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Article information:

To cite this document:
Jon Aarum Andersen , (2015),"How organisation theory supports corporate governance scholarship", Corporate Governance, Vol. 15 Iss 4 pp. 530 - 545
Permanent link to this document:
http://dx.doi.org/10.1108/CG-02-2014-0016

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How organisation theory supports corporate governance scholarship

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Abstract

Purpose – *This paper aims to show how organisation theory can be used to understand the controversy between the shareholder and the stakeholder perspectives. Rationalistic and open system theories may enhance research on corporate governance by offering well-defined concepts and by specifying core relationships.*

Design/methodology/approach – *This paper applies descriptions of the two perspectives in organisation theory as a "method" for illustrating how they are linked to and support the shareholder versus the stakeholder perspectives.*

Findings – *The controversy stems from the fact that the shareholder and the stakeholder perspectives address different relationships. The shareholder perspective captures two relationships that accord with rationalistic organisation theory: shareholders are managing the managers and the organisation, and managers are managing the corporation on behalf of the owners. The stakeholder perspective focuses on three relationships that are not concordant with system theory: managers are managing the shareholders (i.e. the symbolic management of stockholders), managers are managing the corporation (i.e. general management theory) and managers are managing the stakeholders.*

Research limitations/implications – *Organisation theory provides suggestions for more fruitful definitions of the often-used concepts of direction, control, administration and influence. These terms may be substituted with the well-defined concepts of management, power and control.*

Practical implications – *Proponents of organisation theory find it theoretically difficult to deal with the topic of corporate governance, if they do at all. When they do, they do it only perfunctorily.*

Originality/value – *Organisation theory may strengthen research on corporate governance if we insist on both theoretical clarifications of major relationships and on the use of more strictly defined concepts.*

Keywords *Control, Decision making, Corporate governance, Corporate ownership, Management, Effectiveness*

Paper type *Conceptual paper*

Introduction

Letza *et al.* (2004, p. 245) wrote: "All theoretical models on corporate governance neatly fall within two opposing perspectives: the shareholder perspective and the stakeholder perspective". The prevalence of two opposing perspectives is, however, not a problem. The problem addressed here is that these two perspectives lack theoretical clarifications in regard to relationships and concepts, which may impair corporate governance scholarship. The statement by Letza *et al.* (2004, p. 245) is used as a basis for clarifying the differences between the shareholder and stakeholder perspectives by the application of organisation theory.

Scott (2003, p. 11) wrote:

> Most analysts have conceived of organisations as *social structures created by individuals to support the collaborative pursuit of specified goals.* A base of divergence among those who study organisation is *theoretical perspective* employed by the analyst. The analyst may employ a *rational*, a *natural* or an *open system* perspective.

Received 5 February 2014
Revised 5 May 2014
2 April 2015
Accepted 30 April 2015

The author is grateful for the valuable comments from Professor Andreas Jansson, School of Business and Economics, Linnaeus University, Sweden.

These perspectives are not theories, but the meta-theories embracing a large number of theories. Common for rationalistic organisation theories is that organisations are defined as collectivities oriented to the pursuit of relatively specific goals. Goals are specific to the extent that they are explicit, are clearly defined and provide unambiguous criteria for selecting between alternative activities (Scott, 2003, p. 11). Common for open system theories is that they define organisations "as congeries of interdependent flows and activities linking shifting coalitions of participants embedded in wider material-resources and institutional environments" (Scott, 2003, p. 29). The natural perspective does not pertain to corporate governance.

Organisation theory is a discipline older than corporate governance and has influenced the scholarship on corporate governance. The conflicting organisation theories are described to illustrate how they are linked to and support the shareholder and the stakeholder perspectives. In other words, how does organisation theory support corporate governance theory?

Both rationalistic theory and open system theory are applied here as a "method" for illustrating how these organisational perspectives are theoretically linked to the corporate governance perspectives. Corporate governance is understood as the system by which companies are directed and controlled (Cadbury, 2000). Additionally, corporate governance can be conceptualised as a set of processes, customs, policies, laws and institutions affecting the way a corporation is directed, administered or controlled. Its purpose is to influence directly or indirectly the behaviour of the organisations towards its stakeholders (Mostovicz *et al.*, 2011).

On the basis of the definitions of Cadbury (2000) and Mostovicz *et al.* (2011), four concepts emerge as essential: direction, control, administration and influence. In which relationships do these concepts apply? How these and related concepts are perceived and defined in organisation theory is described to clarify the differences between the shareholder and stakeholder perspectives.

How to study organisations?

Whether or not organisations can be studied by a focus on the goals for organised action constitutes the watershed between the system and rationalistic perspectives. One of the universal characteristics of organisations is the presence of a goal (purpose). Rationalistic theory regards the goal as an independent variable and as a prime controlling factor in the organisation's activities. In contrast, system theory does not see goals as controlling the organisation's activities but conceives it as a dependent variable, a product of the activities that take place in the organisation. Or to put it differently, according to rationalistic theory, the goal comes first and then the organisation is established. In system theory, it is the other way round. As all organisations have goals, the question arises: who have the goals? Rationalistic organisation theory is crystal clear on this: the owners have the goals for the organisation. According to system theory, the answer is less clear.

