CORPORATE SOCIAL RESPONSIBILITY SERIES

Global Perspectives on Corporate Governance and CSR

Edited by

GÜLER ARAS AND DAVID CROWTHER

Global Perspectives on Corporate Governance and CSR

Corporate Social Responsibility Series

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Global Perspectives on Corporate Governance and CSR

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GOWER

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Foreword

Güler Aras and David Crowther

At the current time it is quite noticeable how much more prominent the concepts of corporate governance (CG) and corporate social responsibility (CSR) have become – not just in the academic world or in the business world but also in everyday life. Many people have highlighted a lot of factors which have led to this interest – such things as poor business behaviour towards customers, employees and the environment. Particularly, of course, the corporate scandals of the last decade have led to a great deal of interest in governance procedures. Since then other things have also featured prominently in popular consciousness. One of these which has become more pronounced is the issue of climate change and this has affected concern about CSR through a concern with the emission of greenhouse gases and particularly carbon dioxide. Nowadays it is quite common for people to know and discuss the size of their carbon footprint whereas even three years ago people in general did not even know what a carbon footprint was.

Another thing which has become prominent is a concern with the supply chain of business; in particular people are concerned with the exploitation of people in developing countries, especially the question of child labour and also such things as sweat shops and slave labour, as well as generally exploitative management. So no longer is it acceptable for a company to say that the conditions under which their suppliers operate is outside of their control and they are not responsible. Customers have said that this is not acceptable and have called companies to account. And there have recently been a number of high profile retail companies which have held their hands up to say *mea culpa*[1] and taken very public steps to change this. Interestingly the popularity of companies increases after they have admitted problems and taken steps to correct these, thereby showing both that honesty is the best practice and also

1 'I am responsible.'

that customers are reasonable. The evidence suggests that individual customers are understanding and that they do not expect perfection but do expect honesty and transparency. Moreover, they also expect companies to make efforts to change their behaviour and to try to solve their CSR problems. This too has raised the profile of corporate governance, particularly within organisations, as the prime mechanism for managing these problems is through a strong governance system.

Companies themselves have also changed. No longer are they concerned with greenwashing – the pretence of socially responsible behaviour through artful reporting. Now companies are taking CSR much more seriously (Crowther, 2008) not just because they understand that it is a key to business success and can give them a strategic advantage, but also because people in those organisations care about social responsibility. So it would be reasonable to claim that the growing importance of CSR is being driven by individuals who care – but those individual are not just customers, they are also employees, managers, owners and investors of a company. So companies are partly reacting to external pressures and partly leading the development of responsible behaviour and reporting. So accountability – one of the central principles of CSR – has become much more recognised and is being responded to by increasing transparency – another of the principles of CSR. It is not coincidental of course that these are also central principles of corporate governance and attention is being paid also in the development of governance systems and procedures.

The third principle of CSR is that of sustainability and this is a term which has suddenly become so common as to be ubiquitous for business and for society. Every organisation mentions sustainability and most claim to have developed sustainable practices. A lot of this is just rhetoric from people who, we would claim, do not want to face the difficult issues involved in addressing sustainability. There is a danger therefore that sustainability has taken over from CSR itself as a target for greenwashing. Nevertheless, although the relationship between organisations and society has been subject to much debate, often of a critical nature, evidence continues to mount that the best companies make a positive impact upon their environment. Furthermore, the evidence continues to mount that such socially responsible behaviour is good for business, not just in ethical terms but also in financial terms – in other words that corporate social responsibility is good for business as well as all its stakeholders. Thus ethical behaviour and a concern for people and for the environment have been shown to have a positive correlation with corporate performance. Indeed, evidence continues to mount concerning the benefit to business from socially

responsible behaviour and, in the main, this benefit is no longer questioned by business managers. The nature of corporate social responsibility is therefore a topical one for business and academics. The evidence for corporate governance being actually good for business – and therefore an essential platform for sustainability – is even more overwhelming. Strong governance procedures are generally accepted to be worth a premium in the market because of the benefits which will flow therefrom.

Most people initially think that they know what CSR is and how to behave responsibly – and everyone claims to be able to recognise socially responsible or irresponsible behaviour without necessarily being able to define it. So there is general agreement that CSR is about a company's concern for such things as community involvement, socially responsible products and processes, concern for the environment and socially responsible employee relations (Ortiz-Martinez and Crowther, 2006). Issues of socially responsible behaviour are not of course new and examples can be found from throughout the world and at least from the earliest days of the Industrial Revolution and the concomitant founding of large business entities (Crowther, 2002) and the divorce between ownership and management – or the divorcing of risk from rewards (Crowther, 2004). According to the European Commission CSR is about undertaking voluntary activity which demonstrates a concern for stakeholders. But it is here that a firm runs into problems – how to balance up the conflicting needs and expectations of various stakeholder groups while still being concerned with shareholders; how to practice sustainability; how to report this activity to those interested; how to decide if one activity is more socially responsible that another. The situation is complex and conflicting.

