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## Corporate Governance

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### ABSTRACT

In this article general concepts of corporate governance is defined. Although corporate governance mechanisms may differ from country to country, equality, transparency, accountability and responsibility are universally common governance practices. Corporate governance mechanisms support sustainable competitive advantage of the firm.

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### Introduction

Corporate governance is defined as “the determination of the broad uses to which organizational resources will be deployed and the resolution of conflicts among the myriad participants in organizations”(Daily, Dalton, & Cannella, 2003: 371).

A corporate governance code is generally a voluntary set of principles, recommendations, standards, or “best practices”, issued by a collective body, and relating to the internal governance of corporations including the behavior and structure of the board of directors. (Aquilera, & Cuervo-Cazurra, 2004).

Effectiveness of corporate governance mechanisms may differ across countries and are moderated by institutional attributes of a particular economic environment (Hoskisson et al., 2004; Douma et al., 2006; Bruton et al., 2010).

High quality status of corporate governance mean slow capital cost, increase in financial capabilities and liquidity, ability of overcoming crises moreeasily and prevention of the exclusion of soundly managed companies from the capital markets.

Good corporate governance also means improvement of a country’s image, prevention of outflow of domestic funds, increase in foreigncapital investments, increase in the competitive power of the economy and capital markets, overcoming crises with less damage, more efficient allocation of resources attainment and maintenance of a higher level of prosperity.

Below factors generally define the corporate governance of a country:

- Economic status
- Financial conditions
- Level of competition
- Banking system
- Level of development of property rights

Below factors generally define the corporate governance of a company

- Public disclosure of financial and non-financial information
- Equal treatment of shareholders

- Practices of the board of directors
- Independence of the board of directors
- Capital structure
- Level of free float
- Liquidity of stocks
- Level of participation of stakeholders in the decision making process
- Sensitivity of the company to the environment
- Level of social responsibility

Corporate governance practices may vary according to the countries. However, equality, transparency, accountability and responsibility are widely accepted and common practices of corporate governance approaches.

Equality means the equal treatment of share and stakeholders by the management.

Transparency requires to disclose company’s financial and non-financial information to the public in an accurate, timely, understandable, easy to reach, clear manner. Only the trade secrets are excluded for to disclose.

Accountability means the obligation of the board of directors to account to the company as a corporate body and to the shareholders.

Responsibility is the conformity of all operations of the company with legislation, articles of association and company internal regulations.

### Protection of stakeholders’ interests

According to corporate governance literature firms can benefit from protecting stakeholders and inducing firms-specific investments of various stakeholders. Investments by stakeholders which are employees, suppliers, customers, and the local community strengthen the sustainable competitive advantage of the firm.

In 2000s governance theory has been dominated by the view that the board of directors needs to ensure that managers act exclusively in the interests of the corporation’s shareholders (Hansmann & Kraakman, 2001; Jensen & Meckling, 1976).

The effectiveness of corporate governance depends not only on the protection of share holders’ wealth, but also on the

creation of new wealth and its distribution among various stakeholders (Aguilera et al., 2008; Aguilera & Jackson, 2003).

According to Zeitoun, Osterloh, Frey besides shareholders, board of directors have to protect the joint interests of multiple stakeholders, such as employees, suppliers, customers, and the local community to encourage firm-specific investments which contribute to a sustainable competitive advantage of the firm.

According to the studies of Zeitoun, Osterloh, Frey for the protection of the stakeholders', 1) Multiple stakeholders can be represented directly on the boards. 2) Fiduciary decision making can be replaced by shared decision making of shareholders and other stakeholders. Fiduciary decision making is the generic mechanism proposed by legal agency theory. This theory posits that all stakeholders should submit residual control rights to the board of directors, which acts as an autonomous fiduciary (Blair & Stout, 1999; Lan & Heracleous, 2010). The idea is that the board of directors has the fiduciary duty to balance the competing claims of various stakeholders and to prevent the investments of any single stakeholder from being unduly exploited.

Shared decision making, in contrast, means that firms grant their stakeholders direct control rights—for example, by offering them seats on the board of directors.

Corporate governance can be designed by using random selection procedures in the appointment procedures based on demarchy, a form of governance that was successfully used for political governance in ancient Athens.

Demarchy is a form of governance that systematically uses random mechanisms to appoint decision makers (Burnheim, 1985; Dowlen, 2008).

In its extreme form, demarchy implies that all board members are drawn randomly from among stakeholders (Burnheim, 1985). When decision makers are selected randomly from a large pool of candidates, the corrupting influences during the selection process disappear.

Random selection reduces the influence costs of campaigning and self-promotion to achieve political goals (Benz & Frey, 2007; Burnheim, 1985). Random selection provides true representativeness. Random selection encourages members who bring new ideas overlooked by the incumbents. Random selection helps to bring new voices into the boardroom that are otherwise unheard (Fishkin & Farrar, 2005).

Random selection facilitates stability and continuity when stakeholders with diverging interests are involved.

A successful implementation needs to combine it with other selection procedures, such as representative voting and hierarchical selection.

Demarchy gives the advantage of representation of heterogeneous interests of many stakeholder groups at boards.

According to the studies of Zeitoun, Osterloh, Frey for the selection of the board of directors, a dual chamber solution can be proposed which combines demarchy with representative voting and one chamber elected by shareholders and second chamber composed of the other stakeholders.

Shareholders have the privilege to elect their representatives. First, shareholders are uniquely vulnerable concerning the potential exploitation of their investments (Shleifer & Vishny, 1997). Second, as long as shareholders do not expropriate other stakeholders, the shareholders' efforts to increase the firm's stock price are likely to benefit other stakeholders as well (Blair & Stout, 1999). Third, shareholders have relatively homogeneous interests in terms of enhancing

the firm's stock price (Jensen, 2000). Comparing to stakeholders, shareholders can more easily agree on what they expect from their representatives.

