

THEORETICAL FOUNDATIONS OF CORPORATE GOVERNANCE REVISITED: A CRITICAL REVIEW

Alexander M. Dühnfort, Christian Klein, Niklas Lampenius*

Abstract

In this paper we review some of the initial ideologies regarding corporate governance, focusing in particular on the – in the literature dominating – Principal-Agent-Approach. We detail the implied assumptions and the thereof resulting consequences for corporate governance, including some resulting inconsistencies. Overall, we find that in the **discussion about ‘Corporate Governance’ the often referred to principal-agent-conflict is rarely defined with the necessary rigor, but find that the model seems to be applied to almost any situation loosely tied to the topic of corporate governance.** We conclude that due to the missing theoretical rigor and the missed developments in the area of management theory the resulting corporate governance policy recommendations are often inconsistent and that the commonly applied theoretical framework for corporate governance discussions might not be the most suitable one for policy recommendations as well as for regulatory actions.

Keywords: corporate governance, theory, agents, principals

**Corresponding author. Lehrstuhl für Rechnungswesen und Finanzierung Institut für Betriebswirtschaftslehre (510 C) Universität Hohenheim, 70593 Stuttgart. cklein@uni-hohenheim.de*

I. Theoretical foundations of corporate governance

Despite the dominance of the US-American school of thought in the corporate governance debate,¹ there are numerous approaches for the explanation and organization of corporate governance (Nippa, 2002), where most often the allocation of power and competence in the enterprise institutions is assumed to follow the American legal and political system. Hawley and Williams (1997) suggest a basic distinction between four different schools of thought, the principal-agent theory (the dominating approach), the stewardship approach, the stakeholder- approach, and the political approach. Despite the diversity of theories, their share in the debate varies and the principal agent theory plays a dominating role in the overall debate. We, in the following, focus on principal agent theory given its dominance in the ongoing debate regarding corporate governance. For a comprehensive overview on principal agent theory refer to Jost (2001b), Bamberg and Spremann (1989), Hay (2000, pp. 209), Meinhövel (1999, pp. 175), Suter (2000, p. 47), or Picot et al. (1999). In general, principal agent problems are the basis for “principal-agent theory” (PAT)², Starting-point of PAT is the analysis of procedures that originate from the assignment of duties

and responsibilities (by principals) to other people (agents) when dividing labor (Meinhövel, 1999, p.7).

Furthermore, the design of monitoring and incentive systems is addressed, here the focus is on streamlining of interests of the agent – who has an informational advantage over the principal – with the principals’ interest – who is at an informational disadvantage (Schmidt and Terberger, 1997, p. 398). The model proposes the existence of relationships, which can be expressed as contracts between two individuals (principal and agent), where the agent commits himself to supply a service for the principal in exchange for a compensation. Both parties seek to maximize utility (Macharzina, 1995, p. 57). Adopted to a corporate governance context the principal-agent relationship is interpreted as the result of the separation of ownership (the investors) and control (the management), with the effect that in this complex environment it is impossible to capture all possible aspects contractually, i.e. the contracts are incomplete (Berle and Means, 1932; Coase, 1937; Alchian and Demsetz, 1972; Jensen and Meckling, 1976; Boot and Macey, 1999; Jost, 2001a, 2001b).

One of the main elements of PAT is the concept of „agency-costs“. The concept is based on property rights theory (e.g. Demsetz, 1967) where the following central characteristics are assumed to hold:

- Goods are produced with multiple input factors
- Input factors are provided by multiple owners
- There exists a party that appears in all contracts (contractor)
- The contractor is entitled to renegotiate one single input factor, irrespective of the contracts concerning other input factors

¹ According to Shleifer and Vishny, „corporate governance mechanisms“ should be understood as “economic and legal institutions that can be altered through the political process”(Shleifer and Vishny, 1997)

² According to Jensen (1983, pp. 334) the principal-agent theory can be divided into „positive“ and a „normative“ school of thought. We focus on the positive principle-agent theory, as it plays a dominant part in the corporate governance debate.

- The contractor has the claim on the residual income
- The contractor has the right of selling his/her claim on the residual income

According to property rights theory it is extremely expensive (if not impossible) to map every singular relationship between owner and management to contracts in order to dissolve possible conflicts.

Therefore it is necessary to establish a structure to monitor the management. Separating ownership and management as a consequence induces costs as the principal has to streamline managerial action with his own objectives. These possible costs (for both parties) of the resulting state of uncertainty are referred to as „agency costs“ (Jensen and Meckling, 1976; Macharzina, 1995, pp. 57) and can be differentiated into monitoring costs, bonding costs, and residual loss (Meinhövel, 1999, p. 42). The overall goal is to minimize these costs. To achieve minimization a model is needed which allows the calculation of the respective costs and benefits. Jensen and Meckling (1976) provide such a model based on a contribution by Alchian and Demsetz (1972) and on very restrictive assumptions³, where the model is heavily dependent on the enterprise value as a result of the behavior of both parties. Agency costs are derived indirectly through the difference in equity value for a company with and without a monitoring system for the management. It is argued that managerial behavior changes if the managers' share in the company is reduced. A reduction of participation in the equity development then results in a higher consumption of resources by the manager or alternatively to a reduced dedication to corporate issues until the marginal utility of consumption is considered to be equal to the marginal utility of the foregone profit by the manager.⁴ As a result managers with reduced profit sharing will consume more or achieve less, until an optimum is reached (Meinhövel, 1999, pp. 42). Given that potential shareholders are aware of this relationship they will pay more for the share if this managerial reaction could be ruled out – the difference in price is defined as agency costs. An underlying assumption for this proposition is that the individual risk preferences

and utility functions are known (Jensen and Meckling, 1976; Demougin and Jost, 2001, pp. 47).

Fama (1980) pursues an approach which analyzes the efficiency and viability of companies that separate ownership and management, where the separation is based on a characterization by Berle and Means (1932). Fama's approach is mainly based on the work of Alchian and Demsetz, where the company is seen as a set of contracts⁵ with a „coordinator“⁶ as central contractor who has the privilege to renegotiate contracts and a person with claims on the residual who is also capable of selling the residual claim. He assesses the transfer from a shareholder controlled to a manager controlled company, where costs that exceed the contractually agreed level of consumption are not sustained by the manager alone any more.

