

## Corporate Governance: Board Structure, Information Technology and CSR Reporting

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### Abstract

Good corporate governance practices are considered vital for attracting investment capital, improving the performance of companies and reducing risk for investors. This paper provides some general overviews on board structure, information technology (IT) and corporate social responsibility (CSR) reporting. This paper also discusses the various theories related to corporate governance in order to understand the corporate phenomena. This is important to understand each of the theory concept and its implications. These theories include agency theory, stewardship theory, stakeholder theory, resource dependency theory and legitimacy theory. Certainly, board structure, IT and CSR have significant bearing on a firm's state of corporate governance and performance.

*Keywords:* Corporate governance, board structure, IT, technology, CSR reporting

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### 1.0 INTRODUCTION

For the past few decades, corporate governance has been an increasingly significant factor for economic and social development in particular the capital market. Corporate governance can provides extent of investor confidence that is necessary to attract the investment capital, through shareholders promote management with respect to their interests.<sup>1</sup> It handles the objectives and welfare of all the stakeholders, including board of directors, lenders, management, regulators and shareholders.<sup>2</sup> The goal of corporate governance is to balance the welfare of all stakeholders. In a way, good corporate governance is a tool that can define the company's value.<sup>3-4</sup> Use wisely, corporate governance can be a strategic tool to mitigate business risk and boost a firm's value. No management team can ignore the importance of corporate governance to the firm's performance.

### 2.0 LITERATURE REVIEW

#### 2.1 Definitions of Corporate Governance

There are wide definitions of corporate governance due to permanently expanding boundaries of business.<sup>5</sup> Corporate governance defined as the way by which companies' system are directed and controlled.<sup>6</sup> Corporate governance can also be defined as balancing interests for shareholder and other stakeholder, which is needed to achieve value creation for the

benefit of a broader constituency.<sup>7</sup> Corporate governance involves the methods in which suppliers of finance to corporations ensure obtaining return on their investment.<sup>8</sup> From a broader perspective, corporate governance consists of a country's private and public organizations that include formal and informal association between corporate insiders and investors in corporations.<sup>9</sup> In all, whether the emphasis is system of control, harmonizing stakeholders' interest, enhancing allocation of capital or the role of various organizations, they all converge to one ultimate aim – companies need to ensure targeted streams of profit is maintained in accordance with rules, while at the same time ensuring the rights of other stakeholders are not contravened.

#### 2.2 Theoretical Perspective of Corporate Governance

##### 2.2.1 Agency Theory

Agency theory is the most widely used theory by researchers in explaining the relationship between various groups of shareholders – the main group of stakeholder that provides capital to the company.<sup>10</sup> This theory is perhaps first illustrated by Berle and Means in their study of corporate America in the early 1930s. They described firm ownership as separated from the management.<sup>11</sup> Consequently, corporate governance is focused on the agency problems that emerge from the separation of management and ownership. Agency theory suggests that if ownership is separated, management decisions will diverge

from those needed to maximize shareholder returns.<sup>11</sup> Alternatively, agency theory tends to explain the contract relationship between shareholders (refer as principals) that supply capital to firm and management (refer as agents) who operates firm.<sup>12</sup> The directors represent the principals and act behalf of them, which gained the authority in decision making process. However, problems arise because agents who supposedly act on behalf of the principals increasingly gained control of the company. Eventually, the management tends to make decisions for their own private interests.<sup>13-14</sup>

The agency theory emphasizes on relationship between principal and agent has caused uncertainty because of various information asymmetries.<sup>15</sup> The agency problem here is to promote the agent to act in the best benefits for the principal. This lead to increasing agency costs such as monitoring costs to prevent the agents from misusing their authority.<sup>8</sup> Agency theorists explained that good corporate governance mechanisms are considered important to mitigate these agency conflicts and ensure alignment of interests between the agent-principal relationships.<sup>16</sup> This paper will discusses on governance board structures that related to agency theory.

### 2.2.2 Stewardship Theory

Stewardship theory serves as an alternative management view of motivation to agency theory.<sup>17</sup> This theory assumes managers are good stewards of firms whose behaviors are consistent with the aims of their principals.<sup>18</sup> It explained managers are loyalty to the firm and act in the best interest to achieve high performance. Managers are motivated by their desire to perform excellently and to attain the objectives of the firm.<sup>19</sup> This will lead the managers to successfully accomplish the task given to them by the owners. In this respect, for shareholders wealth to be maximized it needs to be matched with the steward utilities.<sup>20</sup> Successful firm tends to provide the stewards with clearer missions. The missions can serve to balance the interest of the stewards and the principals. Stewardship theory aims on promoting trustworthy and cooperative between principal and steward. The association between principals and stewards will lead to better firm performance.<sup>21</sup>