According to Zeitoun, Osterloh, Frey, the relationship between two chambers can be varied. One model offers no real power to the second chamber. However stakeholder representatives do not participate in actual decisions.

Another model gives the veto power to the stakeholders on particular issues such as industrial safety or the selection of a new chief executive officer. In a third model, both chambers have the same weight.

According to Zeitoun, Osterloh, Frey ensuring a fair presentation of stakeholders is very important through

- Stratified sampling as the preferred approach to random selection: One approach is to allocate different weights to the stakeholder groups according to their share of non-contractible firm-specific investments. The second approach is to conduct stratified sampling (Mueller, Tollison, & Willett, 1972). Instead of allocating different weights, each stakeholder group receives a predetermined number of seats, and the random selection procedure is conducted within each stakeholder group.

- Accepting a moderate degree of skewness: A moderate degree of skewness can facilitate the early detection of trends and warning signs. Random selection procedures tend to even out imbalances over time.

- Preventing and correcting extreme skewness: By encouraging participations of stakeholders from all classes (e.g., gender, age, education), representativeness of the chamber will be higher.

- Additional measures to facilitate deliberation: Such measures include the provision of training to prospective board members in board decision making; the arrangement of procedural rules that offer all members the opportunity to make their voices heard; and the availability of neutral, trained mediators.

#### **Importance of large global corporations in the application of corporate governance**

Von Gierke proposed that each corporation has personhood and possesses a distinctive personality. Von Gierke's idea spread around the world and influenced government policies and legal decisions in many nations.

According to Starbuck, because of the geographic scope and economic power of large global corporations place beneficial changes in their governance among the most important challenges for humanity. These corporations have been both creating and mitigating the world's serious long-term stresses. It may be possible to make governance changes that render these corporations more beneficial to humanity and reduce the costs they inflict on humanity. Because of future benefits, large global corporations pay special attention to corporate governance.

Some large global corporations have been making important contributions toward a better future in some areas. These contributions include transfers of wealth from more affluent people to more impoverished people, reductions in the frequencies of armed conflicts, increases in social equality, and investments to create future options (De Grauwe & Camerman, 2003; Doering et al., 2002; Omae, 1999; Starbuck, 2004, 2014).

According to Starbuck, large corporations have the power for mitigating or solving global problems. Changes in the governance of large global corporations is possible only if they perceive these changes to be advantageous.

Global corporations are losing their national identities and gradually becoming citizens of the entire world, and their behaviors are creating bonds between individual people and institutions that span national boundaries (Starbuck, 2004, 2014).

According to Starbuck, survival of humanity is more important than the welfare of an individual person, company, or nation. It also seems obvious that global consequences should dominate local or regional benefits.

According to Starbuck, humans must create organizations that pursue long-term survival of nearly all humans and that are willing to transport local wealth and ideas across national boundaries. Although some large, global corporations are behaving as global citizens, too few are doing so. Improved governance of large, global corporations is essential.

#### **The relation of social & technological change and governance**

More education, telework, increasing diversity, globalization, and technological change are making traditional hierarchies less useful and making intra organizational and inter organizational networks more useful. This implies that alliances and inter organizational networks will replace many organizations and that senior executives and governing boards will need to focus on culture building and the management of trust (Baumard & Starbuck, 2001). According to Starbuck, as alliances and networks replace corporations, formal corporate governance will become less relevant for actual behaviors.

#### **Effective Corporate Governance**

Corporate reputation is a holistic and multifaceted judgment of signals sent by the firm, that reflects assessments of the quality of a firm's outputs, the social appropriateness of its behaviors, and the firm's trustworthiness and reliability (Rindova, Williamson, Petkova, & Sever, 2005). Governance arrangements (i.e. governance related practices and characteristics) will likely play into reputational assessments because they send important signals (Sanders & Boivie, 2004) regarding whose interests will be served, what ideologies or managerial models will inform corporate decisions (Zajac & Westphal, 2004), and what the firm can be counted onto do or not to do.

According to Star buck, for governance changes to have lasting and significant effects, the changes should focus on managers themselves. His opinion is that as corporations expanded globally, they have come to rely increasingly on native-born host-nation executives and these executives rising to the tops of managerial hierarchies. Starbuck also thinks that senior executives need exposure to dissenting views that will help them to remain grounded.

According to Starbuck, governance by management can grow more effective when senior executives receive inputs from people they perceive as their peers: senior executives from other corporations and from government agencies. Everyone, including CEOs and other senior executives, is more likely to listen carefully to people they perceive as peers.

#### **Multiple Theories of Corporate Governance**

##### **Environmental Characteristics as Assumptions in Corporate Governance**

Researchers have documented the strong and consistent links between corporate governance (CG) and firm performance, under the agency theory (Jensen & Meckling, 1976), there source-dependence theory (Hillman & Dalziel, 2003), stakeholder theory (Hillman & Keim, 2001) and institutional theory (Such man, 1995).

Research finds that corporate governance standards are affected by varying regulatory environments (LaPorta, Lopez-de-Silanes, Shleifer, & Vishny, 1998).

#### **Agency theory**

The classical arguments of Jensen & Meckling (1976) suggest that ownership and managerial interest may not be aligned, leading to agency costs (Jensen, 1986;

Jensen & Meckling, 1976), and internal inefficiencies. Firms with high levels of agency are likely to face threats from firms in the environment, through the mechanism of the market for corporate control (Jensen & Ruback, 1983). These assumptions fundamentally presume the operation of an efficient, competitive environment, in which information asymmetries are minimal, and competitive pressures are high.

