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Corporate Governance and Firm Performance: A Review of Theories and Hypotheses

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Abstract

Corporate governance has become one of the most important topics in the business world. It has gained wide acceptance due to its critical role in enhancing firm performance and competitiveness. Many corporate governance theories have emerged and proposed different governance mechanisms to reduce agency problems and enhance firm performance. Understanding different theoretical frameworks of corporate governance can help align the interests of corporate stakeholders and mitigate potential conflicts of interest, thus enhancing firm performance and value. Agency theory is the dominant theoretical framework in the corporate governance literature, and based on the agency literature, several hypotheses have been proposed, such as convergence of interest hypothesis, managerial entrenchment hypothesis, and expropriation of minority shareholders hypothesis. Furthermore, other major theories such as stewardship theory, stakeholder theory, and resource dependence theory have been put forward. This study aims to provide a comprehensive review of the major corporate governance theories and some related hypotheses in order to gain further insight and understanding of the relationship between corporate governance and firm performance. This study contributes to corporate governance literature by providing an in-depth review of the major corporate governance theories, which provides a broader insight regarding the relationship between corporate governance and firm performance. This study can be useful for firms in designing a good corporate governance model, which helps enhance firm performance and value. It can also be useful for investors, managers, boards of directors, and other corporate stakeholders by providing knowledge regarding different perspectives on corporate governance.

Subject Areas

Finance

Keywords

Corporate Governance, Firm Performance, Agency Theory, Stewardship Theory, Stakeholder Theory, Resource Dependence Theory

1. Introduction

Corporate governance has become a well-known concept in the business world. It has gained wide acceptance as it helps companies to increase their efficiency and enhance their performance and competitiveness. Moreover, the importance of corporate governance has emphasized all over the world, so that even countries that have not yet organized the adoption of corporate governance in their organizations have adopted it [1]. The focus on corporate governance in modern organizations was due to the separation of ownership and control situation, which can lead to agency problems and information problems. Therefore, corporate governance mechanisms are needed to ensure that owners are able to control managers [2]. Corporate governance is a wide term that describes the processes, policies, customs, laws, and institutions that direct the corporations' way of acting, managing and controlling their operations; it works to achieve the objective of the organization and manage the relationship among different stakeholders, including the shareholders and the board of directors [3]. Corporate governance basically involves balancing the interests of owners and management; it provides the framework for achieving the firm's goals and includes practically all areas of management from action plans to performance measurement [4]. [5] stated that corporate governance is considered a significant effort to ensure responsibility and accountability, and a set of principles that should be integrated into each part of the organization. According to [6], "*corporate governance is the system by which companies are directed and controlled*". This definition is considered the most famous and widely accepted definition of corporate governance.

However, corporate governance issues have gained great attention in the past two decades as a result of a series of economic and financial events occurring around the world that have driven countries to strengthen their own corporate laws in order to enhance confidence in financial markets [7]. Many international organizations, such as OECD and World Bank, have encouraged all countries in order to implement international standards of corporate governance. They have developed guidelines for corporate governance that provide a framework for good corporate governance. The content and structure of this framework, as stated that OECD, may be adjusted according to the unique situation of each country [8]. In addition, many researchers have highlighted the importance of corporate governance in their research from different perspectives [9], emphasized the importance of corporate governance for the economic health of companies and argued that high ethical values can decrease the costs of achieving a high standard of corporate governance and make it more sustainable. Moreover, [5] stated that corporate governance could help in aligning the interests of individuals, companies, and society through ethical basis. It will help to achieve the long-term strategic objective of the owners, build shareholder value, and establish a dominant market share. [10] mentioned that good corporate governance practices can decrease risk for investors, attract investment capital and enhance firm performance. He argued that although corporate governance issues are important in developed countries, they are even more important in developing countries because these countries don't have well-established financial institution regulation in order to deal with these issues that currently are handled by the state. Moreover, [3] referred to the importance of corporate governance for competitive companies to achieve a strong position in financial markets. He explained that good corporate governance is a fundamental standard for creating an attractive investment climate, which is essential for competitive firms in efficient financial markets. Moreover, good corporate governance is essential to economies with a broad business background and facilitates entrepreneurial success.

