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Corporate governance : a review of literature

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ABSTRACT

This paper reviews the theoretical and empirical literature on the nature and consequences of the corporate governance problem, providing some guidance on the major points of consensus and dissent among researchers on this issue. Also analysed is the effectiveness of a set of external and internal disciplining mechanisms in providing a solution for the corporate governance problem. Apart from this, particular emphases are given to the special conflicts arising from the relationship between managers and shareholders in companies with large ownership diffusion, the issue of managerial entrenchment and the link between firm value and corporate governance

Introduction

Recent financial scandals associated to accounting and other frauds allegedly blamed to top company managers (e.g. Enron, Worldcom, Adelphia) have brought into public light the recurring question of whether companies are managed on the best interests of shareholders and other company stakeholders such as workers, creditors and the general community. A point that has been made frequently is that top managers may possess too much power inside their companies and that a general lack of accountability and control of their activities is prevalent in companies with wide ownership diffusion. Although this kind of scandals is certainly not new, there has been a renewed interest on the mechanisms that can effectively curtail managerial discretion over sensitive company issues that can have an impact on the welfare of the remaining stakeholdersThis paper attempts to provide a survey on the fast-growing theoretical and empirical literature on the corporate governance problem, providing some guidance on the major points of consensus and dissent among researchers regarding the nature and effects of the conflicts of interest between managers and other stakeholders, and on the 3 effectiveness of the set of available external and internal disciplining mechanisms.

Concept of corporate governance

The term "corporate governance" is a relatively new one both in the public and academic debates, although the issues it addresses have been around for much longer, at least since Berle and Means (1932) and the even earlier Smith (1776). Zingales (1998) expresses the view that "allocation of ownership, capital structure, managerial incentive schemes, takeovers, board of directors, pressure from institutional investors, product market competition, labour market competition, organisational structure, etc., can all be thought of as institutions that affect the process through which quasi-rents are distributed (p. 4)". He therefore defines "corporate governance" as "the complex set of constraints that shape the ex-post bargaining over the quasi-rents generated by a firm (p. 4)". Williamson (1985) suggests a similar definition. Viewing the corporation as a nexus of explicit and implicit contracts, Garvey and Swan (1994) assert that "governance determines how the firm's top decision makers (executives) actually administer such contracts (p. 139)". They also observe that governance only matters when such contracts are incomplete, and that a consequence 4 is that executives "no longer resemble the Marshallian entrepreneur (p. 140

Literature review

There are a wide variation and fragmentation among corporate governance studies in India across disciplinary fields including finance, corporate governance practices, earning management, firm performance, firm value, and some other issues. Different areas have been investigated with corporate governance such as corporate illegality (Kaur, Citation2017), financial disclosure (Haldar&Raithatha, Citation2017), equity (Fruin&Dossani, Citation2012; Srivastava et al., Citation2019), internal control disclosure (Ashfaq&Rui, Citation2019), international competitiveness (Haldar et al., Citation2016), ownership (Gollakota& Gupta, Citation2006), quality of financial information (Hundal, Citation2016), regulatory and market model (Sehgal&Mulraj, Citation2008), risk reporting (Saggar& Singh, Citation2017), Satyam failure (Narayanaswamy et al., Citation2015), stock market volatility and efficiency

(Prasanna, Citation2013), sustainability (Kansil& Singh, Citation2018) and talent management (Chahal&Kumari, Citation2013).

Majority of corporate governance studies in India are linked with financial performance (e.g., Arora & Sharma, Citation2016; Bansal & Sharma, Citation2016; Bhatt & Bhattacharya, Citation2015; Kandukuri et al., Citation2015; Mishra &Mohanty, Citation2014; Palaniappan, Citation2017; Rani et al., Citation2014; Sanan, Citation2016; Singla& Singh, Citation2019; Yameen et al., Citation2019). The results of these studies are inconsistent and the findings are conflicted in some cases. Some studies reported that there is an association between corporate governance indicators and financial performance (Arora & Sharma, Citation2016; Kandukuri et al., Citation2015; Rani et al., Citation2014). Some other studies revealed that some corporate governance attributes only have a positive influence on firms' performance; larger board size and attendance of the board members (Bhatt & Bhattacharya, Citation2015), promoters' ownership (Mishra &Kapil, Citation2017), board age diversity (Kagzi&Guha, Citation2018), board size and CEO Chairman dual role (Bansal & Sharma, Citation2016), independent women directors (Sanan, Citation2016), board independence, board size and busyness (Mishra &Kapil, Citation2018). Contradictory, different studies reported that corporate governance attributes have no association with firms' performance. For example, Mishra and Mohanty (Citation2014), Kagzi and Guha (Citation2018), Bansal and Sharma (Citation2016), Bhatt and Bhattacharya (Citation2015), and Mishra and Kapil (Citation2017) respectively declared that gender and tenure diversity of the board, audit committee independence and its meetings frequency, independent directors in the board, and board independence have insignificantly impact on firm performance. However, Bhatt and Bhattacharya (Citation2017) showed a negative impact of board structure on firm performance in family firms compared to nonfamily firms. Further, Palaniappan (Citation2017) found a statistically significant negative relationship between board size and firm performance. Kagzi and Guha (Citation2018) indicated that education diversity negatively affects firm performance.

Corporate governance attributes studied by prior research

This section provides an answer to the second question outlined for this study which asks about how corporate governance attributes have been addressed by prior studies in India? The results show that there are 151 studies that investigated board of directors' issues which is the highest frequency among corporate governance attributes, 90 studies that analyzed ownership structure, 64 studies are discussed audit committee attributes and 11 articles studied audit quality by Big-Four audit companies More specifically, majority focus by prior research in India (91), followed by board size (72), CEO duality (53), board diligence (50), board diversity and gender (22), board committees (16) and board expertise (5). Further, 113 studies investigated different issues of board such as board interlocks, multiple directorships, board profile, remuneration, and some other issues. Similarly, audit committee attributes investigated by prior research in India were distributed in different areas such as Audit committee size, independence, diligence, expertise, and some other issues with a frequency distribution of 16, 30, 22, 9, and 29 respectively. This means that audit committee independence and diligence have the majority concentration by the majority of prior research in India. Finally, ownership structure has been a matter of research by several studies in India. However, both foreign and institutional ownership have the highest frequency of research articles (32 and 31 respectively) as compared to other ownership variables like; government ownership, insider ownership, and ownership concentration (8, 10 and 16 respectively).

Summary and conclusions

This paper analysed the concept of corporate governance, the theoretical reasons for the corporate governance problem and the evidence on the existence of unsolved agency problems in corporations. Some major conclusions were that residual agency costs (Jensen and Meckling, 1976) are significant and that mechanisms for controlling the dimension of these agency costs are available and include external and internal disciplining devices. It was observed that due to important theoretical and practical limitations, external disciplining devices including takeover threat, the managerial labour market, mutual monitoring by managers, reputation, competition in productfactor markets and financial analysts cannot alone solve the corporate governance problem, although they may be important in some particular circumstances.

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