Based on Jensen and Meckling's approach to agency costs Fama evaluates conditions under which the manager assumes the discrepancy from the contractually fixed level of consumption, i.e. suffers economically if the contractual agreements are violated. The aim is to pass on all the generated costs to the agent, i.e. giving the agent the option of maximizing individual utility, and as a consequence the contractually fixed level of consumption does not need to be taken into further consideration, as it has already been accounted for by a reduced income of the manager. This is a necessary precaution since value destroying behavior will not be detected immediately as shareholders tend to diversify and cannot concern themselves with all internal details of each single venture in which they are invested (Fama, 1980, p. 291).

Given the diversification of equity holders the supervisory body, represented by the corporate board, is then directly responsible for monitoring activities, where apart from the company board members external members also have the opportunity to monitor the management. According to Fama (1980, pp. 293), internal supervisors which are members of the board have the advantage of having enhanced interest in the part-taking of monitoring activities given that discovering incompetence can be beneficial to their own career. This proposition fails, if board members collaborate in securing their own interests. In this case, external supervisors should be preferred, as they are highly qualified to supervise corporate top

³ Permanent assumptions: all taxes are reduced to zero; debt is unavailable; all shares held by outsiders are nonvoting stock; it is not possible to issue convertible bonds, warrants or preference shares; no outside shareholder benefits from his share other than through the effects on company value or cash flows; dynamic aspects of multiple periods are ignored given that only a single financing decision has to be taken by the entrepreneur; the reimbursement of the owner-manager is constant; there is only a single manager (peak coordinator) with residual claims on the company; Non-permanent assumptions: company size is constant; monitoring is not possible; financing through external capital is not possible (Jensen and Meckling, 1976).

⁴ Jensen and Meckling also include the consumption of non-monetary utility from i.e. the dimension of the office, air conditioning, thickness of the carpet, quality of relationships of the employees (Jensen and Meckling, 1976).

⁵ “The firm is viewed as a set of contracts among factors of production, with each factor motivated by its selfinterest” (Fama, 1980, p. 289). “The firm does not own all its inputs. It has no power of fiat, no authority, no disciplinary action any different in the slightest degree from ordinary market contracting between any two people” (Alchian and Demsetz, 1972, p. 777), “[...] and a centralized position of some party in the contractual arrangements of all other inputs” (Alchian and Demsetz, 1972, p. 778).

⁶ This corresponds to the manager administering property rights and is borrowed from Alchian and Demsetz's (1972) terminology. His counterpart is the risk-bearer, which is, according to Fama, not the owner/shareholder but, as property is indeterminable, an abstract lobby group that bears the risk invoked by management operations (Fama, 1980, p. 290).

management given their own management activities. He further states that the cost effectiveness of the monitoring mechanisms is the responsibility of the board, i.e. “the Role of the board [...] is to provide relatively low-cost mechanism for replacing or reordering top managers” (Fama, 1980, p. 294). Fama (1980, pp. 295) overall expects a market effect that prevents the abuse of consumption at the workplace, when malpractice of the agent is governed through monetary incentives, such as for instance a contract which includes possible future work relationships or sanctions for diverging behavior. Fama (1980, pp. 296) postulates three necessary conditions to meet this directive:

- Information regarding the manager is derived from achievement in the past and present
- Appropriate evaluation of this information through the market
- The resulting consequences are powerful enough to achieve the desired effect on the manager

Based on the dependency of the future pay on present deviations from the optimal path the manager will abide to the contractually fixed level of consumption. If management is compensated, e.g. according to his marginal utility, costs will be rolled over to the agent in the long run (Fama, 1980, pp. 298; Meinhövel, 1999, p. 47).

II. Contemporary issues with the theoretical foundations of corporate governance

Given the dominance of PAT (Jensen 1993; Jensen and Meckling, 1976; 1979) in the corporate governance debate, it is important to state that the assumptions for PAT are not a reflection of reality but are necessary to obtain a consistent theoretical framework. Observing the policy making on the other hand, it seems as if PAT is utilized to derive corporate governance policy despite its restrictive assumptions. This implies a faulty application of the theory on the one hand and does on the other hand indicate that policy making will potentially not be achieving what it initially was intended for. We in the following illustrate some of the assumptions and the implied consequences.

A. Utility aspects

PAT in general is formulated as static model without the recognition of trust or information benefits from previous encounters. Information regarding the contracting partner is solely determined through information acquisition and evaluation of the concurrent contract. The common contractual negotiation phase, and thereby potential competitive advantages of either side, is entirely ignored. Additionally, the theory focuses mainly on monetary aspects such as fixed and variable wages or profit-sharing; aspects such as quality of output, work conditions/environment, sanctions, etc. are not part of the contracts. The agent is simply viewed as reactionist to the contractual agreement and is expected to adjust

the individual work effort, where the only market imperfection is information asymmetry regarding the completion of the task (Meinhövel, 1999, p. 122). PAT does also not include thoughts regarding the measurement of the work effort or the work quality of the agent. Traditionally it is assumed that higher work effort does lead to better results, which might not hold for all instances since activities exist that do cause higher work effort but do not increase utility, such as an increased research level that leads to a flood of noninterpretable information (Meinhövel, 1999, p. 135). Finally, motivational aspects such as non-monetary rewards from potentially expected promotions are disregarded, although for various situations⁷ the change from being an agent to being a principal indicates that disregarding motivational aspects, particularly when considering motivational factors in long-term contractual agreements, seems problematic (Meinhövel, 1999, pp. 136). This argument is further strengthened given some experimental evidence indicating the relevance of motivational aspects (Sliwka, 2003). Overall, we are of the opinion that utility aspects are assigned too much importance given that the sole focus of the model is on the loss of utility. This implies that various other aspects of contractual agreements are ignored. A valid reason for hiring managers might for instance be the fact that they are more efficient at the task at hand (Schneider, 1995, p. 278), implying utility in the sense of time savings given the same output quality or economies of scale. In addition, frictions such as legal requirements might necessitate the hiring of a specialist, e.g. CPAs, tax accountants, or lawyers.