An agency theory perspective suggests that, for a number of reasons, the owners of modern corporations (i.e., shareholders) ultimately cede control of the day-to-day management of firm operations to professional managers (Berle & Means, 1932).

Agency theory further indicates that managers' personal goals and objectives routinely diverge from those of shareholders and that, under these conditions, self-interested managers frequently exploit their control over company operations to advance their own material interests at the expense of shareholders' principal objectives (Jensen & Meckling, 1976).

In keeping with the premise of the theory, a central purpose of a number of governance mechanisms recommended by an agency perspective, and actively advocated by corporate governance reformers, is to increase the alignment of managers' personal interests with the core interests of shareholders, key among which is strong firm financial performance (Daily, Dalton, & Rajagopalan, 2003; Dalton, Daily, Certo, & Roengpitya, 2003; Eisenhardt, 1989; Jensen & Murphy, 1990).

In the economic view in which agency theory is grounded, personal wealth is an especially important source of subjective utility. Accordingly, agency theorists have argued that, to the extent that they receive financial rewards when their firms are successful, firm executives are more willing to forgo actions that provide them with direct material benefits to instead engage in behaviors that enhance firm performance (Beatty & Zajac, 1994; Daily, Dalton, & Rajagopalan, 2003; Dalton et al., 2003; Jensen & Murphy, 1990; Shleifer & Vishny, 1997; Westphal & Zajac, 1994).

This alignment of CEOs' financial interests with the interests of the shareholders is frequently achieved through CEO stock ownership and other performance-based compensation, both of which strengthen the link between firm performance and CEOs' individual wealth and lead to an increase in the potential financial rewards that they receive for achieving firm success (e.g., Core & Qian, 2001; Guay, 1999; Morck, Shleifer, & Vishny, 1990; Smith & Watts, 1992; see Core, Guay, and Larcker [2003] and Daily, Dalton, and Cannella [2003] for reviews).

#### **Resource dependence theory**

Boards of directors can be a key source of various resources (Hillman & Dalziel, 2003). According to Udayasankar, Das, Krishnamurti, the general proposition that firms can benefit from board capital presumes the existence of a reasonably efficient labour market, wherein such skills are both available and competitively accessible. Therefore the resource-dependence view is strongly contingent on the presence of a competitive environment.

Like stakeholder theory, resource dependency argues that boards should have both a monitoring and a consultative function. Boards should be comprised of diverse members, each of whom brings important resources, to compose a board capable of assisting the firm to create and to sustain competitive advantage.

According to the resource based theory of the firm, firm-specific investments of various stakeholders are essential sources of an organization's sustained competitive advantage because they contribute to the creation of valuable and hard-to-imitate assets (Barney, 1991; Nickerson, Yen, & Mahoney, 2012).

#### **Stakeholder theory**

Stakeholder theory (Freeman, 1984) has gained much force with suggestions that the practice of stakeholder management will contribute positively to the performance of firms (Donaldson & Preston, 1995; Hillman & Keim, 2001).

The emphasis on stakeholders is dependent on the levels of protection that are provided to various stakeholder groups. Firm value is higher in countries with better protection of minority shareholders (LaPorta, Lopez-De-Silanes, Shleifer, & Vishny, 2002), and in countries with strong protection of minority investor rights, overinvestment in declining industries is curbed (Wurgler, 2000).

#### **Institutional theory**

Institutional pressures to meet certain standards of corporate governance may affect firm decision-making (Gillian & Starks, 2001; Shleifer & Vishny, 1997). Institutional actors also lead to reduced "earnings management", or the alteration of firms' reported economic performance by insiders (Leuz, Nanda, & Wysocki, 2003). However, the institutional perspective assumes that the environment recognizes and empowers institutions to award firms, or withhold from firms, resources such as legitimacy. Therefore, the tenets of institutional theory are also best met in a business environment with high levels of regulation.

According to Udayasankar, Das, Krishnamurti, the assumptions of both stakeholder and institutional perspectives on corporate governance are therefore best met in an environment with high levels of regulatory efficiency, whereas the assumptions underlying agency and resource-dependence theories are best met in competitive environments.

Doidge, Karolyi & Stulz (2004) postulate that in economies with poor regulatory development, firms will find it difficult to commit to good governance, particularly because adopting good governance practices involves costs, without any associated benefits.

#### **Reputational Implications of Governance Arrangements**

According to Bednar, Love, Kraatz, 3 relevant sets of arguments in the literature can be identified in considering how governance arrangements may affect reputation.

#### **Interest-Based Arguments**

Subjective evaluations are strongly influenced by the perceived quality of the firms' outputs. Perceptions of product quality have been shown to shape consumers' overall reputational assessments of firms (Fombrun & Van Riel, 2004), while economic performance does the same for corporate actors' assessments (McGuire, Schneeweis, & Branch, 1990). Underlying these arguments is the idea that reputation reflects firms' ability to fulfill evaluating audiences' material interests and needs.

#### **Conformity-Based Arguments**

A different set of arguments holds that corporate reputations are shaped by firms' conformity with external,

socially constructed standards and categories (Staw & Epstein, 2000). Organizations adopt structures and practices in response to field-level pressures and gain legitimacy and material support in return for this conformity (Tolbert & Zucker, 1983). Governance research has drawn on similar ideas to show that different conceptualizations of corporate governance lead to very different ideas about what a firm is, what its goals should be, and whose interests should be served through its actions (Zajac and Westphal, 2004).

For example, changes in the broader institutional environment, such as a shift to a shareholder value orientation, can affect firms' governance arrangements (Fiss & Zajac, 2004). As these broader ideas become institutionalized, firms often adopt governance structures in symbolic ways to maintain legitimacy while effectively retaining autonomy for top managers (Westphal & Zajac, 1994).