Rationalistic organisation theory

Organisations are social phenomena. However, rationalistic theory views the organisation as an instrument, that is a rationally designed means for the realisation of explicit goals set by a particular group of people (Scott, 2003). In management and business administration, organisations are regarded as contrived entities that are established as vehicles for the owners so that *the owners* can achieve *their* goals. Blau and Scott (1962) have presented a typology based on the prime beneficiaries of organisations. Some organisations are established where the owners are the prime beneficiary, namely, business enterprises (Blau and Scott, 1962). Goal attainment is therefore the central issue and the basic definition of effectiveness in management theory for private enterprises.

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When organisations are established, the owners appoint some individuals to act on their behalf. The formal leaders (i.e. managers) are hired to be executives. Their main task is to contribute to the attainment of the goals as decided by the owners. The purpose of the firm is not a problem for the managers. It is the reason why they hold executive positions. It is crucial to stress that the formulation of purposes, goals, strategies and visions in formal organisations is the privilege of the owners, who decide these goals and direct their managers to achieve them. Owners hire and fire managers, not the other way round.

Rationalistic organisation theory and corporate governance

When researchers apply rationalistic organisation theory to study corporate governance, the relationships between the owners, their goals and the managers come to the fore. It is an essential part of rationalistic theory. Owners (ownership) and their goals are key theoretical concepts. The relationship between the owners and the executive is central in this theory. The theory of principal and agent is thus derived from rationalistic theory. Donaldson (1990) has defined corporate governance in terms of how the managers are controlled by the board of directors.

The academic debate on agency contains disagreement about the role of the board of directors. Some scholars have argued that corporate boards are formed to maximise managerial control (Berle and Means, 1932; Mace, 1971). Berle and Means (1932) explored the evolution of big business through legal and economic lenses, and argued that in the modern world, those who legally have ownership over companies have been separated from their control. Their work still serves as a foundational text in corporate governance. Berle and Means argued that the functioning of modern company law destroyed what was commonly called property. The main reason being the dispersal of shareholding ownership in big corporations: the typical shareholder is uninterested in the day-to-day affairs of the company. The result is that those who are directly interested in day-to-day affairs, the management and the directors, have the ability to manage the resources of companies to their own advantage without effective shareholder scrutiny.

As businesses grow and shareholders increase in number, any shareholdings that directors have will be a proportionally smaller capital stake. Directors' income will derive mostly from return on their labour as directors, not from their capital investment. If their motivation is purely pecuniary, the owners will not be served by a profit-seeking controlling group. The implications of their work were clear. Berle and Means (1932) advocated voting rights for all shareholders, greater transparency and accountability.

Mace (1971) found that most boards of directors of large corporations did not establish objectives, strategies and policies. They did not ask discerning questions, select the chief executive officer or carry out managerial functions. Indeed, Mace (1971) claimed that the boards of directors were under control of their chief executive officer in terms of composition, information flow and activities. In fact, the directors answered to management rather than to the shareholders. Axworthy (1988) goes all the way by suggesting that it may be undesirable and inefficient for directors to carry out the directing or supervising function in regard to management.

Some other scholars have argued that boards are formed to minimise agency costs (Fama, 1980; Fama and Jensen, 1983). The interest of the owners has its starting point in agency cost theories. Jensen and Meckling (1976) argued that the duty of the board of directors is to align the interests of senior management with those of the shareholders through the use of compensation. An important function of the board of directors is to minimise costs that arise from the separation of ownership and decision control of the modern-day corporation (Fama and Jensen, 1983). The board of directors receives its authority for the internal control and other decisions from stockholders. Although the board delegates most decision management functions and many decision control functions to top management, the board retains ultimate control over top managers.

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Those who take this view (e.g. Fama and Jensen) do so because they regard market discipline as sufficient to realise benefits associated with internal control mechanisms. Fama (1980) advanced a theoretical explanation for a market in decision control. This operates though the monitoring activities of independent directors who have incentives to protect and sustain reputation as experts in decision control. Fama and Jensen (1983) theorised that the board of directors is the highest internal control mechanism responsible for monitoring the actions of top management. They argued that outside directors have incentives to carry out their monitoring tasks and not to collude with top managers to expropriate stockholder wealth. Inclusion of outside directors is for these reasons favourable for the owners.

Fama (1980) and Fama and Jensen (1983) have argued that it is natural for most influential members of the board to be the internal managers, because they have valuable specific information about the organisation's activities. As a result, they expected the board to include several of the organisation's top managers. However, the board is not effective at decision control unless it limits decision discretion of individual managers (Fama, 1980; Fama and Jensen, 1983). Williamson (1984) noted that the board of directors can easily become an instrument for management and sacrifice the interests for the stockholders. Domination by top management on the board of directors can lead to collusion and transfer of stockholder wealth (Fama, 1980). As a result, corporate boards generally include outside members who act as arbiters in disagreement among internal managers and ratify decisions that involve serious agency problems (Fama and Jensen, 1983). Empirical research provides evidence about the importance of including outside directors on the board for purposes of monitoring management in acute agency settings. These studies supported the prediction that board of director composition is related to board's effectiveness at reducing agency costs (Beasley, 1996).