B. Contractual agreements

Problematic are also the contradicting views of PAT on contractual obligations and the completion thereof. On the one hand, PAT assumes that contractual obligations are fulfilled according to the maxim „pacta sunt servanda“ (Neus, 1989, p. 10). On the other hand, PAT assumes the violation, at least partially, of some of the contractual obligations by the agent to compensate for the lost utility due to the contractual agreement.⁸ The definition of the content of the contracts including a detailed list of all obligations of both sides of the contractual terms therefore seems of utter importance to allow for an effective enforcement. Further supporting the notion of detailed contracts is that for loosely defined contracts a violation of contractual obligations could be caused by a variety of other aspects not tied to the intentional breach of contract, such as for instance a perceived violation by the principal due to the principal’s inability to appropriately voice his/her intentions in the contractual agreement or a general misunderstanding of the contracting partners. As a result, such detailed contracts require a high level of knowledge regarding

⁷ Such as a promotion of a lawyer from associate to the partner level of a law firm (Ferrall, 1990)

⁸ Jensen and Meckling (1976) refer mainly to a reduced work effort.

the activities of the agent. The highly specialized work environments often result in agents being better informed regarding the task at hand than the principal leading to increased difficulties for the principal when formulating the contracts. Given these difficulties, implicit contracts⁹ are supposed to alleviate the problem. Implicit contracts assume that the contractual agreement does not focus on the factual contractual content but on the intended content by the contracting parties. As a result the contracting parties have to consent on a particular utility level without an explicit formulation or negotiation of the latter. This informal contract does not allow for a substantial enforcement (legally or methodologically) (Meinhövel, 1999, p. 142). As a consequence the maxim “*pacta sunt servanda*” should be disregarded and contractual violations should be distinguished according to the inability to fulfill the contract, the impossibility to fulfill the contract, or the unwillingness to fulfill the contract, given that contract analysis studies indicate that for unforeseen incidents adhering to the fulfillment of contractual obligations is often suboptimal (Schäfer and Ott, 1995, pp. 371).

Last but not least, PAT ignores the value of the completion of a task to the principal entirely (Meinhövel, 1999, p. 139). This is of particular interest for cases where the principal has a personal interest in an adequate completion of the task. Minimal task requirements have, given a personal interest, no value to the principal. For a successful completion of the task minimal task requirements have then to be included in the contract to ensure that the detrimental impact of substandard task completion does not occur.

C. Agency costs

The concept of agency cost based on the idea of „residual loss“ is criticized on the basis that measuring the maximal possible utility for the principal is difficult. Further, the difference between the factual and the maximal possible monetary utility is not known, and the only situation where this difference can be determined is when the optimal task completion is observable, i.e. if opportunity costs are factually existent and not just part of a fictive calculation. The existence of such opportunity costs would imply that the conditions for a competitive equilibrium are given and the equilibrium could be utilized as predictor for the maximal possible utility. The conceptual problem is that for competitive markets there is no information asymmetry and agency costs would then be zero, i.e. whenever opportunity costs are observable there is no control necessary since agency cost are zero and whenever the opportunity costs are not observable (necessitating a measure of control) agency costs cannot be determined (Schneider, 1995, pp. 278). Further criticism could include that the assumed agency cost relations are not explained or reasoned for

(Swoboda, 1991, p. 195) but non-monetary utility is derived and that taxation issues are ignored entirely.

D. Market assumptions

In general the underlying market form regarding the principal-agent interaction is assumed to be a bilateral monopoly. A critical evaluation of this bold statement yields that this does not hold for all instances. It seems plausible for instance to assume a monopolistic situation in favor of the agent for some instances, e.g. due to particular skills, and vice versa for other situations. A monopolistic advantage of the agent would reduce the utility maximization potential of the principal drastically (Meinhövel, 1999, p. 121). Also, the lack of homogeneous information in these negotiations yields additional problems when utilizing traditional pricing theory, even necessitating the acknowledgement of the existence of alternative market environments for principal and agent before the signing of a contract (Meinhövel, 1999, p. 122). Finally, the traditionally assumed separation theorem does not hold for PAT problems, necessitating the evaluation and integration of the market structure when modeling the principal-agent relationship (Terberger, 1994, pp. 160).

Additionally, a fair and independent auction administrator is necessary for the formation of a price and, given it exists, the equilibrium (Schneider, 1995, p. 292). To be able to determine the equilibrium price a kind of „order book“ summarizing the demand and supply is necessary. Market transactions at a price in disequilibrium are excluded from the model on theoretical grounds and an equilibrium price on the contrary is the very unlikely event where all market participant have correctly decided on their forecast of the other market participants output. Further, it is assumed that investments can be split in infinitesimal small units and markets should allow for perfect hedges, i.e. trading of derivatives without any restrictions, to be able to converge to an equilibrium. These assumptions are clearly not given for equity and money markets and rule out the practical application of equilibrium theories to real market phenomena. Also, traditional arbitrage arguments do not offer additional insights regarding the applicability of equilibrium models but are a mere application of the consequences thereof (Schneider, 1995, p. 293). Statements such as the market equilibrium is reached when no further arbitrage is possible can be counter argued with arguments that „no arbitrage“ conditions ignore the fact that under uncertainty a set of cases exists where the elimination of all arbitrage strategies is impossible (Mandelbrot, 1971).

Schneider’s criticism further refers to the „theory of the firm“ as it is traditionally viewed by economic theory, where on an abstract level the theoretical price at various output levels is discussed (Schneider, 1995, p. 245). This abstract representation mainly deals with price-demand functions, assumed utility functions, the available income for households and price and quantity of a product. From an applied business point of view

⁹ For further details on implicit contracts refer to Fama (1980).

some of the relevant aspects, such as investments, financing, organization, accounting, as well as the human capital (potentially acting irrational), are ignored (Schneider, 1995, p. 245). The assumed market structure is therefore not intended to depict reality but to detail some isolated effects in a highly stylized environment.