#### **Character-Based Arguments**

A third set of arguments suggests that evaluators assign positive reputations to firms that appear to possess desirable character traits, (Dowling, 2001) as people anthropomorphize firms and attribute human character traits to them (Davies, Chun, DaSilva, & Roper, 2003). That is, organizations are treated as coherent, purposeful social entities rather than mere aggregations of individuals (Whetten & Mackey, 2002).

#### **Corporate Governance in Transition Economies**

Economic reforms and globalization of firms in transition economies have dramatically changed the boundaries and content of governance and strategy. The process of internationalization of firms in emerging market economies exposes them to multipoint competitive pressures (Filatotchev, Demina, Wright & Buck, 2001), and managers of these firms have to make strategic decisions in the most complex decision-making environment (Carpenter & Fredrickson, 2001). However, the question of how large firms in transition countries develop international activities, and their links with managerial ability to make strategic decisions within the context of the firm's governance remains relatively unexplored (Buck, Filatotchev, Wright & Demina, 2003).

Uhlenbruck, Meyer & Hitt (2003) strongly emphasize that the continuously changing market conditions in transition economies require the development of "strategic flexibility" that should help firms to take advantage of existing and new strategic opportunities. Strategic flexibility depends jointly on the inherent flexibility of resources available to the organization and on managers' flexibility in applying those resources to alternative courses of action, or "flexibility in coordinating the use of resources" (Sanchez, 1995: 138). Peng (2000) suggests that environmental uncertainty and institutional changes in transition are usually accompanied by deepening mistrust between managers and "new principals", who may try to limit managers' strategic discretion and assume full control over the decision-making process.

An ultimate long-run firm objective is to achieve superior performance and secure survival. Hence, exporting is an integral part of a wider strategic choice, or "internal" and "external" innovations, such as R&D, new product development, acquisitions, etc. (Filatotchev, Buck & Zhukov, 2000). The continuously changing market conditions in transition economies require a great deal of managerial flexibility in re-configuring, developing new and using existing resources and capabilities, and this strategy process is aimed at improving the firm's competitiveness and performance both domestically and globally. According to Filatotchev, Isachenkova, Mickiewicz, there is a direct link

between managerial strategic independence and firm performance.

From the information-processing perspective, an increase in complexity associated with strategic restructuring and internationalization imposes new demands on managerial ability to develop flexible strategic responses to changing environment. This may lead to strategic errors and loss in competitiveness even when the interests of managers and shareholders are aligned (Carpenter & Fredrickson, 2001). In strategic management research there is growing recognition that, in addition to control functions, corporate governance factors may also play service/resource and strategic roles in the decision-making process (Filatotchev & Bishop, 2002). For example, the characteristics of a firm's board of directors can affect top management decision-making process, shaping the firm's strategic objectives and outcomes. Outside independent directors serving on the focal firm's board may provide an important channel for the inter-firm exchange of strategic information and knowledge that managers can use in the decision-making process. Strategy research particularly emphasizes the importance of the board's service and support roles when the firm faces a highly uncertain environment of transition economies (Peng, 2000). According to Filatotchev, Isachenkova, Mickiewicz, foreign investors' board involvement reduces information asymmetry problems.

#### **The affect of corporate governance characteristics to the human and social capital on the board**

According to Boivie, directors are valuable human resource assets that must be attracted and retained. Strategic human resource management theory suggests that when designing organizational policies organizations should be mindful of how those policies might affect firms' ability to attract and retain talented employees and managers (Arthur, 1994; Leana and VanBuren, 1999; McMahan et al., 1998).

In fact, research shows that organizational policies designed to control employees rather than generate organizational commitment produce lower performance and higher turnover (Arthur, 1994). While it has generally been applied to lower level employees, strategic human resource management theory applies to higher level executives and directors as well (Offstein et al., 2005).

Strategic human resource theory argues that individuals are attracted to and stay with firms for a number of reasons beyond merely compensation (McMahan et al., 1998). Strategic human resource management theory contends that individuals prefer organizations and organizational policies that match their various desires for personal learning and information, increased opportunities to gain power and prestige, rewards (including financial rewards), and more (McMahan et al., 1998).

Strategic human resource theory suggests that as the costs and potential risks of being a director increase, and the benefits of being a director stay stable or decline, individuals will be less likely to accept board appointments.

Directors, who possess pools of valuable skills, experience, knowledge, and contacts, will consider the utility of accepting and/or retaining board positions. Strategic human resource management theory suggests that this should be especially true of the directors with the highest levels of human and social capital (Offstein et al., 2005).

Becker (1962) defined human capital as resources that are embedded within people. Becker argued that individuals make choices about investments in their time that can result in stocks of human capital. The idea is that individuals make

choices about which productivity enhancing activities to pursue in order to maximize future income and psychic benefit (Gimeno et al., 1997). The result of these choices and time-investments is human capital. Human capital accrues through the application of time and energy devoted to learning through education or experience. This stock of capital can then be used in subsequent situations. Indeed, there is extensive evidence that human capital at the executive level can lead to better firm performance (Bantel and Jackson, 1989; Carpenter, Sanders, & Gregersen, 2001; Kor, 2003).

Social capital is another factor that may contribute to the ability of directors to provide quality monitoring and advice. Social capital has been empirically shown to have a number of benefits (Adler and Kwon, 2002). Adler and Kwon define social capital as "the goodwill available to individuals or groups. Its source lies in the structure and content of the actor's social relations. Its effects flow from the information, influence, and solidarity it makes available to the actor" (2002: 23). Directors with greater social capital through more board ties, or connections to prominent others will have better access to information. This will improve their ability to monitor executive action and their ability to provide advice on strategic issues.

