class due to

shareholder is distanced from management. This arises fractional ownership; the management overseeing day-to-day operations of the firm has greater control to information asymmetries. It is also discussed that strong governance can enhance the transparency of the companies.

According to Henry (2008) the transparency and revelation of information are considered as essential elements of corporate governance. Talking about the disclosure, there are different aspects such as board and management structure disclosure, ownership structure disclosure and financial transparency and information disclosure.

Haldar and Rao (2013) in their research paper discussed the board of directors and the top management play a vital role in passing on the chain of command and rules to the lower half of the organization. Also discussed are the size and composition of the Board that play an important role in the issues raised by corporate governance. The Government of India has taken a variety of steps to enhance the performance of public sector enterprises by means of better corporate governance. In this context that governance reforms have attained significance due to the vital role that public sector enterprises carry on to play in the Indian economy (Som, 2013). Andrews *et al.* (2017) advocated that firms with feeble corporate governance measures were more likely to dish out more favorable executive perquisites than other firms. These firms were also more likely to be plagued with agency problems.

Corporate culture is based on certain principles, values and ethical business. Corporate rules get top priority in the globalized world because the present corporate world moves the fast-emerging globalized system. In this context the governance policies takes vital roles as discussed by Sushmitha (2019). Corporate governance explains earlier for the protection of the investors and also realized that it was essential to the smooth functioning and survival of a firm Srivastava, Das, and Pattanayak (2018).

Anginer, *et al.*, (2018) discuss the corporate governance policies and its impact on various stakeholders like employees, creditors, debtors, shareholders etc. The impact of the corporate governance on the company in regards to cost of capital, salaries, after tax profits, operational risks, financing policies etc. also discussed in their research paper. Singareddy *et al.* (2018) in their paper discuss about the corporate governance and the Board of directors role in the corporate governance structure. Also discussed are the corporate governance in the big, small, emerging, politically reserved or open Asian economies.

3.0 Objectives of the Study

By the study of literature, the study seeks to discuss corporate governance from various perspectives and tries to link it with the agency problems and corporate governance. It gives an overview of the factors affecting corporate governance effectiveness and the mechanism of effective corporate governance to help solve the agency problems in the organizations.

3.1 Data and methodology

In undertaking this study the author conducted a meticulous literature review including the use of library and e-journals. The research study based on desk research - methodology as well as library research process. In this regard various journals and research papers and paper articles apropos to corporate governance and agency problem mechanism have been reviewed in this study.

3.2 Corporate governance in India

The 'Corporate Governance Concept' resides in India from the Kautilya's *Arthashastra* time. From primeval period, Kautilya's *Arthashastra* discussed the good governance policies, all administrators, including the king were considered servants of the people. Good governance and stability were completely linked. But today, corporate and shareholders replace them but the principles still remain same, unchanged i.e. good governance. The concept of corporate governance emerged in India after the second half of 1996 due to economic liberalization and deregulation of industry and business. With the changing time companies need to accountabilities towards stakeholders as well as customers with focus on both economical and social aspect. In India, corporate governance is a set of policy and procedures which form the framework of a company's operations and accord with various stakeholders such as management, employees, government, customers and industry bodies. The policies should endorse the principles of transparency, integrity, ethics, and honesty which provides a strong and balanced economic.

The need for good corporate governance is necessary to enable companies operate more efficiently, access to capital, mitigate risk and safeguard stakeholders. A company has to achieve its objectives in relation to its regulatory authorities, stakeholders etc. by implementing corporate governance policies. The reforms in corporate governance have significant importance for India which is moving towards a more transparent and accountable system of economic governance (Sanan and Yadav, 2011).

In India, corporate governance have been debated for a long time in own ways. Both promoters and regulators made effort to bring the right level of transparency into the system through god governance policies. Good corporate governance always serves as a powerful tool for sustainability in the changing business environment.

3.3 Corporate governance and company

In Indian scenario, corporate governance ensures strict and well-organized application of management practices along with legal compliance. The top management that consists of the Board of Directors is responsible for governance, proficiently managing the activities of companies to ensure stability and growth of the business, and maintaining the reputation and reliability for customers and clients. The Indian Companies Act, 2013 introduced innovative measures to appropriately balance legislative and regulatory reforms for the growth of the enterprise. The rules and regulations are measures that increase the involvement of the shareholders in decision making and introduce transparency in corporate governance, which ultimately safeguards the interest of the society and shareholders. The Companies Act, 2013 consists of 29 Chapters, 470 Sections, 7 Schedules and published all the rules and regulations and notification issued by the Ministry of Corporate Affairs (MCA), Government of India. Every company has to fulfill the provisions relating to Board constitution, Board meetings, Board processes, independent directors, audit committees, etc, The Ministry of Corporate Affairs (MCA) 2019 February obligatory all companies to reconfirm their active, photos of the company and its registered office with in-compliance status by filing particulars.