In general, model restrictions are part of almost any rigorously derived theory and do not diminish the achievement and quality of the model, but restrict the applicability to market situations. We find this to be of particular importance given that studies of the neoclassical labor market often utilize PAT – regardless of its restrictive premises – when evaluating the socio-economic situation. The outcome is then merely a result of the initial assumptions and a rigorous application of the model. An interpretation of the result or plan of action should always be treated with caution and evaluated in relation to the restrictive model assumptions.

E. Ethical aspects

Evaluating PAT under ethical aspects reveals further issues when utilizing the theory as basis for corporate governance, where ethicists maintain a critical distance to PAT (Bowie and Freeman, 1992). „The widespread use of a social framework becomes the business of ethicists if there is some risk that this framework will lead to decisions that run counter to, or threaten to undermine, ethical values. [...] A case will be made that principal-agent analysis, in its current popularized form, does pose such a risk.“ (Dees, 1992, p. 26)

The main threats resulting from PAT are according to Dees an unintended interpretation through the recipients and the psychological consequences of the model's assumptions for the principal as well as the agent. According to Dees a generalization of normative statements from PAT to other contexts is problematic. Such a generalization would for instance be an interpretation of the statement that private efficiency is a result of optimal contracts as being equivalent to the statement that public efficiency is a result of optimal contracts. This generalization would, according to Dees explicitly, induce a threat to false sociopolitical recommendations such as a recommendation to enforce the inclusion of profit-sharing in employee contracts (Dees, 1992, pp. 31). The criticism also includes psychological consequences such as the fear of a theory induced negative behavior of principals towards future employees. It is assumed that this would decrease the level of trust within a society, which is regarded as highly counterproductive for the existence of a society, and disproportionately increase the importance of monetary aspects (Dees, 1992, pp. 38; Richter and Furubotn, 1996, p. 24).

Meinhövel (1999) evaluates this criticism as being too extreme granted that no economist does view PAT as a recipe for social reform. We on the other hand stress that even though corporate governance is mainly intended to address corporate management issues it would be fatal to ignore the interaction

between the corporation and various social (sub-)systems. We therefore stipulate that in the long run corporate governance does exert a substantial influence on society as a whole, which needs to be considered when deciding upon corporate governance rules.

As concluding remark we would like to emphasize that empirical validation studies of principal-agent models have been detailed on numerous accounts through experiments as well as field studies and the results have been heterogeneous not allowing for the evaluation of the aptness or inaptness of principal-agent arguments. Reasons for the inconsistent results might be the various fields of study and the various existing operationalizations, where each study seems to introduce new concepts regarding the operationalization of the factors, complicating a consistent evaluation of the overall concepts. In addition, the technical problems when measuring latent constructs regarding measurement error, uni-dimensional factor loadings, or causalities further complicate the issue. Overall, it can be stated that the theoretical foundations of corporate governance are often based on very restrictive assumptions dealing with the firm, with the separation of ownership and control, and the problem solutions of the contracting parties.

It is quite clear, that the more restrictive assumptions apply the less a model will meet the complex needs of reality, as a consequence, we have to agree with Fischer-Winkelmann (1996, p. 996) that corporate governance standards based on PAT reasoning should not be applied to market problems. In the following section the goals and mechanism of corporate governance are detailed further substantiating the argument.

III. Goals and mechanisms of corporate governance revisited

Goals for any corporate governance policy are according to Nippa (2002, p. 21) optimal management and controlling. The corporate governance codex is in this context often referred to as „codes of best practice“, and optimum is defined through a maximization of subjective utility, the determination of optimal investment decisions, and an optimal reallocation of resources. Assuming homogenous information and the homo oeconomicus as applicable paradigm an optimization can be determined analytically (Weise, 1989; Frey, 1992; Tietzel, 1981). For any deviation from these traditional assumptions one or more of the mentioned optimizations problems are only solvable analytically under highly restrictive assumptions. Problematic, for instance, is that subjective utility in its strict definition exists only for individual ownership, given that more individuals are stakeholders the resulting utility can only be a weighted function of the subjective utility functions of the individuals. This implies that the resulting optimal solution includes various individual utility aspects and does not adhere

to the strict definition of subjective utility anymore. Also, an optimal investment allocation assumes the knowledge of all alternative investment opportunities, necessitating homogenous information. And last but not least an optimal reallocation assumes the understanding of the goals of the corporation. Given that the corporation is a legal entity the goals of the corporation turn into the goals of the representatives, i.e. the goals of the individuals in charge of the corporation, which are not necessary rational or derive their goals from a superior maxim (Macharzina, 1995, p. 340).

Beknowingst of the fact that PAT is most often the basis for a discussion of corporate governance and that the necessity of a corporate governance regulation is based on asymmetric information and bounded rationality it seems obvious that the above defined goals are not easily adhered to and an application of PAT does most likely not result in the detailed optimal allocation (Schneider, 1985; Nippa, 2002, pp. 21). Given a path of action is most often necessary the „minor“ issues associated with disregarding the existence of some of the implicit assumptions are often disregarded and corporate governance guidelines are often based on the paradigm of the homo oeconomicus (Nippa, 2002, p. 22).¹⁰ In the light of the voiced criticism the discussion regarding „proper“ corporate governance increases in relevance. We in the following evaluate whether the commonly discussed corporate governance mechanisms are acceptable.

Commonly discussed corporate governance mechanisms include a assumed control through the board, control through the owners, control through institutional investors, control through the markets, control through payment schemes as incentive for the management, a market for corporate control, control through disclosure, and control through liability.

Particularly the market based mechanisms (control through the markets, control through the market for corporate control) are limited in their generalization through restrictive theoretical model assumptions. One important condition for a working managerial workforce market is the appropriate assessment of the managers“ quality through the market. This assumes perfect information efficiency, which has been questioned by many others in the first place (Wosnitza, 1991; Ballwieser and Schmidt, 1981; Hirschey, 1986) and seems particularly inappropriate given that the management has the motivation and the opportunity to manipulate the information flow (Flassak, 1995, p.135).