2. Research Objective

Reviewing the different theoretical frameworks of corporate governance is crucial in explaining and understanding the relationships between the various stakeholders in companies and how their interests can be aligned. This can help reduce conflicts of interest and enhance firm performance and value. The objective of this study is to provide a comprehensive review of the major corporate governance theories and some related hypotheses in order to gain further insight and understanding regarding the relationship between corporate governance and firm performance.

3. Corporate Governance Theories

Many corporate governance theories have emerged and proposed different governance mechanisms to decrease agency problems and enhance firm performance. Agency theory, stewardship theory, stakeholder theory, and resource dependence theory are examples of the basic theories of corporate governance. Agency theory is the dominant theoretical framework in the corporate governance literature, and based on the agency literature, various hypotheses have been proposed.

3.1. Agency Theory

Berle and Means' (1932) analysis of the separation between ownership and control in modern corporations is considered one of the earliest academic studies on corporate governance. They suggest an inverse relationship between dispersed shareholdings and firm performance. Berle and Means' concerns about the separation of ownership and control were later developed by Jensen and Meckling (1976) into what became known as "agency theory" [11]. Agency theory seeks to resolve conflicts of interest between managers and shareholders within a corporation, and to describe methods for resolving such conflicts [12]. [13] defined agency relationship as a contract between one or more persons (the principals) and another person (the agent). Based on this contractual relationship, the agent will perform some services on behalf of the principals and some decision-making authority will be delegated from the principals to the agent. In the case that both parties seek to maximize their own benefits, there is reason to believe that the agent's actions will not always be in the best interests of the principal. [14] stated that, in the principal-agent model, the contribution of the agent is to expand stockholders' wealth through the growth in the company's profitability and market share price. However, the agency theory proposes that the agent may be self-interested, engage in opportunistic behavior, and fail to align his pursuits with the principal's aspirations [15]. Therefore, agency problems arise within a corporation when managers have incentives to seek their own benefits at the expense of shareholders [16].

Information Asymmetry Problem

The information asymmetry problem lies in the heart of agency problems; it affects the level of market illiquidity, which in turn increases the cost of capital [17]. Moreover, the conflict of interest problem can arise as a result of information asymmetry resulting from an incomplete contractual agreement between owners and managers [12]. [18] described asymmetric information as the situation in which the agent is more informed about his own capabilities, his own activities, and also what is going in the company than the principal. [19] explained that the information asymmetry problems in the principal-agent relationship resulting from different levels of information that each party holds. Moreover, [18] emphasized the importance of two types of information asymmetry problems: the first type is moral hazard (also referred to as hidden action) and the second type is adverse selection (also referred to as hidden knowledge). They explained that, moral hazard occurs when the agent's activity can't be observed by the principal, whereas adverse selection occurs when some elements in the situation are known to the agent but unknown to the principal.

Agency Costs

According to [13], agency costs consist of three types of expenditures: monitoring expenditures, bonding expenditures and residual loss. [20] explained that monitoring costs refer to the costs incurred by principal to limit the devious behavior of the agent, bonding costs refer to costs incurred by agent to ensure that managers make decisions that are beneficial to the principals, and residual loss is a possible cost that occurs when both of monitoring and bonding costs fail to control the potential divergent behavior of the managers. [12] stated that, based on the agency theory, companies have the opportunity to improve financial performance if cost is reduced. Therefore, proper management of agency costs can help improve stock price, which means improving the overall financial performance of the company. According to [21], the agency theory suggests two options in order to decrease agency problems and control agent's opportunistic behavior. The first is to design governance structure that helps to monitor and assess the actual behavior of the agent. The second is to design a governance structure in which the contracts are based on the actual outcome of the behavior of agents. However, agency problems are not limited to the principal-agent relationship; they may extend to other parties within a corporation, such as problems that occur between creditors and shareholders and between major and minor shareholders.