3.4 Agency theory and corporate governance: Linkage

The agency theory of corporate governance is entirely straightforward which states that corporate executives have a moral and financial duty to act in the best interests of the firms. Agency theory sometimes quite challenging when the corporate facing the nuisance towards stakeholders interest. In the present corporate, an agency theory wherein the owners of the funds invest their money in a company that is managed by the top management with the objectives of maximize of shareholder's interests. In an organization top management should act in the best interest of stakeholders who especially own equity. It states that corporate executives have a moral and financial duty to act in the best wellbeing of the parties they serve. McColgan (2001) point out the agency theory and corporate governance in a very broader séance. In his research paper he highlights the area that where the interests of managers radiate from those of the interests of shareholders also cover the relationship among manager and shareholders.

The Principal and agent problem are not similar in all firms rather differ from firm to firm and also differ in culture Himmelberg *et al.* (1999). The agency problem can be reduced by the help of effective corporate governance mechanism and which help in reducing the agency cost and the ownership problems in the firms. The governance mechanism is designed in such a way so that the corporate environment is more result oriented (McColgan, 2001).

Risk preference is a major source of conflict between the principal and the agent. Shareholders are associated with the market risk as well as the risk of stock returns but managers are concerned with the firm risk because survival depends on the firm risk. The effective corporate governance can implement these devices which includes the composition of the board of directors, increase number of shareholders, and maximize the inside ownership by providing different financial policies and compensation packages. Novikova (2004) points out that the major participative elements in the firms are board of directors, the shareholders, and the managers. Also discussed are the policies and procedures used to make decisions on corporate affairs of the firm. He designed his research on the definition of OECD which defines corporate governance - in narrow as well as broader sense. In narrow sense corporate governance is associated with the relationship between a company and its shareholder whereas in broader sense the relationship consists of a company with society. The conflict between the principal and agent arises when the interest of both the parties is differing and the firm tries to minimize these situations through concrete corporate governance policies. Corporate governance policies can be used to change the rules as per interest of both the principal and agent. Agency theory emphasizes what interests motivate the agent to act and discouraging moral hazard. A control mechanism helps firms develop better governance policies and procedure to accomplishment of stakeholders' interest.

3.5 Agency control mechanisms and corporate governance

In an organization corporate governance is indispensable to meet the strategic goals. To achieve this objective the principal-agent relationship takes vital role. The principal is a party that legally appoints the agent and agent do all the activities on its behalf. When the agent serving the activities for its own interest or each party has different motivations or two parties at odds with each other, the conflict occurs between the principal and agent which leads to the question mark governance policies of the organization. The agency control mechanism is developed to control over conflict between the principal and agent. The different agency problems faced by the firms due to the conflict between the principals and agents and the governance mechanisms alleviate through the mutual monitoring, shared purposes and rules, proper share of the task

among them. Fjeldstad *et al.* (2012) point out the peer-based control mechanisms which define characteristics of collaborative community governance, contrary to the well-known authority-based mechanisms of hierarchies. Ostrom (2000) defined the rules and norms of governance mechanisms for the agency problems. Puranam *et al.* (2014) defined transparent task structure, resource commons, and membership let participants self-assign to tasks, contribute to and find new uses for shared resources, and initiate new collaborative relationships in governance mechanisms. Jensen's and Meckling's (1976) model shows that agency problems exist, when there are possibilities and incentives for the management to pursue their own interest at the outside stakeholders' expense. However, agency problems and costs associated with them can be alleviated with several mechanisms that focus on the ownership structure, managerial shareholding; and other mechanisms that have been suggested in the literature on agency problems.

Jensen and Fama (1983) mentioned control mechanisms are only loosely tied to the agency theory, and while being mutually compatible they usually need several new assumptions to be modeled. The view taken here is that the firm chooses among several control mechanisms to minimize agency costs but first articulated by Alchian (1969). The control mechanisms form an interrelated system that silhouettes the corporate governance and agency costs in the firm. Several empirical models point out the different aspects of agency problems and corporate governance issues in relation to firms' interest. Ravi (2014) discussed of a better coordination between the agent and principal relationship possible through the corporate governance mechanisms in the firm. The mechanisms are constituted by internal and external mechanisms within and outside the firm. The need for internal mechanism requires proper control and monitoring in internal proceedings and it includes board of directors, stakeholders, employee compensation schemes and other internal processes and systems. The main aim of the internal mechanism is that operations of business work smoothly in a right path for the firm by segregating the roles of responsibility, authority and development of control policy. On the other hand, external mechanism is created by stakeholders of a firm in order to make company operations in accordance with the parties associated with the firm either independent or interdependent way. External governance mechanisms include auditors, governmental regulatory bodies, and the market for corporate control etc. objectives serves the debt management, legal compliance and guides to the firm their best business operations.