Fama (1980) and Fama and Jensen (1983) hypothesised that the viability of the board as an internal control mechanism is enhanced by the inclusion of outside directors. Outside directors have incentives to develop reputations as experts in decision control because the external market for their services prices them according to their performance as outside directors. Most outside directors of corporations are either managers or important decision makers in other corporations (Fama, 1980; Fama and Jensen, 1983). A board composition with outside directors and experts appears to strengthen the interest of the shareholders and aligns theoretically to the rationalistic theory, and it has empirical support. According to rationalistic theory, decision-making is the prerogative of the owners. The managers make decisions on their behalf. The owners also decide to what degree the managers are to be controlled. Furthermore, there is nothing in rationalistic theory which assumes that agents (managers) will act contrarily to the interests of the principal (owners).

Rationalistic theory does not perceive the environment as composed of stakeholders, but instead as external forces defined as economical, technological, political and legal conditions. The *economic conditions* (e.g. a wealthy and expanding national economy) create business opportunities. In fact, these conditions explain why corporations are established in or moved to some countries. Likewise, *technological conditions* have the same effect.

When it comes to *political and legal conditions*, some countries have more favourable business climates and more generous taxes and company legislation. Li (1994) argued that national differences in ownership and board structure create different patterns of corporate governance between countries. La Porta *et al.* (1998) have also focused on the importance of the legal system. A large amount of contemporary research on corporate governance deals with the differences in corporate law, including the differences in the degree to which stakeholders can participate in directing and controlling the firm. With respect to the establishment of a firm, the decision on the goal of the firm, the establishment of the board of directors and the operation of the firm, some legal and company-act jurisdictions apply. The formulation of the organisation's goal is the privilege of the shareholders through the

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voting at the general assembly and the appointment of directors of the corporate board. The differences in legal protections of investors explain why firms are financed and owned differently across countries (La Porta *et al.*, 1998).

Though these conditions or forces are not primarily seen as other organisations or groups or institutions, empirical studies based on rationalistic theory will isolate, for instance, legal, political and economic institutions. These institutions and organisations do not participate in major organisational decision-making, unless the owners invite them. They may have certain claims and expectations on the organisation, but only the owners (and managers on the owners' behalf) decide if and to what degree such expectations and claims will be considered. These three conditions and the organisations that constitute these forces are seen as restrictions or as a framework within which the executive officers have to operate. The term stakeholder does not exist in rationalistic organisation theory. Theoretically, external actors do not decide the goals, have no power, do not manage and do not control the organisation.

The rationalistic organisation theory describes that managers make decisions on behalf of the owners. Agency theory explains the relationship between the owners of corporations and management, where the principal elects the board, who in turn elect the management team to execute the routine daily business decisions. Agency cost or principal-agency theories go a step further than organisation theory, in which the latter focuses on managers' control of subordinates and work processes. The principal-agent theory turns this relationship upside-down by raising the question: Who controls the managers? In organisation and management theories as well as in leadership theories, one focus is on the control of subordinates and production. The main solution is the introduction of formalisation, i.e. subordinates have to work according to rules, routines and procedures.

The economic theory of principals and agent rests on three main assumptions:

1. individuals maximise their own self-interest;
2. social life is a series of contracts; and
3. monitoring contracts leads to opportunism (Perrow, 1986).

Thus, risk is introduced into the analysis due to asymmetric information, as the principal cannot observe agent's behaviour (Douma and Schreuder, 2002). The delegation of ownership power to corporate agents intensifies the likelihood of moral hazard to exist in terms of immoral behaviour, of managers acting illegally, unethically or irresponsibly (Mostovicz *et al.*, 2011). Bukhvalov and Bukhvalova (2011) claimed that it is impossible to avoid managerial fraud and misconduct by means of the board's traditional monitoring. Abels and Martelli (2013) argued that a separation of the CEO and chairman positions within organisations is one solution to this problem.

The rationalistic organisation theory proper does not address the issue of board of director composition. Any board composition, which strengthens the interest of the shareholders, would align theoretically to the rationalistic theory. Whether the use of independent directors does so, or not, remains an empirical issue. Forker (1992) addressed the positive contribution of independent board members in some areas (executive remuneration, share options and fraudulent financial reporting). The results support the need for guidance on the duties and responsibilities of audit committees and non-executive directors (Forker, 1992). As a means of improving internal accounting control, the American Institute of Certified Public Accountants, National Commission on Fraudulent Financial Reporting (AICPA) (1987), otherwise known as the Treadway Commission, recommended US public companies to establish audit committees composed solely of independent non-executive directors. Beasley (1996) concluded that no-fraud firms had boards with significantly higher percentage of outside members than fraud firms. As outside directorship in the firm and outside tenure on the board increased, the likelihood of financial statement fraud decreased. The analysis of Beasley *et al.* (1999) indicated that the fraud companies'

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boards generally were neither independent nor expert. A board's effective monitoring of management relied on independent experts devoting sufficient time and energy to their task. If the directors were neither independent nor experts, the board had no reasonable chance of functioning as a vigorous monitor of management. Additionally, most prior research defines governance in terms of visible formal board attributes such as the proportion of independent directors (Cormier *et al.*, 2010). Their empirical findings highlighted the insight from most prior research that infers the quality of a firm's governance from formal and the observable attributes – for instance, the number of independent directors.