As to the functionality of the stock market to act as a means of control we find that market reactions are not necessarily tied to the observed managerial competence. For markets to reflect managerial

competence firstly the shareholders have to be able to evaluate the managerial achievement (they have to have the relevant information and the knowledge to be able to judge managerial performance) and secondly a distinction between systematic market behavior and managerial performance is necessary. We find it difficult to believe that both conditions are met for real markets. Additionally, when shares decrease in value, the management is not sanctioned immediately or the funds are not immediately reallocated to other investments. According to Flassak (1995, pp. 140) the loss in reputation is only of relevance for future capital increases and assumes that the company is in need of additional capital and has no other means of acquiring it. To ensure that this monitoring instrument is successful the management would have to be deprived of the option of selecting amongst different means of financing and the shareholders would have to be entitled with more rights to have a greater impact on managerial action. A common argument is also that monitoring is also achieved through the debt market. Here it is assumed that after consuming the free cash flow debt is the preferred means of financing where creditors are willing to provide the necessary capital and the necessary control. Whilst the management – according to shareholder value concepts – is supposed to ensure a high free cash flow, the monitoring is achieved through a high level of debt. The effect seems controversial when applied to scenario where a company is arguing in credit negotiations that the company invests on a regular basis, even when exceeding the own available resources, because this provides better means of control of the management. Additionally, analytically modeling of the theory has not yielded sound answers to the question regarding the ideal level of debt. Also the tested models are usually based on too restrictive assumptions to qualify for further generalizations (Hart, 1995, pp. 126; Suter, 2000, p. 129). Further, applying the idea of markets regulating the management to an LBO (Leveraged Buy Out) situation reveals an interesting paradox. With reference to the argument that a concentration of voting rights in the bought out company would exert direct influence (and thereby control) on the management, we question the seriousness of this statement, as an attribute of an LBO is that the management is part of the bought out company and owns a part of the equity capital. Now the issue of who is supposed to control whom arises. Overall, we are of the opinion that the capital market does not enforce the desired monitoring-effects.

The disciplinary mechanism through the market of corporate control, contrary to the control through the capital market discipline, is expected to be generated by the fear of acquisitions and the subsequent dismissal of the management. We are of the opinion that this mechanism can not work in the expected manner, as share prices underlie a multitude of influences. Granted that sometimes one of the models by chance corresponds to reality, it seems bold to grant those models the status of a „mechanism“ let alone be the

¹⁰ For empirical evidence on the success or failure of legislative initiatives on corporate governance refer to Duehnfort (2004) for an example of the Italian legislative reform of capital markets beginning in 1996 as well as for a more detailed view on corporate governance.

basis for a debate about the reform of laws governing corporate and capital markets. Empirically the integrity of stock market facilitating companies and capital market supervisors is important to maintain the trust of the public in the capital markets. It is particularly interesting that the USA, being one of the main driving forces in the field of corporate governance, does not meet that standard. While trying to propagate their idea of corporate governance to the world through e.g. institutional investors (CalPERS etc.) or through the presence/dominance in international financial accounting bodies (like the IFRSB), the most important stock exchanges, the NYSE and likewise the Securities and Exchange Commission, faced harsh criticism. The NYSE for instance, due to the conduct of its yearlong head Grasso, had to restructure its business in 2003 to separate management (operation of trade) from monitoring capacities (Grass and Skorecki, 2003).

Control through liability has often been criticized as it is restricted to gross negligence or embezzlement only (Witt, 2002, p. 52). Law suits only occur for a few extreme situations such as for bankruptcy situations and the individual can be insured through a D&O (directors and officer's liability) insurance eliminating the control function of liability. Most commonly either the manager has to insure him/herself or he/she is insured by his company. For the latter the company could cover the entire premium or the manager could be asked to participate in the costs via a deductible, where the German corporate governance codex recommends the latter.

Control through payment schemes as incentives for managerial performance is closely related to the shareholder value approach. Given that the shareholder orientation and the resulting principles of shareholder value have been widely criticized in general and particularly that its application to European markets seems due to cultural difference problematic (Werder, 1997; Titzrath, 1997, p. 36; Hommelhoff, 1997, p. 20)¹¹ this approach in our opinion does also not achieve its intended purpose. Malik even speaks of a failure of the shareholder value approach, not because of its wrongful application but due to its fundamental flaws (Malik, 2002, pp. 26). One of the basic issues of the shareholder value concept is the focus on maximizing company value (Pfaff and Bärtl, 1999). Here the applicability of DCF-based methods and the evaluation of future cash flows and their discounting is problematic, since DCF-based methods depend on the CAPM where most assumptions of the model are far from being realistic and empirical evidence is indicating that there seems to be a problem with the model (Ballwieser, 2002, p. 738; Bamberg and

Dorfleitner, 2002, p. 878; Schierenbeck, 2000, pp. 387; Perridon and Steiner, 1995, pp. 237). Overall the valuation methods, whilst technically sound given numerous assumptions, allow for interesting bandwidths in resulting company values once the uncertain future expected cash flows and the appropriate risk assessments are estimated by different individuals. Also various technical issues regarding the proper discount rate, such as estimating the risk-free rate, the growth rate, or the risk-premium,¹² allow for interesting bandwidths of company values. Given that the company value is used as basis for performance based compensation and numerous possible outcomes exist it might have an adverse impact on the perceived control over their performance based compensation and/or might induce manipulative window dressing. Coenberg (2003, pp. 66), for instance, lists more than 250 different publicly reported illegal financial accounting manipulations for the year 2002. Resorting to equity options seems also not a suitable solution since active stock price manipulation seems possible, including the faking of trade activities, concealing essential information, or presenting information inaccurately, overall there is a broad spectrum of possibilities (Rosen, 2001). Additionally, empirical evidence does not conclusively indicate that including stock option plans in managerial compensation plans have a positive effect on shareholder wealth (Winter, 1998, p. 1139). A particularly interesting thought is brought forward by Cromme (2002), who demands a profit participation of the members of the supervisory board, which has lately been granted in Germany through recent changes in the law. This, in our opinion, seems to go against the initial intention of corporate governance given that the claim implies that members of the supervisory board, who are allegedly independent, now have the option to partake in short term profits. It seems questionable if they are under these circumstances likely to oppose actions that promise short term profits for sure but could impair the existence of the company in the long run.