[22] referred to the conflicts of interest between creditors and shareholders (as represented by managers), and explained that, creditors incur agency costs by asking for higher interest and managers who use debt agree to incur agency costs and restrict their freedom in making decisions; agency costs may be refer to the costs of solving these conflicts. [23] stated that, creditors need to be wary of the expropriation of their wealth by shareholders or by corporate managers who act on behalf of these shareholders. Although creditors could protect themselves from this opportunistic behavior through adding provisions to loan contracts, these protections are far from perfect. Consequently, the risk of expropriation is expected to be reflected in the cost of borrowing. [12] stated that, different studies have suggested some factors that can help in solving the agency problem, such as appropriate monitoring, control over executive pay, healthy competition in the market, an efficient board of directors, reasonable debt sourcing, and concentrated ownership.

However, agency theory has been criticized in some aspects. According to [24], the agency theory assumes that behaviors and consequences can be easily controlled, which is not true in the real world. Moreover, the choice between the monitoring and the incentives in order to regulate the behavior or outcome is not effective. Furthermore, excessive control against opportunistic behavior can stifle initiatives, entrepreneurship, creativity and innovation in firms, a cost that agency theorists often ignore. [25] explained that, based on the traditional shareholder view, if the goal of maximizing the wealth of shareholders leads to conflicts with the interests of other groups, these other interests should be ignored unless particular regulations and laws that mandate the management to consider those interests. [26] stated that although agency theory is important to explain corporate governance in emerging economies, yet it is not sufficient. He suggested that alternative perspectives are needed in order to explain corporate governance practices in these economies because institutional context and non-economic factors differ in emerging economies compared to more developed economies. However, based on agency literature several hypotheses have been proposed. The convergence of interest hypothesis, managerial entrenchment hypothesis, and expropriation of minority shareholders hypothesis are examples of these hypotheses.

- **Convergence of Interest**

Jensen and Meckling (1976) argued that managerial ownership in a corporation can decrease managerial incentives to consume privileges, expropriate owners' wealth, and engage in other non-maximizing behaviors, thus helping align the interests of management and shareholders. This is referred to as the "Convergence-of-interest hypothesis" [27]. Ownership structure is considered as a potential corporate governance mechanism that can mitigate agency problems. In this aspect, it is argued that managerial ownership and concentrated shareholdings can control the management of a company and affect the maximization of shareholder and stakeholder wealth [2]. Convergence of interest hypothesis suggests that high level of managerial share ownership helps in aligning the interests of managers and owners resulting in superior performance because the managers will act to maximize shareholders' value due to their own interests [11]. According to [5], as managerial ownership increases, the alignment of interests between corporate managers and shareholders will increase because the managers will be less likely to divert the company's resources away from value maximization, which leads to better firm performance. Moreover, [11] explained that, a manager's claim in the company's outcomes and his burden in the costs of non-value maximizing behavior will increase as his equity holdings increase. Therefore, a high ratio of managerial ownership will increase the probability that the manager will dedicate significant effort to innovative activities and protect himself from misuse of firm resources. However, convergence of interest hypothesis has been challenged by managerial entrenchment hypothesis, which assumes a negative effect of managerial ownership on firm performance.

- **Managerial Entrenchment:**

This hypothesis proposes adverse influence of managerial ownership on agency conflicts between owners and managers due to the costs of too large managerial ownership; managerial shareholding may also entrench the existing management team, which leads to an increase in managerial opportunism [27]. Entrenchment hypothesis suggests that when managers have too large control on the company, they may manage its resources in less efficient way and involve in non-value maximization activities, such as investing in negative net present value projects [28]. Therefore, according to managerial entrenchment hypothesis, as the managerial ownership increases, the ability of other shareholders to compel them to manage the company in the shareholders' interest decreases [5]. [29] defined entrenchment in terms of the extent to which the managers of corporations fail to discipline from the full range of control and corporate governance mechanisms. They argued that some corporate managers seem to be substantially entrenched themselves against pressures from both internal and external corporate governance mechanisms. Moreover, [30] described how mangers of corporations can be entrenched by making manager-specific investments that make the replacement of managers are costly for the shareholders. Thus, managers can reduce the probability of replacing them, obtain higher wages and larger perquisites from owners, and attain more freedom in determining the strategy of corporations.

