The Rhetoric of Corporate Governance Legality

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INTRODUCTION

Corporate governance is the system or process by which companies, partnerships, close corporations and trusts are directed and controlled. The concept of corporate governance has grown prominence in recent times because of its apparent importance for the economic health of corporations and society in general. In the wake of Enron, WorldCom, Qwest Communications, Tyco International, Computer Associates, Parmalat, Putman, Boeing, Rite Aid, and Werox, corporate ethics, or lack thereof, came into question. Corporate governance, thus, is defined as mechanisms that assure investors in corporations that they will receive adequate returns on their investments (ROI). The governance mechanisms that have been most extensively studied in the US can be broadly characterized as being either internal or external to the firm. The internal mechanisms (first generation) of primary interest are the board of directors and the equity ownership structure of the firm. The primary mechanisms are the external market (second generation) for corporate control and the legal/regulatory system. The purpose of this article is the third generation, convergence in corporate governance systems, international corporate governance.

CORPORATE SOCIAL RESPONSIBILITY

Over the last two decades, corporate governance has attracted a great deal of public interest because of its importance for the economic health of corporations and society in general. The headlines in regards to corporate social responsibility governance, or a lack of, portrayed a negative image of corporate social responsibility (CSR). The negative image of CSR affects not only developed countries, for the negative image of CSR impacts developing countries, causing more damages. Thus, CSR has emerged as a major policy concern for many developing countries following the financial crisis in Asia, Russia, and Latin America.

CSR can be understood as a management concept, "whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary[1]." A company acts responsible, if it aspires to achieve "an equilibrium between the demands and needs of different stakeholders which is acceptable for everybody involved[2]." Essential components of the concept are the voluntary character, the orientation at expectations and values of company (Joyner & Payne, 2002, p. 300), and its cross-functional nature. According to Goebel, CSR should therefore not be seen as a separate function, but as an integral part of general management (Gobel, 2006, p. 156).

In other words, one common way of using the term is based on the following narrow definition: corporate social responsibility is concerned with ensuring the firm is run in the interests of shareholders (Allen, 2005). This is how the term is typically used in Anglo-Saxon countries such as the USA and the UK. The standard mechanisms for ensuring that this occurs are: 1) the board of directors, 2) executive compensation, 3) the market for corporate control, 4) concentrated holdings and monitoring by financial institutions, and 5) debt. Underlying this narrow view of corporate governance is Adam Smith's notion of the invisible hand as the key principle that the organization of the economy is based on.

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HISTORY OF CORPORATE SOCIAL RESPONSIBILITY

In the 19th century, state corporation law enhanced the rights of corporate boards to govern without unanimous consents of shareholders in exchange for statutory benefits like appraisal rights, to make corporate governance more efficient. Since that time, and because most large publicly traded corporations in the US are incorporated under corporate administration, and because the US's wealth has been increasingly securitized into various corporate entities and institutions, the rights of individual owners and shareholders have become increasingly derivative and dissipated. The concerns of shareholders over administration pay and stock losses periodically has led to more frequent calls for corporate governance reforms. Adolph Berle and Gardiner Means' (Berle & Means, 1991) monograph *The Modern Corporate and Private Property* continues to have a profound influence on the conception of corporate governance in scholarly debates today. Eugene Fama and Michael Jensen's (Fama & Hensen, 1983) *Separation of Ownership and Control* firmly established agency theory as a way of understanding corporate governance: the firm is seen as a series of contracts. According to Jay Lorsch and MacIver "many large corporations have dominant control over business affairs without sufficient accountability or monitoring by their board of directors" (Lorsch & MacIver, 1989).

AGENCY THEORY

Agency theory has been used by scholars in accounting (Demski & Feltham, 1978), economics (Spence & Zeckhauser, 1971), finance (Fama, 1980), marketing (Basu, Lal, Srinivasam, & Staelin, 1985), political science (Mitnick, 1986), organizational behavior (Eisenhardt, 1985, 1988; Kosnik, 1987), and sociology (Eccles, 1985). Agency theory, from its roots in information economics, has developed along two lines: positivist and principal-agent (Jensen, 1983). The two streams share a common unit of analysis: the contract between the principal and the agent. They share common assumptions about people, organizations, and information. However, they differ in their mathematical rigor, dependent variable, and style.

BACKGROUND OF AGENCY THEORY

During the 1960s and early 1970s, economists explored risk sharing among individuals or groups (Arrow, 1971). This literature described the risk-sharing problems as one that arises when cooperating parties have different attitudes toward risk. Agency theory broadened this risk-sharing literature to include the so-called agency problem that occurs when cooperating parties have different goals and division of labor (Jensen & Meckling, 1976). Specifically, agency theory is directed at the ubiquitous agency relationship, in which one party delegates work to another, who performs that work. Agency theory attempts to describe this relationship using the metaphor of a contract (Jensen & Meckling, 1976).

Agency theory is concerned with resolving two problems that can occur in agency relationships. The first is the *agency problem* that arises when: 1) the desires or goals of the principal and agent conflict and 2) it is difficult or expensive for the principal to verify what the agent is actually doing. The problem here is that the principal cannot verify that the agent has behaved appropriately. The second is *the problem of risk sharing* that arises when the principal and agent have different attitudes toward risk. The problem here is that the principal and the agent may prefer different actions because of the different risk preferences.

The agency structure is applicable in a verity of settings, ranging from macro-level issues such as regulatory policy to micro-level dyad phenomena such as blame, impression management, lying, and other expressions of self-interest. Most frequently, agency theory has been applied to organizational phenomena such as compensation (Colon & Park, 1988; Eisenhardt, 1985), acquisition and diversification strategies (Amihud & Lev, 1981), board relationships (Fama & Jensen, 1983; Kosnik, 1987), ownership and financing structures (Argawal & Mandelker, 1987; Jensen & Meckling, 1976), vertical integration (Andersen, 1985; Eccles, 1985), and innovation (Bolton, 1988). Overall, the domain of agency theory is relationships that mirror the basic agency structure of a principal and an agent who are engaged in cooperative behavior, but have differing goals and have differing attitudes toward risk.

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