Finally, the proposed corporate governance mechanisms of control through shareholders and institutional investors seem plausible but given that individual shareholders have limited possibilities of administering control we also regard this measure of control as being ineffective. We argue that the influence of shareholders consists mainly of voting rights and the option of selling shares, and for minority shareholders the influence, especially for big publicly owned firms, is very low and the difference between ownership and control is typically very distinct (Fama, 1980, p. 288). Institutional investors on the other hand attempt to bundle their voting rights to allow for substantial influence on management decisions.

Here the identification and accumulation of interests seems problematic, since every shareholder would have to agree to the concept that the merged

¹¹ The assumed disadvantage of the shareholders as postulated by Rappaport, is especially in Germany not given; additionally the structure of European capital markets (especially the shareholders structure) differs fundamentally from the USA and theory originating in the USA should be carefully applied to European markets (Werder, 1997, p. 13).

¹² Determining a forward looking beta, the market return, or the risk-premium for non-listed companies proves to be a challenge.

position does not necessarily conform to his initial idea but is the consequence of the consensus. In addition, the transfer of blank voting rights might be abused (Dolce, 1998, p. 13). Finally, it should be noted that the often referred to control of institutional investors over corporations seems to be exerted through other means than voting rights given that the biggest institutional investor in the U.S. (CalPERS) did not exceed 0.5 percent of ownership for any firm in the year 1998 (Suter, 2000, pp. 125).

In conclusion only the mechanisms of „control through the (supervisory) board“ given the board is independent and not included in profit-sharing plans and the „control through disclosure“ are the only acceptable means of effective control. Based on the above arguments and the so far missing systematic evaluation of the overall utility of corporate governance initiatives as well as their costs (legal, implementation, control of the implemented regulations, etc.) the question regarding the economic efficiency of corporate governance arises. Nippa, for instance, postulates that corporate governance decreases economic efficiency due to the indirect and hidden costs (Nippa, 2002, pp. 29). On the other hand, the competition of various corporate governance systems indicates that there seems to be a consensus that one solution to the corporate governance problem exists.

IV. Conclusion and outlook

Overall, a critical review of the assumptions of PAT reveals that utility aspects seem to be overstressed, the proposed principal-agent relations seem unrealistic given real market environments, the theory lacks empirical validation, and ethical aspects seem to be underrepresented. The problematic assumptions regarding the contractual compliance, the missing arguments regarding the assumed agency cost relations, the problematic concept of the „residual loss“, the assumption of a company as a set of contracts, the unrealistic market equilibrium assumptions, and the missing taxation do not support that a straight forward application to real world problems is recommendable. In addition, human factors such as motivational aspects are regarded as non-relevant and technical problems, such as the measurability of the agent's effort are ignored, further questioning the applicability to real problems.

Despite the critical arguments regarding PAT and the assumed underlying mechanisms the theoretical constructs – albeit the continuous development of the areas of strategic management¹³ as well as systemic management¹⁴ – have continued to dominated the literature. Overall, the Jensen and Meckling (1976) approach is drawing its conclusions from traditional

microeconomics and could be considered to be approximately 30 years behind the concurrent development. In addition, the discussion regarding the „optimal“ corporate governance seems (mainly) to be driven by practitioners on the one and scientists on the other hand, where (most often) both parties seem to be isolated in their viewpoints of the issue. Managers and board of directors seem not too much interested in aligning corporate and individual goals and scientists seem to ignore the recent changes of corporate practices (Nippa, 2002, p. 4). It is further interesting that Jensen (1983) indicates, in reference to Simon (1962), that a system theoretical approach implies many difficulties.

„Unfortunately, the vast literature of economics that falls under the label of ‚Theory of the Firm‘ is not a positive theory of the firm, but rather a theory of markets. The organization or firm in that theory is little more than a black box that behaves in a value or profit-maximizing way. In most economic analyses, the firm is modeled as an entrepreneur who maximizes profits in an environment in which all contracts are perfectly and costlessly enforced. In this firm there are no „people“ problems or information problems, and as a result the research based on this model has no implications for how organizations are structured or how they function internally. The firm is, in effect, assumed to be an elementary component of the analysis even though in fact it is an exceedingly complex subsystem. This is not necessarily wrong. When it is appropriate for a scientist to treat a complex subsystem as an elementary component is a subtle and difficult issue. [...] Just as astronomers can usefully abstract from the complexities inside a star or a galaxy for certain purposes, the classical economic notion of the firm has usefully abstracted from the internal complexities of organizations. It has yielded a robust theory of markets that is of great value. However, precisely because the definition of the firm abstracts from most of the real problems and complexities of organizations, it provides no insights to the construction of a theory of organizations.

The concepts of marginal analysis, competition, opportunity cost, and equilibrium that have been useful in the development of a theory of markets will also be valuable in the development of a theory of organizations. They are not, however, enough to accomplish the job. This raises the question of what we use to replace the black box view of the firm.“ (Jensen, 1983, pp. 12)

Ten years later Jensen states:

„Financial economists have a unique advantage in working on these control and organizational problems because we understand what determines value, and we know how to think about uncertainty and objective functions. To do this we have to understand even better than we do know the factors leading to organizational failures (and successes): we have to break open the black box called the firm, and this means understanding how organizations and the people in them work. In short, we're facing the

¹³ For details on strategic management developments refer for example to Welge and Al-Laham (1999).