The review of corporate governance literature studies is still based on agency theory perspective which focuses on corporate governance as mechanisms to address the agency conflicts. However, some literature argues why agency theory is not sufficient to study corporate governance in emerging countries.

3.6 Factors affecting governance effectiveness

In India, corporate sectors follow the Indian model of corporate governance with universally accepted principles of corporate governance and the company carries out according to the stakeholders' interest. Board of directors and other related committees are responsible for running the organization, conducting business decisions to maintain a balance between individual and societal goals, and economic and social goals. The effectiveness of corporate governance is influenced by many factors which include different components basically referred to as internal and external equity holdings of the concern. Factors reported in the literature that have a high influence on the corporate governance are discussed in several research papers.

Hutchinson and Gul (2004) have documented that internal shareholdings help to solve the agency problem associated with governance policies which would result in making the board more effective and efficient towards fulfillment of organization desires. John and Senbet (1998) exposed that corporate governance effectiveness can be affected by the committee structure and internal as well as external directors need to be included in the committees in which they can work successfully. It also explains that outside directors are more effective in the monitoring committees. Based on the appreciated work of outside directors, it is advised to include them in the monitoring committees such as audit committee, remuneration committee and nomination committee. 'Board composition' traced onto independence, size and composition (John and Senbet, 1998) has influence on its effectiveness in ensuring that companies are run for shareholders' interests. David and Kochhar (1996) point out that the corporate governance effectiveness can also be explained by the types of the shareholders of the company. Basically there are two types of shareholders i.e. institutional, which include pension funds, insurance funds etc and individual investors. Institutional investors have incentive to stress components of corporate governance and hence make them more effective as compared with individual investors.

4.0 Findings from Review

In the present research review, all the firms have implemented good governance initiatives and recognized their responsibility towards different stakeholders. Most of the studies in the literature have point out about usefulness of agency theory and corporate governance. On the other hand, no studies have managed to assess all components of corporate governance. Corporate governance is formed by some bodies and committees that include internal directors and independent directors. It doesn't not exist as a single body. Most of the researchers have focused on the determinants and key players of

corporate governance in their research studies. Weir and Laing (2000) examined that the relationship between principal and agent with the focus of effectiveness of corporate governance through the agency mechanism. Also, there are mixed findings on the relationship between board composition (age) and firm performance. Shleifer and Vishny (1997) discussed the mechanisms that form an interrelated system that shapes the corporate governance and agency costs as well as different aspects of agency problems and highlights the effectiveness of corporate governance. Klein (1998) documented insignificant relationship between corporate governance and agency theory while McIntyre *et al.* (2007) have pointed out strong association between corporate governance and agency theory.

In summary, prior researchers have noted the contributions of corporate governance and agency theory towards the effectiveness and efficiency of corporate performance. In addition to that, most authors have pointed out the importance of agency control mechanism and corporate governance relationship. This gives an impression of good governance which is the main issue for the policy makers and regulators. The findings helped and will continue to help regulators and policy makers to focus on the area of improvement in order to make corporate governance more fruitful and strengthen control mechanisms.

5.0 Conclusion

The aim of the review is to check the effectiveness of corporate governance and its effective control mechanism tools towards managing business operations. In the review process, the main issue taken up is the principal-agent problem and its effect on corporate governance. Corporate governance is a frame of rules, regulations, policies and procedures to safeguard the interests of the corporate stakeholders. Most of the studies show that effective corporate governance enhances a strong relationship between principal and agent. A sound corporate governance framework is essential in reducing agency costs as well as holding up problems that tend to discourage control mechanism policies. Finally all the research papers reviewed provide an overview of principal-agent problem and ownership and control which will be useful for the researchers and academic practitioners in the domain of corporate governance.

5.1 Limitations of the study

The study only reviews literature on corporate governance and agency theory from the perspective of different countries while the empirical aspect of studies have not been focused on. Different nations can influence the practices of the business and its

corporate governance separately due to region and the cultural aspect. The practical aspect of the corporate governance and agency theory practices in real corporate environment need to be studied closely.

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