- **Expropriation of Minority Shareholders**

The expropriation of minority shareholders hypothesis proposes that ownership concentration may permit major shareholders to expropriate small shareholders. In this way, these major shareholders can behave in their own best interest. They can use their power to benefit themselves at the expense of small shareholders by redistributing wealth from them [31]. Moreover, excessive control rights can facilitate potential tunneling activities by large shareholders. Tunneling activities involve many forms of self-dealing transactions, such as selling assets to listed corporations at high prices, or transferring assets and profits out of corporations [17]. [11] explained that, the term "tunneling" refers to the transfer of resources out of companies for the benefit of controlling investors. [32] described other forms of tunneling, such as increasing the number of shares through dilutive stock issues, and also by setting above-market compensation that is not justified by performance or effort. According to [11], small investors' fear of being expropriated may result in a higher cost of capital for companies, which in turn leads to inefficient investment. [33] stated that investors' protection turns out to be an important issue because, in many countries, the expropriation of small shareholders and creditors by major shareholders is extensive.

Private Benefits of Control

Private benefits of control over the resources of companies play a fundamental role in modern thinking regarding corporate governance; the recent literature concerning private benefits of control focus mainly on investors' protection, and also on the amount of private benefit that are extracted by controlling shareholders from corporations they run [34]. According to [35], private benefits of control can be defined as the benefit that the controller (large shareholder) expropriates from other shareholders. He explained that, these benefits lead to two types of agency conflict: a conflict between owners and managers, and a conflict between large shareholders and minority shareholders. [32] stated that, dominant shareholders obtain benefits, such as tunnel the firm's resource to their companies or the adaption of dividend policies that benefit them only. These behaviors increase the conflict between large shareholders and small shareholders regarding firm resources, which impacts firm performance negatively.

[34] explained that, the nature of private benefits of control makes it difficult to observe or measure them reliably. A controlling party can allocate value for himself only in the case that this value is not verifiable and also, when it is difficult for other shareholders to prevent him from appropriating it. Hence private benefits of control are difficult to measure intrinsically. [36] indicated that private benefits of control are resulted by the opaque part of the informational environment. The access to internal information may allow insiders to build channels to obtain benefits. This advantage tends to increase in countries in which the investors' protection is weak and large shareholders have voting rights exceeding their rights to cash flows. On the other hand, [37] argued that although conventional accounts of ownership concentration warn against abusive practices of control and extraction of private benefits by controlling shareholders, these accounts are in sharp contrast with several cases of companies with concentrated ownership that achieved great performance and success.

3.2. Stewardship Theory

The stewardship theory was developed by Donaldson and Davis (1991 and 1993) and rethought the issue of corporate governance by challenging the main assumptions of human motivation that derived from the agency theory [38]. In the context of stewardship theory, directors are good stewards of companies and work hard to achieve high levels of corporate profits and shareholder returns. It assumes that corporate managers are motivated by intrinsic rewards, such as trust, job satisfaction and reputational enhancement [39]. This theory proposes a humanistic model of man in which the behavior of a steward is based on serving others and is aligned with the interests of the principal [21]. According to stewardship theory, stewards (mangers or executives) are responsible agent and behave in the best interests of firm owners even though the interests of principals are not compatible with managers' individual goals [40]. Steward places greater value on collective objectives, and understands the company's success as his own achievement [38]. Hence, managers try to increase their benefits through enhancing the firm performance and in turn maximizing the firm value [40]. Thus, stewardship theory illustrates the positive relationship between owners and managers, which is a requirement for good corporate governance [41].

Stewardship theory has its roots in both psychology and sociology; it was designed for researchers in order to study the situations in which mangers as stewards are motivated to behave in the best benefits of shareholders. The model of man proposed by this theory is based on a steward whose actions are organized so that organizational and collective behaviors are of higher utility than individual and self-interest behaviors [42]. Therefore, stewardship-focused companies are aligned with the needs of society and seek to improve the lives of others using a business approach. In such companies, managers are not motivated by individual needs and desires, yet they see themselves as stewards with the same aims and motives as the owners of the company. The core values of the company are integrity, justice, and respect; these values are the basis for actions taken by managers on all decisions [43]. The primary focus of this theory is to realize how managers are motivated to contribute to the achievement of corporate objectives. Therefore, the theory is based on aligning the interests of managers and shareholders [41]. The central assumption of stewardship theory is that the relationship of principal and steward is based on a choice. There are times when both of them choose to act as a steward and place the interest of the principal first. Accordingly, the theory suggests a positive effect on firm performance as both parties are working toward the same objective [21].