Organisation, management and leadership theories are not based on the assumption of managers and subordinates acting immorally, illegally, unethically or irresponsibly. Perrow (1986) pointed out that the agency literature does not deal with principal and agents symmetrically. Opportunistic and immoral behaviour may be equally frequently found in stockholders, stakeholders, managers and subordinates.

According to Westphal and Zajac (1998), shareholder management is a concept that describes how managers try to deal with or "manage" shareholders by symbolic, but not implemented, plans. According to rationalistic theory, managers do not manage the owners. It is the other way round. Consequently, stakeholder governance does not make sense in the view of rationalistic theory. Shareholder governance does.

The concept of goal

The firm – as one type of organisation – is perceived clearly and undoubtedly as rationalistic in theories of business administration and management (Douma and Schreuder, 2002). It is one or more individuals who pursue the common goal of generating dividends from the capital invested in the firm. This very goal motivates its establishment. The firm is an instrument, a means for the owners. The goal is financial dividends. Only owners have the right to change the business's objectives (goals) (Sternberg, 1997). Corporate governance and assigning the proper role to the board of directors require deep understanding of the goal of the firm as a whole (Bukhvalov and Bukhvalova, 2011). Private organisations are in operation because some individuals (or other organisations) have decided to invest their funds into the firms. They continue to be in operation as long as the owners wish and the market allows it.

Fama (1980, p. 295) wrote that:

> [. . .] the firm's security holders are generally too diversified across the securities of many firms to take much direct interest in a particular firm nor directly controlling the management of any individual firm.

If the axiomatic view that shareholders are the owners is adopted, the question remains who the principal is and what his goals should be, as different shareholders hold different objectives (Mostovicz *et al.*, 2011). Additionally, Westphal and Zajac (1998) described how managers "manage" shareholders by symbolic actions. Managers can and, in many occasions, enforce their goals on shareholders.

The concept of owners

Shareholders are the owners of the corporation. The corporation has legitimate obligations and the managers have a fiduciary duty to act in the interests of shareholders (Mayson *et al.*, 1994). Owners can close down the corporation even if it is profitable, if they so wish. Legal institutions can also cease the operation of the firm if its activities are found to be illegal. Creditors can demand the firm to be declared bankrupt if it does not fulfil its payments. Other stakeholders cannot do so. As La Porta *et al.* (1998, p. 1114) have written:

> Thus shares typically give their owners the right to vote for directors of companies, whereas debt entitles creditors to the power, for example, to repossess collateral when the company fails to make promised payments.

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The concept of management

Rationalistic theory highlights the relationship between the owners and managers. A manager is appointed to run the organisation on their behalf. Shareholders have to delegate control to a few directors and managers to run the company on behalf of all shareholders (Letza *et al.*, 2004). Whenever one entrusts one's assets or affairs to another, the agent – principal relationship is invoked. Stakeholder theory renders this critical relationship unworkable by denying that agents have any particular duty to their principals (Sternberg, 1997).

The separation of ownership and control induces conflicts of interest between managers and shareholders. Agency theory suggests that a number of governance mechanisms may help to align the interests of managers with those of shareholders (Bekiris, 2013). Jensen and Meckling (1976) argued that the duty of the board of directors is to align the interests of senior management with those of the shareholders through the use of compensation. The central question in the theory of principal and agent is how the principal should design the agent's reward structure (Douma and Schreuder, 2002).

The concepts of power and control

According to rationalistic theory, power and control rest with the owners. As Abrahamsson (1993a, p. 205) has written:

> The law is clear on this point. Decision-making authority ultimately rests with the mandatory, even if there are other stakeholders in the picture. The Swedish Co-Determination Act, for example, gives employees the right to take part in decisions in companies and authorities. However, the scope of this legislation is limited by the Companies Act, which places final decision-making authority in the hands of the owner-mandator.

In short, the professionalisation of management and control functions does not mean that the control is transferred from owner to administrator (Abrahamsson, 1993a, p. 205). The controlling shareholders typically have power over their firms that significantly exceed their cash-flow rights (La Porta *et al.*, 1999).

Rationalistic theory and corporate governance – conclusion

Stakeholder theory has been offered as an alternative model of corporate governance. Sternberg (1997) has concluded that stakeholder theory is incapable of providing better corporate governance, business performance or business conduct. The key concept in corporate governance is accountability: the accountability of corporate employees to the corporation via the board of directors. Stakeholder theory explicitly denies that corporations should be accountable to their owners. It is an essential principle of this theory that corporations should be accountable to *all* their stakeholders. This principle is unworkable. An organisation that is accountable to everyone is accountable to no one (Sternberg, 1997).

The corporation is a legal entity. The corporation, as well as the board (and its individual members) and the managers, can thus be subject to prosecution. Each shareholder is legally stated as the owner of a part of the company. While it is possible from the political, economic and financial perspectives to *perceive* that organisations do not have owners, as Fama (1980) has done. It is nonetheless incorrect in formal and legal terms.

According to rationalistic organisation theory, there are no stakeholders. External actors do not manage the corporation. They neither exercise control nor have any power over the firm. External actors constitute a framework within which the corporation operates.

