ANALYSIS

Corporate governance systems as dynamic institutions

by Zainab Dere On Jan 16, 2019

Corporate governance

The appropriateness of existing models of corporate governance which firms adopt in achieving their mission is being questioned for its inadequacies in reducing agency problems. Increasingly, there are calls for the adoption of a dynamic model of corporate governance given its inherent nature that might help overcome the problems and limitations of agency approach used in studying corporate governance systems.

The US sub-prime mortgage crisis of 2007 and consequent global economic crisis further explicates the inadequacy of existing corporate governance systems. The corporate governance system remains popular among management scholars. In simple terms, it is defined as a system of rules, practices and processes within a firm through which it is directed and controlled to balance the interests of all

stakeholders (especially shareholders and managers). It defines the division of wealth and power in a corporation. The call for a dynamic model in this regard is targeted towards developing a globally acceptable framework that takes into account a balanced view of human nature and behaviour that can be applicable in varying business contexts.

A popular framework in the context of corporate governance is that of Jensen-Meckling (J/M) model of agency which is operational based on the Shareholder Value Maximization (SVM), and the agency role of firm managers to articulate the principals' objectives of maximizing their financial returns on investment. Principals possess the ultimate decision making rights concerning organizational goals, values, commitments, and identity; these are not just shareholders but the brains behind the establishment of the firm. On the other hand, the agents as fiduciary are expected to represent the best interest of the principals without recourse to self-interest.

However, the existing framework of corporate governance systems in practice and academia has been delineated based on the agency assumption of the J/M model and studies have revealed the inadequacy of such arrangement. The J/M model emphasized the separation of ownership and control of a firm; the principals are differentiated from the manager. In such situation, there is high likelihood of conflict of interests between the goals of principals and agents and could lead to agency problems. The associated reduction in economic efficiency of the firm consequently, reduces the firm's financial performance. Hence, principals have to monitor, design, and implement financial incentives to reduce agency problems.

Recent realizations have also stressed the inadequacy of the agency arrangement of the J/M model. Empirical studies over time have presented little evidence linking governance structure to firm financial performance. Also, the alignment of the agent's utility with those of the principals appears to be really associated with firm market value. The use of incentives such as stock options, bonuses and other monetary incentives encourage agents to focus on short-term quarterly benefits for shareholders while the market value of the firm is being destroyed with consequential effect on the overall long run performance. However, in spite of the inadequacy of the J/M model, the agency problem cannot be completely written off between the principals and their agent. Hence, the need focus on an approach that looks into the realities as it concerns agency problems in corporate governance systems.

One property of social science is that they are artificial realities knowingly or unknowingly synthesized by humans. This explains the Principle of Double Hermeneutic (PDH) which links knowledge developed by social scientists to their audiences' decisions and designs. PDH implies that the knowledge developed by social scientists can become part of the knowledge that humans use in designing their artificial realities. Just like other social inventions of humans and phenomena studied in social science are artificial realities that are modifiable to suit current realities, corporate

governance systems as designed for the purpose of monitoring and guiding a firm's control system are changeable to fit current realities. Therefore, it is important, that corporate governance systems are treated as evolving institutions which are designed to monitor, incentivize, and strategically guide agents to fulfill the mission of the firm as desired by principals.

The dynamic model of corporate governance systems as suggested seeks to respect the nature of corporate governance systems as institutions which better explains the antecedents and consequences of corporate governance systems universally. Achieving a dynamic model of corporate governance system revolves around the firm's mission as against the principals' goal. The mission of the firm should be designed to capture not only the goals of the firm, but also the values, commitments, identity, and guiding principles for decision-making of the firm. This will embody the goals of principals (for example, what products/services of value should the firm offer to consumers, what should the firm be known for; what is its distinctive identity and competencies), as well as the goals of their human and capital providers. As a result, the firm becomes a human community pursuing a collective mission.

Within the dynamic framework, the firm's mission is such that it allows for flexibility in adapting to future opportunities and threats in changing organizational field conditions. As such, the corporate governance system will be negotiated by both the principals and agents to protect the interests of all stakeholders. The principals perform their functions by monitoring and providing incentives, resources, and strategic guidance to agents. The agents perform their function by providing information about firm operations to principals, making strategy suggestions to principals, and implementing the firm's mission.

No doubt about the possible weaknesses of the dynamic model of corporate governance system as suggested, but it presents a holistic analytical framework for understanding the functioning of corporate governance systems. A firm is part of broader society and has its part to play in societal wellbeing. These corporate governance systems condition and guide agents' choices within the firm, and are aimed at helping agents achieve the mission of the firm.

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