However, for stewardship theory to succeed, the firm needs board structure which can perform efficiently in between the managers and owners.<sup>19</sup> In this situation, when one person holds the position of CEO and Chairman, firm can attain greater performance because CEO has complete authority and power in decision making. The firm has advantages of direction unity, in particular through strong leadership, command and control. Stewardship theory emphasizes on structures that encourage and authorize rather than monitor and control.<sup>19</sup> This theory favours the appointment of single person for the position of chairman and CEO; and suggestion of specialist executive directors rather than non-executive directors.<sup>22</sup>

### 2.2.3 Stakeholder Theory

Stakeholder theory is related to obligation of firms to the broader community. Stakeholder refers to person that will affect or be affected by the firm operations, in attaining the firm's goals.<sup>23</sup> Stakeholders may be divided into two groups where primary stakeholders refers to shareholders/investors, creditors, customers, employees and suppliers; secondary stakeholders directs to government, trade associations, political groups and the community.<sup>24</sup> The firm's goals could be reached by balancing the interests regarding the various stakeholders.<sup>25</sup> The basic assumption of stakeholder theory is that the firm needs to focus on how to manage all the relationships with its various

stakeholders in order to success. In short, corporate governance is designed to promote the welfare of various stakeholders.<sup>26</sup>

Responsibility of board of directors in the stakeholder theory is not only toward shareholders but also to other stakeholders.<sup>20</sup> Stakeholder theory can be viewed as an expansion of agency theory, where broader group of stakeholders are taken into account such as those interest groups associated to social, environmental and ethical considerations.<sup>23,27</sup> Government is also considered as an important stakeholder because the government power is demonstrated in its enforcement mechanisms, where the management of firm is required to oblige. Firms that use socially responsible activities to mitigate the risk of government intrusions probably influence the value of firm.<sup>28</sup> Accordingly, stakeholder theory agrees with the implementation of CSR and risk management policies to handle different interests of various stakeholders.

### 2.2.4 Resource Dependency Theory

The basic assumption of resource dependence theory is environmental linkages between the firm and outside resources. Successful firm has internal structures adapted to meet the environmental demand.<sup>29</sup> In this theory, directors tend to link the firm with external factors by having the resources needed to survive.<sup>30-31</sup> Firm reacts to the conditions of external environment through board of directors.<sup>32</sup> Boards of directors are vital for monitoring critical factors that come from environmental uncertainty. Resource dependence theory states that linkages with environmental elements generally results in reduction of transaction costs and uncertainty situation.<sup>31,33</sup> There is a need for firm to seek efficient resources in transaction with other firms, which could eventually promote the development of better exchange relationships between firms.<sup>34</sup> This is because imbalance distribution of resources leads to firms interdependent relationships.

Directors' role in resolving this resources allocation conundrum comes as very significant. They bring highly sought after specialized skills and expertise.<sup>35</sup> Thus, board of directors has high impact on firm's performance. Resource-based theory investigates the relationship between internal characteristics, particularly board of directors and performance of firm.<sup>36-37</sup> If external linkages increase, more numbers would be needed on the board as directors to reduce uncertainty.<sup>38</sup> In general, resource dependence theory suggests the creation of linkages between the firm and external environment in order to improve a firm's performance, and to achieve this a firm's board structure plays a significant role.

### 2.2.5 Legitimacy Theory

Legitimacy theory is defined as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate with some socially constructed systems of norms, values, beliefs and definitions".<sup>39</sup> The concept of legitimacy theory suggests that social contracts exist between the society and firm. In this theory, firm has the obligation to society which believes social responsibility as contractual duty.<sup>40</sup> In addition, society first allow the firm to run and accountable to the firm operation, because society is the one that provides authority to firm.<sup>15</sup> The legitimacy theory focuses on the rights of public, not only the rights of investors. Many previous studies have used legitimacy theory to study social and environmental reporting.<sup>15</sup> In incidences where the firm fails to fulfill the community expectations, this causes the imposition of sanctions such as

restrictions on firm's operations, resources and demand for its products.

The theories discussed above have been the basis of many corporate governance studies, albeit at varying degree. Agency theory remains popular from the perspective of finance while the stakeholder and legitimacy theories have been the choice from the CSR viewpoint.