System theory

System theory was a reaction to and is an argument against rationalistic theory. This perspective is based on the seminal work of Katz and Kahn (1978). Several writers of corporate governance (Freeman, 1984; Letza *et al.*, 2004; Freeman *et al.*, 2010) have,

however, referred to contemporary textbooks on organisation theory. Katz and Kahn rejected the idea of studying organisations on the basis of goals. It is imperative to note that Katz and Kahn (1978) did not address the issue of owner and ownership. In fact, these words are not found in the index of the book. Organisations are dependent on other organisations and groups to acquire input and to find outlets for their products and services. Katz and Kahn (1978) call other organisations constituent groups or *constituencies*. However, the concept of constituency is not well-defined. Theoretically, all constituent groups are equally important (Katz and Kahn, 1978; Pesueux and Damak-Ayadi, 2005).

A key concept within system theory is that of constituent. The term "stakeholder" does not exist in the original versions of system theory. The organisation is perceived as a kind of market for various groups of constituents, that is different parties that find that they may have something to gain by means of cooperation (or exchange) with the organisation. The character of the exchange, however, varies with the different needs of the organisation. Consequently, the set of constituents (i.e. stakeholders) will differ from time-to-time and from organisation-to-organisation. The definition of stakeholder must necessarily be somewhat arbitrary. The perception of the organisation as a system responsive to stakeholders' needs and striving towards equilibrium and adjustment to its environment leads to the lack of interest in the purposes for which the organisation was established.

System theory does not regard the organisation primarily as an instrument for the realisation of the mandators' goals. Rather, the organisation is perceived as a structure that responds to and adjusts itself to a multitude of demands from various stakeholders and tries to maintain balance by reconciling these demands. However, the sundry constituents have different demands or expectations regarding the outcome that the organisation in question produces. In practice, stakeholder interests are so diverse and conflicting that different stakeholders' interests are likely to be incompatible to some degree, and such incompatibility might even arise within a single group (Letza *et al.*, 2004). Specific outcomes or consequences of the activity of the organisation are to some constituents unwanted.

A goal is a description of a future, desired state. The same applies to corporate strategies. Katz and Kahn (1978), however, have regarded organisational goals as abstractions or generalisations of future activities and behaviour in organisations on a general level. System theory uses the constituents to explain how goals *emerge*. Goals are formulated through a complex process involving different and possibly competing expectations from the constituents. Importantly, no scholars have claimed that constituents have contact or negotiate with each other. In most cases, constituents do not have any knowledge about other constituents.

According to the system perspective, the manager plays an active role when organisational goals are formulated. The formulation of goals is an interdependent activity in which the aim is to express goals which can find broad acceptance. As Abrahamsson (1993b, p. 90) has written:

> The organisation's management acquires a kind of mediator role, i.e. a role of weighing the demands from different stakeholders against each other. One can contrast this role description to that forwarded by the rationalistic tradition, in which management is seen more as the "extended arm" of the mandatory.

According to Freeman and Phillips (2002), the managers' job is to maintain the support of all of the stakeholders and to balance their interests. In system theory, the goals may change when the coalition or set of constituents changes. In rationalistic theory, the goals may change due to owner structure change.

It is impossible to address the question of goals without discussing who have goals. Individuals have goals for their professional and private lives, but not goals for other persons. They may have expectations and maybe claims on other individuals. The way of

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reasoning by Katz and Kahn (1978) is that the definition of organisational goals rests on the assumption that different constituents have different goals for the organisation. This may be understood as different constituents present claims or expectations regarding the goal formulation. Theoretically, the constituents do not *decide* organisational goals. For system theory, the problem arises of how to rank or weigh these claims or expectations.

Now, who decides the organisational goals? Is it the owners, the managers or the constituents? In the final analysis, it is not a question of who *influences* the organisational goals, but who *decides* the goals. The company act gives the owners (shareholders) the sovereign right to decide the overriding goals and to appoint the executive officer. Official goals do not simply emerge. They must be stated in writing when the corporation is registered with the authorities. The argument is, once again, that organisations are structural arrangements which are established to achieve specific goals. To understand organisations, we need to understand their goals.

Contemporary scholarship on corporate governance and system theory

Over the years, the concepts of constituency and stakeholding have changed dramatically. From the start, the concept of stakeholder was an extension of the original concept of constituent from system theory. In system theory, constituent and constituency were descriptions of the environment that the organisation was dependent on, and which the organisation needed to *adjust* to.

Any individual, group, company, public agency, government, local administration may be seen as a constituent if this "actor" has or may in the future have an exchange or interaction with the organisation (Katz and Kahn, 1978). The constituents will continue to interact with the organisation as long as the reward they achieve is equal to or larger than the contribution they give to the organisation. Further, system theory claims that the adjustment to the environment and constituents is the key to survival.

Freeman (1984) defines stakeholders as any group of individuals who can affect or be affected by the realisation of a company's objectives. The stakeholder map (Freeman, 1984, p. 55) includes "owners" and "employees", but not "managers". In Freeman *et al.* (2010, p. 24), the owners have disappeared and are now "financiers". Although the books are explicitly based on system theory, Freeman (1984) makes only one reference to Katz and Kahn (1978), while Freeman *et al.* (2010) make none.

Stakeholders were originally identified as those without which an organisation could not survive, that is those in whom the organisation had a stake. Now, stakeholders are more commonly identified as those who have a stake *in* an organisation. This, Sternberg (1997) has noted, represents a radical shift from those who affect the organisation to those who are affected by it. As a result, the number of groups identified as stakeholders has increased dramatically. It transforms everyone into a stakeholder (Sternberg, 1997).