Research has shown that social networks may give actors access to information that leads to greater innovation (Burt, 1987; Powell, Koput, & Smith-Doerr, 1996). Social capital may also give a board power and influence in the eyes of external stakeholders (Burt, 1983; Filatotchev and Bishop, 2002; Uzzi, 1999). Therefore, having a board comprised of members with higher levels of social capital is likely to lead to improved firm performance.

According to Boivie, directors may be selective about the boards they serve on. Thus, boards with greater risk and requires more time and involvement faces difficulty of finding the best directors. According to a recent survey the best directors are likely to receive multiple board offers and tend to not accept every board invitation they receive (Felton and Watson, 2002).

According to Boivie, directors with high social and human capital have the most to lose if a directorship goes badly, this will allow them to be selective which appointments they accept.

They also are reluctant to accept board membership which require greater investments of time and energy.

It is often argued that increases in the proportion of outside directors improve the independence and functioning of the board. According to agency perspective, outsider dominated boards has more power to effectively monitor. It will be also more attractive for board appointment. Despite these advantages, there is no empirical evidence to suggest that the proportion of outsiders actually improves firm performance (Dalton and Dalton, 2005; Dalton et al., 1998)

According to Boivie, high proportions of outside directors can be seen as risk to returning and prospective directors. These directors can see this situation as requirement of more time and effort on the boards. They can evaluate this situation also greater conflict between the CEO and the board. (Baysinger and Hoskisson, 1990; Westphal, 1998).

According to Boivie, the increase in proportions of outside directors may actually lower the human and social capital of the board.

Directors may be less willing to join a board if the current atmosphere is contentious or filled with struggles for power. Insiders serve a useful purpose on boards. Insiders generally

have more extensive knowledge about the firm and provide useful insight into the day to day activities of the firm (Baysinger and Hoskisson, 1990).

#### **High-involvement work systems**

Research on human resource practices has shown that a specific set of practices – known as “innovative”, “high-performance” or “high-involvement” work systems - can have a positive impact on establishment performance by providing employees with skills, incentives, and opportunities to work more efficiently and to share and implement their ideas (e.g., Combs, Liu, Hall, & Ketchen, 2006; Ichniowski, Kochan, Levine, Olson, & Strauss, 1996; Ichniowski, Shaw, & Premeaux, 1997). Furthermore, high-involvement work systems have been associated with several beneficial work-related outcomes, such as low employee quit rates (e.g., Huselid, 1995) and high job satisfaction (e.g., Kooij, Jansen, Dijkers, & De Lange, 2011).

Research on human resource practices submits that high-involvement work systems require substantial investments by employers and employees to foster the accumulation of firm specific human capital (Lado & Wilson, 1994; Lepak & Snell, 1999), which can be an important driver of the firm's sustainable competitive advantage according to resource-based approaches of the firm (Foss & Foss, 2000; Grandori & Kogut, 2002; Grant, 1996; Kogut & Zander, 1996; Mahoney & Pandian, 1992; Penrose, 1959; Rumelt, 1984; Teece, Pisano, & Shuen, 1997).

According to Zeitoun and Pamini, on the part of employers, these investments include employee training, regular information sharing, employment security, and the redesign of work processes and incentives to encourage teamwork. Employee training and the redesign of work processes involve direct costs to employer, others involve indirect costs.

Empirical studies indicate that high involvement work systems often require complementary investments in information technology to reach their full productivity-enhancing potential (Black & Lynch, 2001; Bresnahan, Brynjolfsson, & Hitt, 2002; Brynjolfsson & Hitt, 2000).

According to Zeitoun and Pamini, successful implementation of high-involvement work systems depends on risky investments by both employers and employees. Given these risks, employers are more likely to persist in their implementation of high-involvement work systems if they can rely on stable, cooperative relationships with their employees. Furthermore, employees are more likely to make firm-specific investments if they can count on some protection of their interests. This is where corporate governance is likely to provide an impetus.

According to Zeitoun and Pamini, there are four mentioned corporate governance dimensions - the presence of relational shareholders, owner-managers, union recognition, and collective disputes procedures - are likely to be complementary with high-involvement work systems

1) Firms may be owned by relational shareholders, such as family owners and individuals who hold a substantial share of the firm's equity for the long term. In contrast to transactional shareholders, relational shareholders are typically more supportive of employee interests and therefore provide some insurance against exploitation of employees' firm-specific investments (David, O'Brien, Yoshikawa, & Delios, 2010).

2) Firms may have owner-managers who simultaneously control a substantial share of the firm's equity and are engaged in the firm's day-to-day business. Owner-managers are likely

to develop a certain degree of loyalty toward the firm's employees (Akerlof, 1983), which may prevent them from exploiting employees' firm-specific human capital.

3) Firms may recognize trade unions as negotiating partners who take employees' interests into account. While such recognition reduces the firm's flexibility, it is likely to stabilize employment relationships and thus to induce investments in firm-specific human capital (Blair, 1999). Employees have a better rationale to make productivity-enhancing suggestions to management if they need not fear that an increase in productivity will lead to layoffs (Freeman & Lazaar, 1995).

4) Firms may adhere to formal collective disputes procedures committing them to enter into negotiations with their employees when there are disagreements concerning pay, working conditions, redundancies, or other issues.

According to Zeitoun and Pamini, the implementation of high-involvement work systems needs to be considered in the context of corporate governance characteristics.

Unless governance mechanisms support stable relationship between employers and employees, high involvement work systems may not produce the desired performance outcomes.