### 2.3 Board Structure

All the underlying theories have one common feature – board of directors is one of the principal mechanisms. This is totally unsurprising; board of directorship is mandated to all public listed companies. It is a vital mechanism to improvement firm's performance.<sup>6</sup> The role of board of directors can be seen from two perspectives, depending on the firm's requirement. Board structure can be utilized to concentrate power to the management on the grounds that the management has greater understanding in the running of the company and the business issues than outside directors.<sup>11</sup> On the other hand, it can be structured in such a way to minimize management power by allowing greater monitoring and ratification by outside director.<sup>16</sup>

While board of directors consists of few individuals, often, the focus is on the CEO and the Chairman. They ranked as the top two individuals responsible to the company's performance. There is suggestion that if both roles is combined, decisions can be reached faster and more efficient.<sup>41</sup> In contrast, it can be argued that if one individual responsible for both roles may cause unfettered powers in decision making which do not maximize the wealth of shareholders.<sup>42</sup> The board composition is also considered as an important element in the board structure. Based on the agency theory, non-executive directors on the board capable to perform well is due to their independence from corporate management.<sup>43</sup> Likewise, it is suggested that effective board build up by greater number of outside directors.<sup>44</sup> It is also debated that increase the size of the board would lead to better firm performance, where CEO can obtain quality advice from non-executive directors. However, larger size of board may restrain board processes due to problems such as difficulty in communication and organization.<sup>66</sup> The structures of board of directors remain an important mechanism of corporate governance. They are keys to company's decision and understanding them are the prelude to better corporate governance insights.

### 2.4 CSR Reporting

Another area of corporate governance studies that is growing in popularity is CSR reporting. Analysing corporate governance without understanding the importance of CSR may render a researcher outlook incomplete. CSR reporting is the voluntary disclosure of corporate actions with respect to social and environmental issues.<sup>45</sup> There is increasing pressure for firms to accelerate CSR activities hence CSR reporting.<sup>46</sup> One of the roles of corporate report is to inform society of the activities or actions taken by the firm in fulfilling their responsibilities.<sup>15</sup> CSR reporting comes from the idea of accountability, which is a vital concept in corporate governance. In accountability model, reporting is explained to be driven by responsibility rather than demand.<sup>15</sup> There are many academic studies that addressed CSR activities affect on financial market.<sup>47-49</sup>

Firm performance is interrelated with firm corporate reporting practices. Better management practices will lead to better firm performance, eventually cause share prices to

increase.<sup>50</sup> All of these happened because of better disclosure and transparency corporate information that provided through corporate reporting practices of firms. It is mandatory for firm to provide information regarding CSR because it has seen as key factor for firm to approach wider community in business activities.<sup>51</sup> The firm's responsibility is not only to its shareholders but to all stakeholders as well, which is needed for its success.<sup>52</sup> Although CSR is a new concept, many scholars have examined the relationship between CSR and firm performance.<sup>52-53</sup> CSR is a business policy that would establish competitive advantage, market opportunities as well as customer satisfaction.<sup>54</sup> Empirical studies have showed results that CSR will influence on financial markets.<sup>49,53</sup> On the whole, previous studies support the argument that CSR will affect firm performance.

### 2.5 Information Technology (IT)

In comparison to CSR, appreciation on IT and corporate governance are relatively few and is need of greater number of studies. One of the main significances is the role of IT in improving performance and combating fraud.<sup>55</sup> In today's age of technology, it has been known that IT can enhance a firm's performance if it is well implemented and governed.<sup>56-57</sup> It can be seen that IT assets such as financial and information systems need to be better governed in order to prevent fraud and to protect the interest of board as well as the overall corporation. In spite of the increasing importance of corporate governance technology, evidence shows that a number of organizations have failed in their quest to receive advantages from IT.<sup>58</sup> Unsuccessful project development, losses of competitive strength and even organizational failure have been assumed as lack of governance regarding IT.<sup>58</sup> Previous studies recommend on IT in corporate governance serve as a top management which concern about the impact of IT's strategic, and delivered high value to the organization.<sup>59-60</sup> Hence, IT serves as a strategic element for organizations in achieving their purposes and objectives, as well as establishing and implementing effective corporate governance technology.

The business environment has become more competitive due to globalization and rapid technological growth in the past decades. As firms respond to global competition, there is a growing recognition of the important technology role in determining market success.<sup>61</sup> IT technologies improve and enhance the transparency and governance structure of companies.<sup>62</sup> In term of management reporting system such as company websites, internets, emails, and business intelligence systems that allow people to acquire almost everything through IT technologies. Theoretical and empirical evidence indicated that firms implementing IT strategy are able to gain competitive advantage over their direct competitors.<sup>63-65</sup>

## 3.0 CONCLUSION

Board structure is an important element in corporate governance, which would enhance firm performance if it is well implemented. Better reporting practices will lead to better firm performance. Equally important is CSR. It is growing as a key factor to success, where firm can gain competitive advantage greater engagement with the community can create competitive advantage. Accordingly, firms need to provide CSR reporting in greater detailed. There are needs to be more transparent disclosure in CSR statement for firms in order to better structured and implemented. Nevertheless IT, unlike CSR and board structure, is not well researched despite its importance. IT

plays important role in corporate governance especially in today's age of technology as well as sustained growth of business. IT also can enhance firm performance if it is well governed. Alternatively, IT technologies can improve the transparency and governance structure of firms.<sup>62</sup> Certainly, board structure, CSR and IT have significant bearing on a firm's state of corporate governance and performance.

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