A huge theoretical leap is taken when it is claimed that stakeholders are all of the agents for whom the firm's development is of prime concern. Among stakeholders, we find pressure groups, which in fact do not regard the organisation of contributing to anything good.

The main idea of the instrumental stakeholder theory is that (*ceteris paribus*) firms that practice "stakeholder management" will perform better in respect of profitability, stability, growth and so on (Pesueux and Damak-Ayadi, 2005). Stakeholder management is, however, the *opposite* of system theory. In system theory, stakeholders are those who the organisation and its managers must adjust or adapt to, rather than manage. The organisation is in the hands of the environment (Pfeffer and Salancik, 1978). To put it bluntly, system theory can be said to imply that the stakeholders "manage" the organisation rather the other way round. According to system theory, constituents *influence* the organisation's goal setting through a mediatory process with the manager. However, there

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is nothing in system theory – based on Katz and Kahn (1978) – which assumes that constituents control the organisation or have power over the organisation.

From the corporate perspective, some stakeholders such as employees and customers are critical for corporate survival (Letza *et al.*, 2004; Spitzeck and Hansen, 2010). It is imperative, however, to acknowledge that the constellation of stakeholders, which any firm at any time has, is a consequence of the strategy chosen. A new strategy implies new products and therefore new customers and suppliers. In that way, the expectations of the stakeholders will be different. The need to adjust to the stakeholders will also change. The owners (shareholders) can also reduce the stakeholders' influence by various strategies, like vertical and horizontal integration, by the use of pyramids or alliances, by out-sourcing, by moving the corporations' headquarters to other countries or regions (for tax purposes or legal reasons) and by lobbying.

The concept of goal

When Fama (1980) argued that firms do not have goals and that only individuals have them, he rejected the basic assumptions of micro-economics and business administration. Freeman (1984) and Freeman *et al.* (2010) have listed neither "goals" nor "purpose" in their respective indices. La Porta *et al.* (1999) have not made any reference to the terms "goal" and "purpose" of the organisation. The term "expectations" of shareholders used by Letza *et al.* (2004) is confusing. Owners do not have expectations: they have goals for the organisation.

The concept of owners

Letza *et al.* (2004) claimed that the dominant corporate governance model focuses on shareholders' rights and control. Shleifer and Vishy (1997) have extended the finance view to include not only shareholders, but also debt-holders and bankers. Fama (1980, p. 289) wrote: "We first set aside the typical presumption that a corporation has owners in any meaningful sense". He claimed that the ownership of capital is shared by bondholders and stockholders. Yet there is a fundamental difference between the two. Bondholders are among those who finance the firm, but only stockholders have the opportunity to decide the goals of the firm. Moreover, Fama (1980, p. 290) argued that "In this 'nexus of contracts' perspective, ownership of the firm is an irrelevant concept". Letza *et al.* (2004) also argued that the firm is best viewed as a "nexus of contracts" and contractual relations exist not only between shareholders, but also with all other stakeholders. Mostovicz *et al.* (2011) have also argued against the view that shareholders constitute the owners of the company. Freeman (1984) has stated that owners not only want returns, but also want control. Owner control exists because an owner can expend resources in the form of voting power by voting for directors, by voting to support management or by even "voting" to sell their shares (Freeman, 1984).

The concept of management

Management is according to Fama (1980) a type of labour with a special role consisting of coordination and decision-making. This description of management is not what we find in classical and modern management theory.

The concepts of power and control

Corporate governance and ownership governance deal with how managers can be controlled. Fama (1980, p. 293) turned this upside down when arguing that "[managers] are the best ones to control the board of directors". Letza *et al.* (2004) have rightly pointed out that a three-tier structure of governance of the shareholder general meeting, the board of directors and executive managers is required in company law. They have noted that through stock markets, share ownership has become dispersed and fragmented and shareholders are more like investors than owners. This observation does not change the

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fact that stock holders have the right to appoint directors of the board and thus to take part in major decisions regarding goals and strategies or can refrain from doing so. If we see stockholders as investors, we only imply that they have decided to be passive owners. Not all shareholders hold similar investment horizons, as some are "transient" and some are "dedicated" (Mostovicz *et al.*, 2011).

The rights attached to securities become critical when managers act in their own interest. These rights give shareholders the power to extract from managers the returns of their investment. La Porta *et al.* (1998, p. 1114) have written: "Shareholders receive dividends because they can vote out the directors who do not pay them, and creditors are paid because they have the power to repossess collateral". In instrumental stakeholder theory, it is suggested that corporate governance should not depart from ownership rights, but that such rights should not solely be claimed by, and thus concentrated in, shareholders. Ownership right can also be claimed by other stakeholders, particularly employees (Letza *et al.*, 2004). If this is the case, then anyone may claim ownership or ownership rights. Such claims are, however, futile if one does not possess any shares.

System theory and corporate governance – conclusion

The notion of constituent and the concept of stakeholder derived from system theory to explain corporate governance turns out to be a theoretical dud. This is why contemporary organisation literature excludes to a large extent, corporate governance and ownership. A search in some textbooks on organisation theory and management for "corporate governance" in the index shows that Cook and Hunsaker (2001) make no references, neither do Scott (2003), Hitt *et al.* (2005), Daft (2007) and Jones (2013). However, Hatch (2006) makes one reference to corporate governance. Evan (1993) contains one chapter on governance, as do Hodge *et al.* (2003).