#### **An agency perspective of corporate ownership**

Agency theory argues that firms' competitive position will depend on their efficiency in reducing the agency costs, which arise from the separation between ownership and control (Fama, & Jensen, 1983, Demsetz, & Lehn, 1985). Villalonga and Amit (2006) refer to this owner-manager conflict as type I agency problem. Berle and Means (1932) suggest that ownership concentration may alleviate the conflicts of interest between owners and managers, reducing the agency costs. However, a large shareholder may use her power to improve her own position at the expense of other shareholders (Hart, 1995: 683). It gives rise to another type of conflict, type II agency problem, which characterizes the conflict of interest between the large shareholder and the small shareholders.

Firms are affected by their institutional environment when deciding whether to comply or not with the recommendations of their country corporate governance codes. According to De Castro and Cladera, firms with high ownership concentration, where the type II agency problem is more common, generally choose not to comply with codes. The degree of non-compliance is stressed when families have more stakes in the firm. In contrast, high institutional investors' shareholdings lead to low degree of non-compliance with codes' recommendations. According to De Castro and Cladera, there is strong support for the differential effect of country institutions and, consequently, different firm behavior across countries.

Ownership and control concentration is an important factor that affects the role and function of corporate legislation and hence the direction of its reforms. According to De Castro and Cladera, for instance, in countries where widely held companies prevail (e.g. U.S. and U.K.), the main function of corporate governance regulation is to protect shareholders from being expropriated by the management, known as “type I agency problem”.

In the other hand, in countries where companies have a concentrated ownership and control structure (e.g., continental European countries) the function of corporate governance regulation is to minimize the extent of agency problems

between majority and minority shareholders, “type II agency problem”.

Despite the differences in corporate governance realities across countries, it has been argued that corporate governance practices converge and harmonize around the world (Djelic, 1998; Hansmann, & Kraakman, 2001; Aguilera, & Cuervo-Cazurra, 2004; OECD, 2004). Such harmonization grounds on the reason that effective governance systems become attractive to investors (La Porta et al., 1998), domestic and/or foreign, and therefore, can promote economic growth (Aguilera, & Cuervo-Cazurra, 2004).

According to De Castro and Cladera, firms with high ownership concentration are more likely to have higher degree of non-compliance with codes’ recommendations than firms with dispersed ownership.

### **An institutional perspective of corporate ownership**

#### **Family ownership**

A vast literature in the corporate governance field tries to understand the puzzle of family ownership as a mechanism to solve agency problem between owners and managers (Claessens et al., 2002; Anderson, & Reeb, 2003; Cronqvist, & Nilsson, 2003;

Villalonga, & Amit, 2006; Dalton et al., 2007), even though with mixed results. At one perspective, the family block-holder could diminish the type I agency problem as family members are more likely to monitor managers. Yet, it could be the case that a high equity positions by family members increase the incentives to expropriate rents from other shareholder driving to a new agency problem (e.g., type II agency problem). Chung and Luo (2008) and Young et al. (2008) argue that the family model of corporate governance carries an institutional logic of family control.

It means that family members expect to control the decision-making processes in such a way that they can maintain the family assets for future generations including decisions associated with the governance system of the firm, like the election of the board of directors, the decision to disclose or not the executive (e.g. family members) compensation, or the independence of the directors. For instance, Anderson and Reeb (2003) state that the family’s role in selecting managers and directors can also create impediments for third parties in capturing control of the firm, suggesting greater managerial entrenchment. It implies that families will pursue actions to maximize their personal utility and to maintain the control and power on the hands of their constituents.

According to De Castro and Cladera, firms with higher family shareholdings are more likely to have higher degree of non-compliance with codes’ recommendations than firms with lower family shareholdings.

#### **Do country matters to non-compliance with corporate governance codes?**

International comparative corporate governance research contrast two systems of corporate governance - Anglo-American and continental European, and at the core of this distinction are the different systems of corporate ownership and the formal institutions that set the environment for the economic exchange (Gedajlovic, & Shapiro, 1998; Hall, & Soskice, 2001; Aguilera, & Jackson, 2003, 2010). Together with ownership structure, legal systems and its related corporate law, the development and structure of capital, product and labor markets, and political and economic institutions define the myriad of varieties of capitalisms that,

ultimately, characterize corporate governance systems (Hall and Soskice, 2001).

It follows that country environment may have an important influence on governance structures (Doidge, Karolyi, & Stulz, 2007; Li, & Harrison, 2008).

Zattoni and Cuomo (2008) report that countries from the Anglo-American system of corporate governance are early adopters of corporate governance codes which provided the legitimacy innovation and compliance, while continental European countries, as late adopters, were then under pressure to implement the reforms for fear of losing legitimacy.

According to De Castro and Cladera, Firms from continental European system of corporate governance are more likely to have higher degree of non-compliance with codes’ recommendations than firms from the Anglo-American system.

#### **The board reform logic in Canada**

According to the researches of Shipilov and Rowley, between 1999-2005, the boards of large Canadian organizations have been reformed.

The first wave of board reform that spread across the Canadian economy emphasized increased board independence, via practices such as having a majority on boards of independent directors who are not otherwise affiliated with the firm on whose board they sit; separating the CEO and board chairman positions; and full independence (no insider directors) of a board’s audit and compensation committees. The second wave of board reform was aimed at altering processes in the boardroom, via practices such as adopting formal processes for evaluating the performance of individual directors and the performance of a board as a whole.

In a public corporation, the board of directors is legally charged with exercising oversight on behalf of the shareholders over the actions of management. The logic of board reform is a socially constructed pattern of practices, assumptions, and rules whereby boards are reformed in such a way that they become more independent from management (Westphal & Zajac, 1998). This logic originates in the works of agency and managerial hegemony theorists, who have maintained that reduction in a board’s dependence on management is vital to improving its ability to control managerial decision making and maximize shareholder value (Beatty & Zajac, 1994; Crystal, 1984; Fama & Jensen, 1983).