¹⁴ For details on systemic management refer for example to Gomez, P. (1981)

problem of developing a viable theory of organizations. To be successful we must continue to broaden our thinking to new topics and to learn and develop new analytical tools.” (Jensen, 1993, p. 54) During this time interval management theory experienced tremendous change apparently without opening the black box „firm“. According to Nippa (2002, p. 4) the dominating role of capital, finance driven models, as well as the US-American point of view (with a tendency towards doctrine) were driving forces in the unreflected adoption of the premises, the simplifications, and assumed causal relationships. Jensen unfortunately did not specify the called for new analytical tools but given our critical review of PAT we are of the opinion that the new tools should not be based on traditional microeconomic theory given the model’s intended usage is a recommendation of effective measures to enforce the intended means to standard setters. In addition, the referred to factors leading to failure or success are difficult to define and always in dependence on the assumed underlying model. Nicolai and Kieser (2002), for instance, detail in reference to a study by March and Sutton (1997) that it is empirically difficult to attribute economic success to certain factors, essentially claiming that the asked for factors have not been substantiated empirically as of yet. Basing a theory on assumed interactions and relationships amongst these factors is bound to fail when applied to real market problems.

References

1. Alchian, A. and Demsetz, H. (1972): Production, Information Costs and Economic Organization, in: *The American Economic Review*, Vol. 62, 777-795.
2. Ballwieser, W. (2002): Der Kalkulationszinsfuß in der Unternehmensbewertung: Komponenten und Ermittlungsprobleme, in: *WPg*, 14, 736-743.
3. Ballwieser, W. and Schmidt, R.H. (1981): Unternehmensziele und Finanztheorie, in: Bohr, K. (1981): Unternehmensverfassung als Problem der Betriebswirtschaftslehre, Berlin.
4. Bamberg, G. and Dorfleitner, G. (2002): Is Traditional Capital Market Theory Consistent with Fat-Tailed Log Returns?, in: *ZfB*, 8, 868-878.
5. Bamberg, G. and Spremann, K. (Hrsg.) (1989): Agency Theory, Information and Incentives, Berlin.
6. Berle, A. and Means, G. (1932): *The Modern Corporation and Private Property*, Revised Edition, first printed 1932, New York, reprinted in 1968.
7. Boot, A. and Macey, J. (2004): Objectivity, proximity and adaptability in corporate governance, *Cornell Law Review*, Vol. 89, No.2, 356-393.
8. Bowie, N.E. and Freeman, R.E. (1992): *Ethics and Agency Theory*. New York .
9. Coase, R.H. (1937): The nature of the firm, in: *Economica*, Vol. IV (New Series), No.16, 386-405.
10. Coenenberg, A.G. (2003): Shareholder Value - Betriebswirtschaftliche Sicht und öffentliche Wahrnehmung, in: Fakultät für Wirtschaftswissenschaften der Technischen Universität München,
11. Verleihung der Würde eines Ehrendoktors der Fakultät für Wirtschaftswissenschaften der Technischen Universität München an die Professoren Roland Berger, Adolf G. Coenenberg.
12. Eberhard Witte, unveröffentlichte Beiträge der Akademischen Feier am am 15.Januar 2003.
13. Cromme, G. (2002): "Wir brauchen ehrbare Kaufleute", in: *Handelsblatt* 26.06.2002.
14. Dees, J. G. (1992): Principals, Agents and Ethics, in: Bowie, N.E. and Freeman, R.E. (1992): *Ethics and Agency Theory*, New York.
15. Demougins, D. and Jost, P. (2001): Theoretische Grundlagen der Prinzipal-Agenten-Theorie, in: Jost, P. (Hrsg.) (2001): *Die Prinzipal-Agenten-Theorie in der Betriebswirtschaftslehre*, Stuttgart, 45-81.
16. Demsetz, H.: Toward a Theory of Property Rights, in: *American Economic Review* 57 (1967), 347-359.
17. Dolce, R. (1998): *Corporate Government - Neues italienisches Kapitalmarkt- und Gesellschaftsrecht*, in:
18. Cian, G. et al. (Hrsg.) (1998): *Jahrbuch für italienisches Recht* 11, Heidelberg.
19. Duehnfort, A. (2004): *Mediale Unternehmensüberwachung - Ergebnis einer kritischen Analyse zu Begriffsinhalt und Anwendbarkeit von "Corporate Governance" am Beispiel Italiens*, Hamburg.
20. Fama, E.F. (1980): Agency Problems and the Theory of the Firm, in: *Journal of Political Economy*, Vol. 88, Nr. 2, 288-307.
21. Ferrall, C. (1990): Agents becoming principals: theory and estimation of a tournament model of promotions in partnerships, Ph.D. thesis, University of Minnesota
22. Fischer-Winkelmann, W.F. (1996): Empirische Analyse des Prüferwechsels im Kontext der Agency- und Signalling-Theorie - Stellungnahme, in: *ZfB*, Nr.8, 995-1005.
23. Flassak, H. (1995): *Der Markt für Unternehmenskontrolle - Eine ökonomische Analyse vor dem Hintergrund des deutschen Gesellschaftsrechts*, Bergisch-Gladbach.
24. Frey, B. (1992): *Economics as a Science of Human Behaviour - Towards a New Social Science Paradigm*, Boston.
25. Gomez, P. (1981): *Modelle und Methoden des systemorientierten Managements - eine Einführung*, Bern.
26. Grass, D. and Skorecki, A. (2003): New Yorker Börse steht Umbruch bevor, in: *FTD* v. 19.09.2003.
27. Hart, O. (1995): *Firms, Contracts, and Financial Structure*, Oxford.
28. Hawley, J.P. and Williams, A. T. (1997): The Emergence of Fiduciary Capitalism, in: *Corporate Governance*, Vol. 5, Nr. 4, 206-213.
29. Hay, P. (2000): US-amerikanisches Recht, München.
30. Hirschey, M. (1986): Mergers, Buyouts and Fakeouts, in: *American Economic Review*, Vol. 76, 317-322.
31. Hommelhoff, P. (1997): Corporate Governance: Vertragen sich die deutsche Unternehmensverfassung und das Shareholder Value-Prinzip? In: *ZfB-Ergänzungsheft*, 4, 97, 17-21.
32. Jensen, M. (1983): Organization Theory and Methodology, in: *The Accounting Review*, Vol. 58 (1983), 319-339.
33. Jensen, M. (1993): The Modern Industrial Revolution, Exit, and the Failure of Internal Control Systems, *Journal of Finance*, Vol. 48(3), 831-880.
34. Jensen, M. and Meckling, W.H. (1976): Theory of the firm - Managerial Behaviour, Agency Costs and Ownership Structure *Journal of Financial Economics*, Vol. 3, 305 -360.