There are obvious reasons for this. Most literature on organisation theory is based on open system theory, which marginalises the importance of goals and owners, while the original concept of constituent has been transformed into stakeholder. The idea from the system theory that the organisation needs to *adjust to* the constituents (stakeholders) has in the stakeholder theory been turned into the idea of *management of* stakeholders. Pesueux and Damak-Ayadi (2005) have claimed that stakeholder theory as an organisation theory helps to nourish a relational model of organisations. The argument put forward here is that a relational organisation model is contrary to the stakeholder model. The stakeholder concept in corporate governance scholarship is the opposite of what we find in system theory.

The concept of governance and corporate governance is not a part of system theory as presented by Katz and Kahn (1978). In system theory, the relationship between owners and managers is not in any way differently than the relationship between the organisation and any other constituent. The weakness of stakeholder theory lies in the failure to sufficiently specify the organisation – stakeholder relation itself (Letza *et al.*, 2004).

Suggestions for alternative concepts

Influence, decision-making and power

All knowledge is conceptually mediated (Danermark *et al.*, 2002). The initial concepts in corporate governance literature of influence, direction, administration and control appear to be ill-defined and to lack a satisfactory theoretical foundation. The concept of *influence* is defined as the power to direct the thinking or behaviour of others, usually indirectly (Encyclopaedia Britannica Online). The concept is not especially defined in terms of the outcome of (indirect) influence, but as power.

What does "influence" mean? How can we ascertain that someone has been influenced? In corporate governance, scholarship influence is most often used in reference to decision-making. Is the core of this concept the attempt to sway someone, or does it refers to a successful attempt, whereby another person now acts differently or makes a different

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decision? It is obvious that many attempts to influence other people come to nothing. The individual may acknowledge other alternatives, but this in itself does not change his or her decision or behaviour. To remove the ambiguity over whether an attempt to influence someone is successful or not, it is suggested to apply the concept of "power" to corporate governance literature. In organisation literature, power is defined as the ability or possibility to overcome resistance. Thus defined, the question related to decision-making is narrowed down to the question of who in fact decides.

The study of Spitzeck and Hansen (2010) illustrates this point. They tried to explore how stakeholders were voluntarily granted influence in corporate decision-making. Stakeholders were granted a voice regarding operational, managerial as well as strategic issues. Only a minority of corporations granted stakeholders significant power in shaping corporate decisions (Spitzeck and Hansen, 2010). However, the authors provide no information on whether the stakeholders' ideas and expectations resulted in different decisions being made by boards and managers from what would otherwise be the case.

Influence on decisions is not the same as decision-making. Any board of directors and any owner decide whether the opinions of other people will be taken into account or not. Consequently, stakeholders do not have any *power* over corporations because they cannot overcome the resistance from the majority of the shareholders. Stakeholders may influence the decision makers but never make corporate or managerial decisions. Decision-making in corporations is the sole prerogative of the owners and executive managers. It appears that the concept of *influence* is vague with respect to what has actually happened (e.g. in decision-making), while the concept of *power* is well-established in social sciences and facilitate empirical investigations.

The concept of management

The concept of management is derived from Fayol (1919/1949), who argued that the functions of managers were to plan, organise, co-ordinate, command and control. Management today involves four basic activities: planning and decision-making, organising, leading and controlling (Griffin, 1999). According to Donnelly *et al.* (1992, p. 5), "management is the process undertaken by one or more individuals to coordinate the activities of others to achieve goals not achievable by one individual alone". It is important to note that management control implies a comparison between goals (plans) and outcomes, results or what have been achieved (Fayol, 1919/1949). It is impossible to control unless there is a goal and a plan. As stakeholders do not decide the goals and plans, they cannot control the organisation. When corporate governance is understood as the system by which companies are directed and controlled (Cadbury, 2000; Mostovicz *et al.*, 2011), it is virtually the same as management.

Pesueux and Damak-Ayadi (2005) describe the main idea of instrumental stakeholder theory in terms of firms practising "stakeholder management". When the concept of stakeholder management is used in terms of a corporation managing their stakeholders (and not the managers managing "their" firms), we expect to find that the corporation is planning, making decisions, organising, leading and controlling the stakeholders. A firm cannot set the goals, nor make plans, nor organise, nor lead and nor control other companies unless this firm owns the other companies.

The concept of "direction" is more fruitful, but it needs to be more precise. Direction presupposes a road to follow or a destination to reach or goal to achieve. In that way, direction can theoretically be linked to the managerial function of planning (Fayol, 1919/1949). Planning, however, requires goals, as planning is a function by which the means to achieve the goal are specified. Consequently, the concept of direction can be substituted with the concept of goal, which is related to who decided the goal. Additionally, the concept of "administration" is just another word for "management". Administering or managing is the execution of the managerial functions. In present-day language, the term "commanding" (i.e. giving orders) has been eclipsed by "directing" (Griffin, 1999).

The concept of control implies the examination of results by comparing the results with what was planned (Fayol, 1919/1949). In that way, control is an essential part of management, as it presupposes goals and plans. Having control is the privilege of managers and owners. Consequently, the initial term of administration ought to be replaced by the more specific concept of management. Not only are the concepts of goal, management, power and control theoretically well-defined, they are also empirically defined and may improve investigations into corporate governance.