In 1994, Canadian institutional investors and the Toronto Stock Exchange commissioned the Dey Report, which identified six “best practices” that conformed to the board reform logic. These comprised two distinct groups: structural practices altering board composition and process practices evaluating board and individual director performance.

The Dey Report recommended that

- (1) A board should contain at least two-thirds independent directors,
- (2) A single individual should not hold both a company’s CEO and board chair positions,
- (3) A board’s audit committee should consist of only independent directors, and
- (4) A board’s compensation committee should consist of only independent directors. In addition to these structural prescriptions, the report suggested boards adopt
- (5) Formal director evaluation and
- (6) Formal board evaluation as means of tracking board performance. Director evaluation involved peer-to-peer assessment of each director’s performance, usually annually.

Board evaluation was also based on directors' assessment and focused on the quality of board meetings, board information packages, the chair's leadership, and specific board processes.

This change closely followed the passage of the U.S. government's Sarbanes-Oxley Act, which in response to the corporate governance scandals demanded the adoption of board reform practices and the abandonment of practices associated with the management-controlled-board logic.

#### **Network influences**

Network ties between organizations represent information conduits that spread practices because individuals view information obtained through an interpersonal contact as more salient and reliable than information obtained through other sources (Davis, 1991).

The board interlock network is seen as the most consequential conduit because it represents an efficient means of transferring information among a set of individuals who make decisions (Canyon & Shipilov, forthcoming; Davis & Greve, 1997). For example, board interlocks have been shown to facilitate the spread of poison pills (Davis & Greve, 1997), the multidivisional form of organization (Palmer, Jennings, & Zhou, 1993), and the separation of CEO and chair positions (Westphal & Zajac, 1997).

According to Shipilov and Rowley, an organization's adoption of a practice is positively influenced by the cumulative adoption of the same practice by the firms with which it has interlock ties.

#### **Multiple Waves of Practices**

The adoption of first-wave practices (increased board independence) signifies an organization's commitment to the underlying institutional logic. That is, the organization that has adopted the first wave of logic-defining practices has identified the problem that the first-wave practices address and labeled itself as an entity that solves such problems (March, Sproull, & Tamuz, 1991).

Organizations can become committed to an institutional logic by implementing first-wave practices (increased board independence), which facilitate the adoption of second-wave practices (adopting formal processes for evaluating the performance of individual directors and the performance of a board as a whole) sharing a common rhetoric and rationales (Lee & Paruchuri, 2008).

According to Shipilov and Rowley, the adoption of a second-wave practice (adopting formal processes for evaluating the performance of individual directors and the performance of a board as a whole) is positively influenced by an organization's prior adoption of the first-wave practices (increased board independence) from the same institutional logic.

#### **Institutional Investors**

In this changing environment, strategic decision makers have witnessed the emergence of a new stakeholder group, institutional investors, which include public and union pension funds, mutual funds, investment bankers, insurance companies, and private firms (Chaganti & Damanpour, 1991; Pound, 1992). Because the investments made by institutional shareholders are so large, they have less ability than individual shareholders to move quickly in and out of funds without affecting share price (Pound, 1988).

As a result, these institutional investors have a strong interest not only in the financial performance of the firms in which they invest, but also in the strategies, activities, and other stakeholders of those firms (Fortune, 1993; Gilson &

Kraakman, 1991; Holderness & Sheehan, 1988; Pound, 1992; Smith, 1996). Thus, institutional investors may see the long-term benefits of these firms' maintaining product quality, being responsive to the natural environment, and being responsive to the communities in which they operate and the people they employ (Turban & Greening, 1997). Stakeholder responsiveness has also been linked to the increased involvement of boards of directors (Wang & Dewhirst, 1992) as well as to increased scrutiny of top management team incentives and investment behavior (Jensen & Murphy, 1990).

#### **Corporate Social Performance**

Several CSP-related research questions have been investigated, with mixed results (Griffin & Mahon, 1997). Use of the database developed by Kinder, Lydenberg, Domini, and Company (KLD), which objectively rates firms on nine dimensions of CSP (Investment managers, pension funds, top management team equity, outside directors, community, women and minorities, employee relations, environment, product quality) may rectify these problems.

Five of the KLD dimensions have been frequently used for research purposes (Graves & Waddock, 1994; Turban & Greening, 1997): a firm's social performance with regard to local communities, women and minorities, employee relations, the natural environment, and the quality of products or services.

Researchers have generally accepted the notion that GSP is multidimensional (GarroU, 1991; Griffin & Mahon, 1997) but have combined the various dimensions used to measure the construct into one aggregate measure (Griffin & Mahon, 1997).

- (1) People dimension: A community, women, minorities, and employee relations dimension and
- (2) Product quality dimension: a product quality and environment dimension.

The community, women and minorities, and employee relations grouping, which is called the people dimension, relates to the contributions firms make to communities, to their hiring of women and minorities, and to their treatment of employees. The product quality and environment dimension—hereafter, the product quality dimension—relates to product and service quality and to a firm's stance toward the natural environment. Product quality and environmentally sound manufacturing are, in effect, two attributes of producing a product.

The establishment of the ISO 9,000 criteria by the International Organization for Standardization requires firms to establish a series of management subsystems, standards, and guidelines to ensure product quality as well as safe and environmentally responsible practices (Uzumeri, 1997). The later ISO 14,000 criteria explicitly emphasize standards for production that require firms to be environmentally conscious and compliant (Gascio, 1996; Puri, 1996).

Zahra and colleagues (1993) suggested that the number of outside directors on a company's board increases the racial, ethnic, and gender diversity of the company.