Many would say that the situation for corporate governance is more simple because it is more straightforward, being merely concerned with how a corporation conducts itself while undertaking its business. This is overly simplistic and we have sought to show that corporate governance and corporate social responsibility and interrelated and overlapping concepts – hence we treat them together in this book, although some authors focus more one and some more on the other. This is personal preference rather than any serious attempt at differentiation: we are concerned equally with both concepts in this book. This is one of the distinguishing features of the book. There have been many books which consider different governance systems and even make international comparisons. Equally there have been many books which investigate corporate social responsibility from one of a variety of different perspectives. Such books have a tendency to make comparisons through dichotomisation – dwelling

upon differences to make distinctions. Our book is different as we focus upon similarities; moreover we do not give superordinacy to the Anglo-Saxon approach. In an increasingly global business environment it does not seem to us to be apposite to adopt this approach. Consequently the contributors are from a wide range of locations and a wide range of perspectives, and consider a wide range of different issues of local and/or global significance. Our purpose in this volume is to show that there are issues which are global in nature, which is unsurprising in an increasingly globalised world, but that also there is a richness of cultural diversity (see Aras and Crowther, 2008a, 2008b) which prevents homogenisation. Some would see this as desirable while others would see this as undesirable, many would view it as transient. We do not take any position on this – it is for each of us to decide our views – but we do finish the book by considering the prognosis and whether or not harmonisation can be expected to occur in the future.

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Corporate Governance and Corporate Social Responsibility in Context

Güler Aras and David Crowther

Introduction

It will be readily acknowledged that as a concept, governance has existed as long as any form of human organisation has existed. The concept itself is merely one to encapsulate the means by which that organisation conducts itself. Recently however the term has come to the forefront of public attention and this is probably because of the problems of governance which have been revealed at both a national level and in the economic sphere at the level of the corporation. These problems have caused there to be a concern with a re-examination of what exactly is meant by governance and more specifically just what are the features of good governance. It is here therefore that we must start our examination.

When considering national governance then, this has been defined by the World Bank as the exercise of political authority and the use of institutional resources to manage society's problems and affairs.

This is a view of governance which prevails in the present, with its assumption that governance is a top down process decided by those in power and passed to society at large. In actual fact the concept is originally democratic and consensual, being the process by which any group of people decide to manage their affairs and relate to each other. Such a consensual approach is however problematic for any but the smallest of groups and no nation has actually managed to institute governance as a consensual process. With the

current trend for supra-national organisation[1] then this seems even more of a remote possibility; nor is it necessarily desirable. Thus a coercive top down form of governance enables a society to accept leadership and to make some difficult decisions which would not otherwise be made.[2] Equally of course it enables power to be usurped and used dictatorially – possibly beneficially[3] but most probably in a way in which most members of that society do not wish.[4]

This top down, hierarchical form of governance is the form of governance which normally takes place in large monolithic organisations such as the nation state. Conversely the consensual form tends to be the norm in small organisations such as local clubs. There are however other forms of governance which are commonly found. One of these is governance through the market (see Williamson, 1975). The free market is the dominant ideology of economic activity and the argument of course is that transaction costs are lowered through this form of organisation. From a governance perspective however this is problematic as there is no automatic mechanism and negotiation is used. The effect of this is that governance is decided according to power relationships, which tend to be coercive for the less powerful (e.g. consumers). Consequently there is a need to impose some form of regulation through governments or supra-national organisations such as the World Trade Organisation, which thereby re-imposes the eliminated transaction costs. The argument therefore resolves into an ideological argument rather than an economic one.

An increasing number of firms rely upon informal social systems to govern their relationship with each other, and this is the final form of governance. This form is normally known as network governance (Jones, Hesterly and Borgatti, 1997). With this form of governance there is no formal rules – certainly none which are legally binding. Instead social obligations are recognised and governance exists within the networks because the different organisations wish to continue to engage with each other, most probably in the economic arena. This form of governance can therefore be considered to be predicated in mutual self interest. Of course, just as with market governance, power relationships are important and this form of governance is most satisfactory when there are no significant power imbalances to distort the governance relationships.

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1 Such as, for example, the European Community.

2 For example, the decision to abolish capital punishment in the UK in 1969 could not have been made consensually; nor too could the decision to invade Iraq in 2003.

3 The ancient Greeks favoured beneficial dictatorship as a means of running their city states.

4 Few would argue that, for example, power was usurped in the USSR by Stalin because of a centrally imposed governance; equally few would suggest that this power was used beneficially or in a way which most members of the society were happy about.