35. Jensen, M. and Meckling, W.H. (1979): Rights and Production Functions: An Application to Labor Managed Firms and Codetermination, *Journal of Business*, Vol. 52, No. 4.
36. Jost, P.-J. (2001a): Die Prinzipal-Agenten-Theorie im Unternehmenskontext, in: Jost, P.-J. (2001b).
37. Jost, P.-J. (Hrsg.) (2001b): Die Prinzipal-Agenten-Theorie in der Betriebswirtschaftslehre, Stuttgart.
38. Macharzina, K. (1995): Unternehmensführung: das internationale Managementwissen; Konzepte-Methoden-Praxis, Wiesbaden.
39. Malik, F. (2002): Die Neue Corporate Governance - Richtiges Top-Management, wirksame Unternehmensaufsicht, 3. Edition, Frankfurt/M.
40. Mandelbrot, B.B. (1971): When can price be arbitrated efficiently? A limit to the validity of the random walk and martingale models, in: *Review of Economics and Statistics*, Vol. 53, 225-236.
41. March, J.G. and Sutton, R.I. (1997): Organizational Performance as a dependent variable, in: *Organisation Science*, Vol. 8, 698-706.
42. Meinhövel, H. (1999): Defizite der Principal-Agent-Theorie, Lohmar.
43. Neus, W. (1989): Ökonomische Agency-Theorie und Kapitalmarktgleichgewicht, Wiesbaden.
44. Nicolai, A. and Kieser, A. (2002): Trotz eklantanter Erfolglosigkeit: Die Erfolgsfaktorenforschung weiter auf Erfolgskurs, in: *DBW*, H. 6, 579-596.
45. Nippa, M. (2002): Alternative Konzepte für effiziente Corporate Governance, In: Nippa, M. et al. (2002): *Corporate Governance*, Heidelberg.
46. Perridon, L. and Steiner, M. (1995): *Finanzwirtschaft der Unternehmung*, 8. Edition, München.
47. Pfaff, D. and Bärtl, O. (1999): Wertorientierte Unternehmenssteuerung - ein kritischer Vergleich ausgewählter Konzepte, in: Gebhardt, G. and Pellens, B. (Hrsg.): *Rechnungswesen und Kapitalmarkt*, ZbF-Sonderheft 41, 85-115.
48. Picot, A. et al. (1999): *Organisation. Eine ökonomische Perspektive*, 2. Edition, Stuttgart.
49. Richter, R. and Furubotn, E. (1996): *Neue Institutionenökonomik*, Tübingen.
50. Rosen, R.v. (2001): *Corporate Governance: Eine Bilanz*, *Die Bank* 2001, 283-287.
51. Schäfer, H.-B. and Ott, C. (1995): *Lehrbuch der ökonomischen Analyse des Zivilrechts*, 2. Edition, Berlin.
52. Schierenbeck, H. (2000): *Grundzüge der Betriebswirtschaftslehre*, 15. Edition, München.
53. Schmidt, R.H. and Terberger, E. (1997): *Grundzüge der Investitions- und Finanzierungstheorie*, 4. Edition, Wiesbaden.
54. Schneider, D. (1985): *Allgemeine Betriebswirtschaftslehre*, 2. Auflage der „Geschichte betriebswirtschaftlicher Theorie“, München.
55. Schneider, D. (1995): *Betriebswirtschaftslehre, Band 1: Grundlagen*, 2. Edition, München.
56. Semler, R. (1993): *Das Semco-System: Management ohne Manager - das neue revolutionäre Führungsmodell*, München.
57. Shleifer, A. and Vishny, R. (1997): A Survey of Corporate Governance, *The Journal of Finance*, 52/2, 737-783, 1997.
58. Simon, H.A. (1962): *The Architecture of Complexity*. *Proceedings of the American Philosophical Society*.
59. Sliwka, D. (2003): Anreize, Motivationsverdrängung und Principal-Agenten-Theorie, in: *Die Betriebswirtschaft*, 3, 293-307.
60. Suter, R. (2000): *Corporate Governance & Management Compensation - Wertsteigerung durch Lösung des Manager-Investoren-Konflikts*, Zürich.
61. Swoboda, P. (1991): *Betriebliche Finanzierung*, 3. Edition Würzburg.
62. Terberger, E. (1994): *Neo-institutionalistische Ansätze*, Wiesbaden.
63. Tietzel, M. (1981): Die Rationalitätsannahme in den Wirtschaftswissenschaften oder Der homo oeconomicus und seine Verwandten, in: *Jahrbuch für Sozialwissenschaft*, 32, 115-137.
64. Titzrath, A. (1997): *Corporate Governance: Vertragen sich die deutsche Unternehmensverfassung und das Shareholder Value-Prinzip?* In: *ZfB-Ergänzungsheft* 4/97, 31-43.
65. Weise, P. (1989): Homo oeconomicus und homo sociologicus: Die Schreckensmänner der Sozialwissenschaften, in: *Zeitschrift für Soziologie*, H. 2, p.148-161.
66. Welge, M.K. and Al-Laham, A. (1999): *Strategisches Management - Grundlagen, Prozess, Implementierung*, 2. Edition, Wiesbaden.
67. Werder, A.v. (1997): *Corporate Governance: Vertragen sich die deutsche Unternehmensverfassung und das Shareholder Value-Prinzip? - Ein betriebswirtschaftliches Statement*, in: *ZfB-Ergänzungsheft* 4/97, 9-17.
68. Winter, S. (1998): Zur Eignung von Aktienoptionsplänen als Motivationsinstrument für Manager, in: *zfbf* 50, H. 12, 1120-1142.
69. Witt, P. (2002): *Grundprobleme der Corporate Governance und international unterschiedliche Lösungsansätze*, in: Nippa et al. (2002): *Corporate Governance*, Heidelberg.
70. Wosnitza, M. (1991): *Das agency-theoretische Unterinvestitionsproblem in der Publikumsaktiengesellschaft*, Heidelberg.