This increased diversity would logically be related to the people dimension of GSP; diverse boards will probably be more sensitive to racial and gender imbalances as they have nonprofit goals as well as profit goals (Pfeffer, 1973) and may be more inclined to see a relationship between maintaining constituency legitimacy and continued financial sustainability. The resource dependence framework (Pfeffer & Salancik, 1978) suggests that the selection of outside members can be viewed as a strategy for dealing with an organization's

relationships with its environment. Some support has been found for the effectiveness of outside directors as resource acquisition agents (Boeker & Goodstein, 1991). In addition, outside directors may enhance the reputation and credibility of an organization and help to establish and maintain its legitimacy (Pfeffer & Salancik, 1978).

### **Governance Structure**

Internationalization increases information processing demands on the firm due to added communications necessary to bridge information asymmetries between the management and the board. Additionally, internationalization also creates the demand for more resources and capabilities to manage the firm's far flung operations. Firms deal with the information processing demands by increasing information capacity through governance arrangements like board structure and CEO duality (Sanders & Carpenter, 1998). The increased organizational complexity (resulting from internationalization) also increases agency costs necessitating changes in governance mechanisms.

Whether instructed by Sarbanes-Oxley or the private stock exchanges, the criterion for selecting board directors is simple: Pick only independent directors, those who have no material or familial connections to management. In fact, the New York Stock Exchange requires the board to have an independent director majority and that all important audit, nomination, and executive committees be wholly comprised of independent directors.

According to Kaufman and Englander, this reliance on independent directors proceeds from a financial agency or shareholder maximizing model. By the late 1980s, it had replaced managerial stakeholder theory as accepted corporate governance wisdom. Where stakeholder theory conceives of the firm as a new-wealth-creating coordinators, the shareholder model conceives of the firm as a shareholder maximizing enterprise and directors as shareholder agents.

The shareholder maxim focuses managerial attention on short-term market price rather than on long-term value creation. Total value maximization, as finance theorists now admit, does not incur these deficits. It directs managers' attention on sustained value-creation by pegging long-term rather than short-term stock prices to be the best scorecard.

According to Kaufman and Englander's team production model for selecting board members, rather than conceiving of boards solely as monitoring agents for shareholders, the team production model asks that the board replicate team members, both within and connected to the firm, who add value, assume unique risks, and possess strategic information in the corporation. When chosen by these three criteria, directors bring to the board the know-how by which the firm competes, the information required for engaging management in serious deliberations, and the expertise to evaluate managers on multiple performance standards.

According to this team production model, each firm's success depends on motivated, self-reliant employees and stakeholders who quickly turn the latest scientific and technological knowledge into knowhow. According to Kaufman and Englander only independent non-CEO directors populate audit, nominating, and compensation committees.

Although there is near consensus among theoreticians concerning the best CEO-board chair structure- agreements that one individual should not simultaneously hold the roles of CEO and board chairperson (e.g., Dalton & Kesner, 1987; Malette & Fowler, 1992; Zahra & Pearce, 1989).

Rechner and Dalton (1991) reported that firms with dual structures had higher financial performance than other firms. It has been also reported that boards with high outsider representation are more likely to be strategically involved in firm restructuring (Johnson, Hoskisson, & Hitt, 1993). According to Daily and Dalton, boards with many outsiders may be more likely than others to take action to prevent further performance declines, and ultimately, bankruptcy itself.

According to Daily and Dalton, directors (or nominees) with the following relationships to a firm must be identified:

- (1) employment by the corporation or an affiliate within the last five years,
- (2) Any family relationship by blood or marriage closer than second cousin,
- (3) Affiliation in the last two years with a concern that has had a customer, supplier, banker, or creditor relationship with the corporation,
- (4) Affiliation with an investment banker who has performed services for the corporation within two years or will do so within one year,
- (5) Holding control of corporate stock, with control based on the extent of shareholdings (federal securities law sets forth exact amounts and conditions), and
- (6) Association with a law firm engaged by the corporation.

According to Daily and Dalton, bankrupt firms will have higher proportions of affiliated directors than survivor firms.

According to Daily and Dalton, a governance approach characterized by separation of the CEO and chairperson offices and a high proportion of nonaffiliated outside directors would produce a relatively independent structure. Conversely, combining the offices of CEO and board chairperson and having a large number of affiliated directors suggests a more centralized approach.

CEO Duality is an indication of high CEO power and reduced board independence. Duality helps establish unity of command and clarifies decision-making authority (e.g., Baliga, Moyer, & Rao, 1996). Furthermore, increased complexity from internationalization increases information asymmetries, thus necessitating greater monitoring of management by the board. Since the CEO also serves as the presiding officer of the board, duality compromises the ability of the board to monitor the CEO's practices, policies and performance (e.g., Jensen, 2005).

Additionally, aboard chair and a CEO may have different network ties and access to different sets of resources. From a resource dependence perspective, the different network ties and additional resources are useful for the success of international operations.

A number of empirical studies have suggested that independent boards, which are thought to more closely monitor CEO decision making and performance, are more willing and able to dismiss CEOs of poorly performing firms (Boeker, 1992; Cannella & Lubatkin, 1993; Warner, Watts, & Wruck, 1988; Weisbach, 1988). The evidence also indicates that board vigilance tends to strengthen the link between firm Performance and elements of CEO compensation, such as CEOs' annual bonuses, that are determined primarily by directors' assessments of CEOs' effectiveness (Ittner, Larcker, & Randall, 2003; Larcker, 1983; Tosi & Gomez-Mejia, 1989; Ryan & Wiggins, 2004).

According to McDonald, Khanna and Westphal, CEOs who are closely monitored by their boards will be especially

concerned with making high-quality strategic decisions that lead to superior firm performance and with avoiding ineffective strategic decisions that lead to poor performance.

CEO compensation is positively linked to organizational complexity (Henderson & Fredrickson, 1996) and additional risk taking (Wiseman & Gomez-Mejia, 1998), both of which increase with internationalization.

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