

# **The Principal-Manager Choice Model and Corporate Governance: An Empirical Study of Agency and Stewardship Theory**

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## **Overview**

The separation of risk-bearing and decision functions in organisations led to the rise of corporate governance (Fama and Jensen, 1983). The word ‘governance’ has its origins in captaining a ship; steering and keeping in good order (Farrar, 2001). Corporate governance is thus concerned with how the board of directors oversees the organisation and manages the CEO (Farrar, 2001). The board of directors is expected to uphold the principles of good governance including transparency, accountability, responsibility and fairness (du Plessis et al., 2005). The duties of the board of directors are divided into three areas: nominations (hiring or firing the CEO), audit (or risk management), and remuneration (Farrar, 2001).

While researchers in corporate governance have studied a number of the aspects aforementioned, researchers have tended to focus on structure and remuneration. For example, Coles et al. (2001) studied the percentage of inside and outside directors and CEO remuneration. Leblanc (2004) criticises this type of research and argues that performance is most influenced by the process of governance, rather than the structure. Process focuses on the relationship between the board of directors and the CEO, specifically the degree to which the process is characterised by control or collaboration (Sundaramuthy and Lewis, 2003).

This PhD research focuses on the relationship between the board of directors and the CEO, specifically how to design the internal governance systems including structure, remuneration and process. This is entrenched in Maslow’s (1943) hierarchy of needs and McGregor’s (1960) theory X and theory Y. Maslow (1943) and McGregor (1960) focus on motivation by designing management systems that fulfil human needs. Theory X’s crucial assumption is that people dislike work, which leads to systems of control. Theory Y’s crucial assumption is that people like work, which leads to systems of collaboration. McGregor (1960) argues that systems of control emphasise monetary incentives and focus on lower-order needs such as physiological, security and

ego, whereas systems of collaboration emphasise intrinsic rewards and focus on higher-order needs such as social, esteem and self-actualisation. Thus, successful internal governance must consider the different needs and motivations of people (Frey, 2002).

Theory X is comparable to agency theory, which assumes that people are rational actors that seek to maximise their utility through self-serving actions (Jensen and Meckling, 1976). Agency theory argues that due to incomplete contracts the board must monitor the actions of the CEO and due to asymmetric information the board must use monetary incentive schemes to motivate the CEO (Jensen and Meckling, 1976; Fama and Jensen, 1983). While some evidence supports the notion that monitoring and incentives do align the CEO interests with the board (Eisenhardt, 1989; Shleifer and Vishny, 1997), other evidence contradicts agency theory and leads to behavioural explanations of board-CEO relationships (Davis, et al., 1997; Roberts et al., 2005).

Theory Y is comparable to stewardship theory, which assumes that people are rational actors that seek to maximise their utility through collective-serving actions (Davis et al., 1997). Stewardship theory, entrenched in Maslow's (1943) hierarchy of needs, argues that the CEO is motivated by high-order needs, and therefore the board should collaborate with the CEO and use intrinsic rewards to enhance the CEO's performance (Davis et al., 1997). Researchers have often tested the predictions of agency theory against stewardship theory, but the evidence is mixed (for example: Donaldson and Davis, 1991; Muth and Donaldson, 1998; Lin, 2005). It appears that agency and stewardship theory are contingent upon other factors (Pye, 2004; Pye and Pettigrew, 2005; Sundaramuthy and Lewis, 2003). Thus, McNutly, et al. (2005) suggests that researchers need to move beyond either/or thinking.

Davis et al. (1997) argue that the board chooses between wanting a CEO that is an agent or a steward, and the CEO chooses between being an agent or a steward. If both parties choose agent or steward, then their relationship will be characterised by agency or stewardship theory and performance will be maximised. If one party chooses agent and the other party chooses steward, then their relationship will not be characterised by agency or stewardship theory and performance will be hindered. While Davis et al.'s (1997) advocacy of stewardship theory has encouraged further studies, researchers so far have not examined Davis et al.'s (1997) principal-manager choice model.

This PhD research will test Davis et al.'s (1997) principal-manager choice model. Essentially, this research will seek to determine whether the alignment of the board and CEO 'agent or steward' choice leads to a controlling or collaborative system of internal governance (including structure, process and CEO remuneration), and whether this leads to higher performance. In order to enhance external, internal and construct validity, quantitative and qualitative research methods will be employed to study these variables (Modell, 2005). Firstly, a questionnaire has been constructed based on the literature reviewed. Secondly, the questionnaire will be pilot tested using semi-structured interviews and a mailed survey. Thirdly, the revised questionnaire will be mailed to a sample of large NZ companies. Fourthly, the results will be interpreted using semi-structured interviews.

The questionnaire is divided into two parts; in each company a director will complete one part and the CEO will complete the other part. Choice will be measured using self-typing paragraphs (Stevenson, 2004) and Porter's (1961) instrument (based on Maslow's (1943) hierarchy of needs). Governance structure will be measured using binary questions (e.g. does the CEO have voting rights on the board?) and counting questions (e.g. how many directors are independent, affiliated or executive?). Governance process will be measured using Westphal's (1999) instrument, which examines board monitoring, friendship ties, and advice and counsel interactions. CEO remuneration will measure: remuneration philosophy (Anthony and Govindarajan, 2004), use of performance measures (Chenhall and Langfield-Smith, 1998) and the relative size of each component of remuneration. Organisational performance will be measured using a self-rating instrument (Govindarajan, 1988; Govindarajan and Fisher, 1990, Chenhall and Langfield-Smith, 1998).

There are many limitations of this PhD research. For example, researchers have struggled to discover meaningful relationships between corporate governance and performance (Leblanc and Gilles, 2005) because, in part, performance is difficult to measure. However, this PhD research is innovative and novel as it will examine the principal-manager choice model and the internal governance mechanisms of NZ companies, which contributes to knowledge by "carrying out empirical work that hasn't been done before" (Phillips and Pugh, 1994, p.61).

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