Different Approaches to Corporate Governance

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**Approaches to Corporate Governance**

**Instructor Note for ET2800:** Carefully review the table below and notice especially how the roles of managers and owners affect the final column related to ethical focus. There is additional information about each of the 4 theories about how organizations are governed below this table that will help you with the assignment.

Summary Table

This table summarizes materials from Introduction: Theories of Governance (Clarke, 1 through 30) and provides a taxonomy of several different approaches to corporate governance.

<table>
<thead>
<tr>
<th></th>
<th>Description</th>
<th>Theory of Human Nature</th>
<th>Owner Role</th>
<th>Manager Role</th>
<th>Corporate Ethics Focus</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Agency Theory</strong></td>
<td>Managers act as agents of the corporation fulfilling the goals established by the owners / directors</td>
<td>Managers are rational, but self-interested beings who must be controlled from the outside</td>
<td>Owners are principals, that is, they originate the action and bear primary moral responsibility.</td>
<td>Managers are agents, that is, responsible for acting in the interest of the principals who hire them. Faithful agency implies avoiding conflicts of interests and maintaining confidences.</td>
<td>Compliance focus uses (1) rule-based codes, (2) systems of monitoring, and (3) punishments and rewards to motivate compliance from outside.</td>
</tr>
<tr>
<td><strong>Stockholder Approach</strong></td>
<td>Corporation is property of stockholders who dispose of it as they see fit.</td>
<td>Stockholders pursue self interest. They are rational (instrumental), economic self-interest maximizers</td>
<td>Owners invest in corporation and seek a return (profit) on their investment</td>
<td>Managers are responsible for ensuring that owners get maximum return on investment</td>
<td>Stockholders direct compliance toward manager control and external conformity to laws.</td>
</tr>
<tr>
<td><strong>Stakeholder Approach</strong></td>
<td>Owners drop out of center focus. Corporation is run for the sake of its stakeholders</td>
<td>Groups have special interests but recognize the need to integrate these. Humans possess capacity for procedural</td>
<td>Owners drop to one of a group of equal stakeholders. Still advocate their financial interests but not</td>
<td>Managers are meta-stakeholders. They treat stakeholders and stakes equally and integrate</td>
<td>Create common goals to unite stakeholders in the pursuit of excellence. Both compliance to get things started</td>
</tr>
</tbody>
</table>
### Stewardship Model

<table>
<thead>
<tr>
<th>Reasoning</th>
<th>Stewardship Model</th>
<th>Value-based: (1) identify and formulate common standards of excellence, (2) develop training programs to foster pursuit of these excellences, and (3) develop support structures to help reduce value &quot;gaps.&quot;</th>
</tr>
</thead>
<tbody>
<tr>
<td>Managers act as stewards for absentee owners; oversee the operations of corporation and exercise care over them. Emotion (care) plays an equal role with instrumental rationality.</td>
<td>Desire and self interest are balanced out by social motives such as Rousseau's pity and Aristotle's virtues. Owners still set cardinal objectives but they also are responsible for providing managers with a meaningful work environment. Managers are stewards exercising care over the property of the owners in their absence. Stewardship is based on internally generated and self-imposed motives toward care.</td>
<td></td>
</tr>
<tr>
<td>to exclusion of other stakeholders</td>
<td>these to the fullest extent possible.</td>
<td></td>
</tr>
</tbody>
</table>

**Agency Theory**

1. In agency theory, the owners/directors set the central objectives of the corporation. Managers, in turn, are responsible for executing these objectives in the corporation's day-to-day operations. Corporate governance consists of designing structures and procedures to control management, i.e., to keep their actions in line with director-established objectives.

2. Managers cannot be trusted to remain faithful agents, i.e., to stay faithful to the interests and goals of the owners/directors. This presupposes a particular view of human nature. Humans are rational, egoists. They have desires and use reason to devise means to realize them. Since one desire can be checked only by another desire, this egoism is potentially without limit. Agency theory assumes that managers will divert corporate resources to pursue their own selfish ends unless checked by some system of external controls. Thus, another key element of corporate governance under agency theory is to find the most efficient systems of controls to keep manager egoism in check.

3. The owners/directors play the role of principal in agency theory. The principal originates the action and bears primary moral and legal responsibility for it. Most of the time the principal of an action is also its executor. But there are times when the principal lacks the knowledge and skill necessary for executing the objectives he or she originates. In this case, the principal contracts with an agent. The principal authorizes the agent to act on his or her behalf. This requires that the agent remain faithful to the goals and interests of the principal. See Hobbes’s *Leviathan*, Chapter 16 for an important historical account of the agent-principal relation.

4. Managers are agents. Their primary responsibility is to serve as faithful executors of the goals and interests of the principals. This requires, first, that managers are responsible for exercising their professional judgment in a competent way. Managers are also responsible for remaining faithful to the interests of their principals. To do this they must avoid conflicts of interests and maintain confidentialities (i.e., keep secrets). Agent can also range from being free (unguided by principals) to bound (tightly monitored and controlled by principals).