Conclusions

The controversy between the shareholder and the stakeholder perspectives may be understood by the application of organisation theory. Rationalistic organisation theory focuses on owners, executives and organisational goals. It constitutes a basis for the principal – agent relationship. External actors, whether they are named constituents or stakeholders, constitute limitations or possibilities or boundaries within which the corporation operates. Over the years, it has been possible to isolate three principles of corporate governance. Lazonick and O'Sullivan (2000) have described a shift from "retain and reinvest" to the principle of "downsize and distribute". Now they have made a case for maximising shareholder value as the new ideology for corporate governance, especially in the USA and Great Britain.

Most literature on organisation theory is based on open system theory which marginalises the importance of goals and owners. The original concept of constituent has been changed into stakeholder. System theory does not accommodate principal–agent relationships. The idea from system theory of an organisation *making adjustments* to the stakeholders is transformed into the idea of *managing* the stakeholders in stakeholder theory. Stakeholder management is, thus, contrary to system theory. For these reasons, contemporary writers on organisation find it theoretically difficult to deal with the topic of corporate governance; and they do so only marginally.

Now, how does organisation theory support corporate governance scholarship? Rationalistic organisation theory inherently rejects the idea of stakeholders. Consequently, corporate governance based on stakeholding is also rejected. In fact, little or no empirical evidence is presented to support that stakeholding – in the strict sense of goals, management, power and control – exists. Shareholding governance, however, does exist. It is important in real life and as a subject of study. Corporate governance is shareholding governance. It is owner governance. According to OECD (1999), corporations should be run first and foremost in the interests of shareholders.

The lack of theoretical clarification regarding the major relationships and the scope of corporate governance compromises empirical studies. It is crucial to recognise that the objects of social science are relational: they are what they are by virtue of the relations they enter with other objects (Danermark *et al.*, 2002).

Which relationships are the core ones in corporate governance? The *shareholder perspective* includes the following core relationships:

- shareholders managing the managers;
- managers managing the corporation on behalf of the owners; and
- these relationships accord with rationalistic organisation theory.

On the other hand, the *stakeholder perspective* addresses these core relationships:

- the stockholders manage the managers;
- managers managing the shareholders, as in the symbolic management of stockholders;

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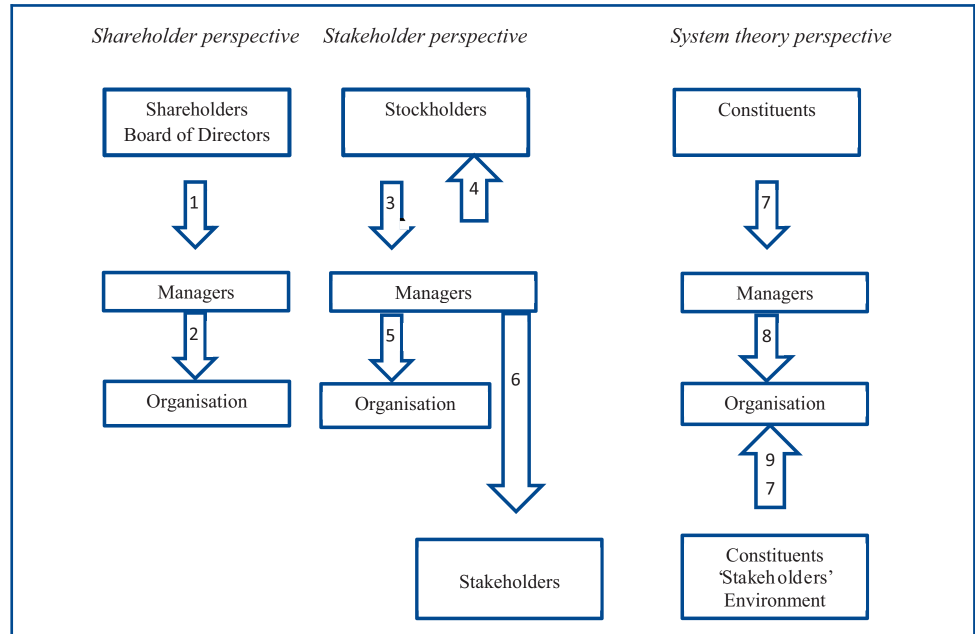
Figure 1 Main relationships and their directions in the shareholder, stakeholder and system theory perspective



- managers managing the corporation, as in general management theory; and
- manager managing the stakeholders.

The *system theory perspective* includes the following relationships:

- the constituents managing the managers;
- managers managing the organisation on behalf of the constituents; and
- stakeholders "managing" the corporation.

The notion of constituents managing the managers and the stakeholders "managing" the firm appears to have no place in corporate governance. Figure 1 illustrates the relationships and the way in which the core elements are seen to influence, control, direct or manage the others.

It is concluded that organisation theory clarifies the main relationships of the shareholder and the stakeholder perspectives of corporate governance. Additionally, organisation theory provides suggestions for more fruitful concepts and definitions of the often-used concepts of influence, direction, administration and control. These terms may be substituted with the well-defined concepts of goal, management, power and control to foster developments in corporate governance scholarship.

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