According to stewardship theory, the precise aim of corporate governance is to find the appropriate structure and mechanisms to facilitate the most effective coordination between owners and managers [38]. The theory realizes the importance of structures that empower managers and provide maximum autonomy based on trust. It emphasizes the position of employees or executives to work more independently so that owners' returns are maximized due to the reduction of monitoring and controlling costs [15]. Further, this theory suggests that executive directors have greater knowledge about their corporations and more likely to improve the performance of their organizations. Moreover, when the same person holds the positions of chairman and chief executive, this will lead to faster decision making and decreases unnecessary bureaucracy, which enhances the corporate performance [44]. According to [38] [40], stewardship theory suffers from being static because it takes into account the principal-agent relationship at a single point in time and supposes that individuals don't learn anything from their interactions. Also, it does not reveal the motivations that agents may have to turn from an agent position towards steward position. Moreover, the theory is not often used because of the risk of empowerment of the chief executive**.** In addition, [44] stated that**,** ignoring intrinsic nature of the human being is a main issue in stewardship theory; several studies have indicated that moral hazard problem is the main reason why corporate managers don't act honesty to increase shareholders' wealth.

3.3. Stakeholder Theory

Freeman (1984) made one of the first presentations of the stakeholder theory, proposing a general theory of the firm that includes corporate accountability to a wide range of stakeholders [38]. Since the publication of Freeman's book, "Strategic Management: A Stakeholder Approach (1984)", a large body of literature has focused on the stakeholder concept [45]. The stakeholder theory claims that there are other parties involved besides the shareholders of a company. Stakeholders of a company are the individuals or groups that have an interest in the company or can significantly affect or be affected by the company's welfare [40]. Stakeholder theory was mainly developed in order to identify, develop, analyze, and manage strong coordination among the stakeholders. This theory focuses on wider groups of stakeholders compared to agency theory that focuses mainly on the maximization of shareholders' wealth [46]. Stakeholder analysts have argued that all individuals or groups who have legitimate interests and participate in a business do so in order to obtain benefits and there is no priority for one set of benefits and interests over the other [45]. Consequently, the theory suggests that companies should look beyond the shareholders view of profit maximization, and postulates that the performance of corporations cannot be measured only by the gain of its shareholders [46] [47]. From a stakeholder perspective, companies cannot maximize the interests of shareholders at the expense of other stakeholders because doing so is neither ethically nor economically efficient. Therefore, the claims of stakeholders must be taken into consideration, although they may generally be subordinate to the claims of shareholders [25]. According to [44], the stakeholder theory provides a better explanation regarding the role of corporate governance by clarifying diverse constituents of a corporation compared to agency theory and stewardship theory. Hence, stakeholders of a corporation include different parties, such as its shareholders, employees, suppliers, creditors, banks and society etc. [25] explained that, while the agency theory emphasizes corporate governance effort to ensure shareholders' interests, stakeholder theory suggests that companies should serve all individuals or groups who have a stake in the company.

However, [48] argued that value maximization is logically impossible in more than one dimension. He explained that previous work in economics and finance suggests that when there are no monopolies and externalities (and all commodities are priced), social welfare will be maximized when every company in an economy maximizes its overall market value. Moreover, [39] stated that the number of groups classified as stakeholders has increased so much that the term is no longer meaningful for analysis purposes because it does not offer an effective standard for judging corporate agents. Also, [25] stated that stakeholder theory is often criticized as being incompatible with business and all essential goals, detrimental to accountability and private ownership, and therefore unable to provide better corporate governance and business performance. [48] criticized the stakeholder theory in some aspects and stated that, stakeholder theory claims that managers should take into account the interests of all stakeholders in a company (e.g. employees, customers, the environment, the communities). Since the supporters of stakeholder theory refuse to define how to make tradeoffs among these conflicting interests, it is impossible for managers to make purposeful decisions based on such a theory. Moreover, in the absence of any means to keep score, this theory makes corporate managers unaccountable for their behavior; thus, the theory can be appealing to the self-interest of corporate managers and board members.