5. How does ethics enter into corporate governance under agency theory? Primary emphasis is placed on compliance, i.e., enforced conformity to rules that constitute minimum thresholds of acceptable behavior. Compliance approaches develop (1) rule based codes, (2) systems of monitoring to detect violations, and (3) punishments and rewards to deter non-compliance and reward compliance. Trevino and Weaver provide an empirical analysis to the goals achieved through compliance ethics: "[4] the
perception that better decisions are made because of the ethics program [5] ethical advice seeking, [6] decreased unethical behavior in the organization...[7] ethical awareness.” (Weaver and Trevino, 1999: 333.)

Stockholder Theory

1. The stockholder approach is quite similar to that set forth in agency theory. The difference is that it views the corporation as the property of its owners (stockholders) who may dispose of it as they see fit. Most of the time this involves using it to receive maximum return on investment.

2. Stockholders are oriented toward self-interest, so stockholder theory, along with agency theory, takes an egoistic/Hobbesian view of human nature. Humans are rational, self-interest maximizers. Owners should expect this from the corporation's managers and employees. They should integrate procedures and controls that channel the corporation and its members in the direction of their (owners) self-interest.

3. The owners invest in the corporation and seek a return (profit) on this investment. But this narrow role has been expanded into overseeing the operations of the corporations and its managers to ensure that the corporation is in compliance with ethical and legal standards set by the government. Just as the master, under tort law, was responsible for injury brought about by the negligence of a servant, so also are directors responsible for harm brought about by their property, the corporation.

4. Managers are role-responsible for ensuring that investors get maximum return on their investment. This includes exercising good business judgment and avoiding conflicts of interests and violations of confidences.

5. Like corporations operating within agency theory, stockholder corporations focus on compliance strategies to monitor managers and make sure they remain faithful agents. However, directors under the stockholder approach also take seriously oversight responsibility which include ensuring corporate compliance with laws such as Sarbanes-Oxley and the Federal Sentencing Guidelines.

Stakeholder Theory

1. Owners drop out of the center of attention in this approach to become one of several, equal stakeholders. A stakeholder is any group or individual that has a vital interest, right, good, or value in play or at risk. (A gambler's stake is the money on the table in play as the roulette wheel turns. Depending on the outcome of the situation, the gambler either keeps or loses the stake.) Examples of corporate stakeholders include stockholders, employees, customers, suppliers, local community, and government. The corporation on this view exists for the sake of its stakeholders, not stockholders.

2. The stakeholder view can be closely tied to egoism if it is assumed that the different stakeholder groups exist to maximize their selfish interests. But the stakeholder approach to corporate governance goes beyond the egoistic account of human nature. The corporation (and its managers) become responsible for mediating between these different, often conflicting, stakeholder interests, always keeping in mind that all stakeholders deserve equal respect. If stakeholders have any solidarity with one another, it is because the interest set of each includes the interests of the others. (This is how Feinberg defines solidarity.) The ability to envision the interests of each stakeholder and to work toward integrating these must be built on a view of human nature that is as altruistic as egoistic. While not embracing the social view of human nature outlined above, the stakeholder view assumes that stakeholders are capable and willing to negotiate and bargain with one another. It begins, in other words, with enlightened and long term self interest.

3. The first feature of the owner role is the reduction in centrality mentioned just above. They advocate their interests in the same arena as the other stakeholders, but they also must work to make their interests compatible with the other stakeholders. This requires integrating interests when possible and drawing integrity-preserving compromises when necessary. (See Benjamin 1990).

4. Managers play an important meta-role here. They are faithful agents but of all stakeholders, not just stockholders. Thus, they becomes referees or (to switch metaphors) brokers between stakeholders. They
oversee the generation of expansive corporate values capable of absorbing and integrating narrower stakeholder interests.

5. Stakeholder approaches combine compliance and value-based approaches. In compliance, corporate officers define a moral and legal minimum; this consists of the minimum set of rules necessary for stakeholder coexistence. Beyond this, value-based approaches seek to create common, broader objectives, aspirations that can unite the different stakeholders in the pursuit of excellence. Stakeholder approaches need both; the compliance approach gets things started and the values-based approach sets them on the path to excellence.

Stewardship Theory

- Managers and employees can be trusted to act as stewards or guardians of the corporation. This means that while they do not own the corporation's resources, they will safeguard these for the owners. A steward is a caretaker who looks after the owner's property and interests when the owner is absent.
- This approach definitely makes use of the social approach to human nature. Humans, naturally and spontaneously, realize their innermost natures by forming social unions. The corporation, under this view, is such an organization. While taking on the characteristics of a social contract with the other approaches, especially agency theory, the corporation under the stewardship view is more of a cooperative, collaborative enterprise. Humans can act and find meaning in interests and concerns well beyond the confines of the ego. In fact, to organize the corporation around egoistic assumptions does harm to those capable of action on altruistic motives. The emphasis here is on building trust and social capital to strengthen the social potentialities of human nature.
- Owners still establish the cardinal objectives for the sake of which the corporation exists. But they are also responsible for providing managers with an environment suitable developing human potentialities of forming societies to collaborate in meaningful work.
- Managers act as stewards or caretakers; they act as if they were owners in terms of the care and concern expressed for work rather than merely executors of the interests of others. In other words, the alienation implied in agency theory (acting not out of self but for another), disappears as the managers and employees of the corporation reabsorb the agent function.
- Stewardship approaches are primarily value-based. They (1) identify and formulate common aspirations or values as standards of excellence, (2) develop training programs conducive to the pursuit of excellence, and (3) respond to values "gaps" by providing moral support.