3.4. Resource Dependence Theory

According to the resource dependence theory, firms depend on external resources (e.g. labor, funds, and raw materials) to run their operations, and their relationships with external stakeholders affect their ability to access these resources. Therefore, effective corporate governance is required to manage these relationships and ensure that firms have the resources they need to succeed [49]. The theory suggests that, the aim of corporate governance is to generate and utilize resources; moreover, it emphasizes the role of governance process in improving corporate performance through the use of resources to gain competitive advantage [50]. Accessibility to resources is introduced by the resource dependence theory as a crucial dimension of the current corporate governance debate; these resources must be rare, valuable, distinctive, and non-substitutable in order to maintain the company's competitive advantage [39]. The resource dependence theory view regarding corporate governance stems from the basic logic that different elements of corporate governance can serve as essential resources for a firm. Hence, corporate governance can lead to resource generation [50]. Moreover, this theory suggests that the issue of the contradiction between executives and non-executive directors is not really relevant, and claims that what is relevant is the presence of the company on the boards of other corporations. This is to establish relationships in order to gain access to resources in the form of information that can be used to the benefit of the company [39]. In particular, boards of directors contribute to a company through their expertise and connections with other institutions and companies. Moreover, directors can contribute to the positive evaluation of a company through their reputation; thus, they can be a major source of various resources [50].

Reviewing previous literature regarding corporate governance theories reveals a wide diversity of theoretical frameworks for corporate governance. However, the existence of different theories of corporate governance can help to explain and understand corporate governance practices in different contexts. According to [51], governance may vary from country to country due to differences in many factors such as cultural values and social, political and historical circumstances; this means that governance may differ between developed and developing countries depending on the cultural and economic contexts of each country. Moreover, [15] stated that, good and effective corporate governance cannot be explained by a sole theory, but rather it is better to combine a variety of theories, taking into account not only social relations, but also focusing on the rules, legislation, and strict implementation regarding good governance practices. In line with this, [51] emphasized the suggestion that a combination of different corporate governance theories is better for describing efficient and effective corporate governance practices rather than formulating corporate governance hypotheses based on a single theory. However, reviewing the different theoretical perspectives of corporate governance is crucial in explaining and understanding the relationships between various stakeholders in a company and how their interests can be aligned. This can help companies design an appropriate corporate governance model that contributes to enhancing company performance and value.

4. Conclusion

This study provides a comprehensive review of the major corporate governance theories and some related hypotheses that explain the relationship between corporate governance mechanisms and firm performance. It can be concluded that agency theory is the dominant theoretical framework in the corporate governance literature. The theory emphasizes the important role of corporate governance in reducing the conflict of interest between managers and shareholders, and suggests governance mechanisms, such as appropriate monitoring, managerial incentives, capital structure and ownership structure in order to mitigate agency problems and improve firm performance. Based on agency literature, several hypotheses have been developed, such as the convergence of interest hypothesis, managerial entrenchment hypothesis, and expropriation of minority shareholders hypothesis. On the other hand, stewardship theory presents a humanistic model of managers who behave in the best interest of corporate owners and work to maximize shareholder wealth. The stakeholder theory claims that the interests of all stakeholders in a company should be taken into account rather than focusing only on maximizing shareholder value. Moreover, resource dependence theory emphasizes the role of corporate governance in resource generation and utilization.

This study contributes to corporate governance literature by providing an in-depth review of the major corporate governance theories and some related hypotheses, which provides a broader insight regarding the relationship between corporate governance and firm performance. This study can be useful for companies in designing a good corporate governance model that helps align the interests of different stakeholders and improve firm performance. It can also be useful to investors, managers, boards of directors and other corporate stakeholders by providing knowledge on different perspectives regarding the relationship between corporate governance and firm performance.

Conflicts of Interest

The author declares no conflicts of interest.

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