Although in some respects these different forms of governance are interchangeable they are, in reality, suited to different circumstances. Whichever form of governance is in existence however the most important thing is that it can be regarded as good governance by all parties involved – in other words all stakeholders must be satisfied. For this to be so then it is important that the basic principles of good governance are adhered to.

The Principles of Governance

There are eight principles which underpin every system of governance:

TRANSPARENCY

As a principle, Transparency necessitates that information is freely available and directly accessible to those who will be affected by such decisions and their enforcement. Transparency is of particular importance to external users of such information as these users lack the background detail and knowledge available to internal users of such information. Equally therefore the decisions which are taken and their enforcement are done in a manner that follows rules and regulations. Transparency therefore can be seen to be a part of the process of recognition of responsibility on the part of the organisation for the external effects of its actions and equally part of the process of redistributing power more equitably to all stakeholders.

RULE OF LAW

This is a corollary of the transparency principle. It is apparent that good governance requires a fair framework of rules of operation. Moreover, these rules must be enforced impartially, without regard for power relationships. Thus the rights of minorities must be protected.[5] Additionally there must be appeal to an independent body as a means of conflict resolution, and this right of appeal must be known to all stakeholders.[6]

5 This would imply of course the protection of human rights but could be taken also to imply concern for the environment and its protection.

6 This can be to national courts, trade associations, supra-national courts such the European Court of Human Rights, or to an organisation such as the United Nations. Whatever the body it needs to be appropriate and not just impartial but also seen to be impartial to all concerned in order to maintain the creditability to adjudicate disputes.

PARTICIPATION

Although participation by all stakeholders is of course desirable, this is not an essential principle of good governance. The ability of all to participate if so desired is however an essential principle. Participation of course includes the freedom of association and of expression that goes along with this. Depending upon the size and structure of the organisation, participation can be either direct or through legitimate intermediate institutions or representatives, as in the case of a national government. Participation of course would involve everyone, or at least all adults, both male and female.

RESPONSIVENESS

This is a collorary of the participation principle and the transparency principle. Responsiveness implies that the governance regulations enable the institutions and processes of governance to be able to serve all stakeholders within a reasonable timeframe.

EQUITY

This principle involves ensuring that all members of society feel that they have a stake in it and do not feel excluded from the mainstream. This particularly applies to ensuring that the views of minorities are taken into account and that the voices of the most vulnerable in society are heard in decision-making. This requires mechanisms to ensure that all stakeholder groups have the opportunity to maintain or improve their well-being.

EFFICIENCY AND EFFECTIVENESS

Efficiency of course implies the transaction cost minimisation referred to earlier whereas effectiveness must be interpreted in the context of achievement of the desired purpose. Thus, for effectiveness, it is necessary that the processes and institutions produce results that meet the needs of the organisation while making the best use of resources at their disposal. Naturally this also means sustainable use of natural resources and the protection of the environment.

SUSTAINABILITY

This requires a long-term perspective for sustainable human development and how to achieve the goals of such development. A growing number of writers

over the last quarter of a century have recognised that the activities of an organisation impact upon the external environment. These other stakeholders have not just an interest in the activities of the organisation but also a degree of influence over the shaping of those activities. This influence is so significant that it can be argued that the power and influence of these stakeholders is such that it amounts to quasi-ownership of the organisation. Central to this is a concern for the future which has become manifest through the term sustainability. This term sustainability has become ubiquitous both within the discourse globalisation and within the discourse of corporate performance. Sustainability is of course a controversial issue and there are many definitions of what is meant by the term. At the broadest definition sustainability is concerned with the effect which action taken in the present has upon the options available in the future (Crowther, 2002). If resources are utilised in the present then they are no longer available for use in the future, and this is of particular concern if the resources are finite in quantity. Thus, raw materials of an extractive nature, such as coal, iron or oil, are finite in quantity and once used are not available for future use. At some point in the future therefore alternatives will be needed to fulfil the functions currently provided by these resources. This may be at some point in the relatively distant future but of more immediate concern is the fact that as resources become depleted then the cost of acquiring the remaining resources tends to increase, and hence the operational costs of organisations tend to increase (Aras and Crowther, 2007a).[7] Sustainability therefore implies that society must use no more of a resource than can be regenerated (Aras and Crowther, 2007b). This can be defined in terms of the carrying capacity of the ecosystem (Hawken, 1993) and described with input – output models of resource consumption.

ACCOUNTABILITY

Accountability is concerned with an organisation recognizing that its actions affect the external environment, and therefore assuming responsibility for the effects of its actions. This concept therefore implies a recognition that the organisation is part of a wider societal network and has responsibilities to all of that network rather than just to the owners of the organisation. Alongside this acceptance of responsibility therefore must be a recognition that those external stakeholders have the power to affect the way in which those actions of the

7 Similarly once an animal or plant species becomes extinct then the benefits of that species to the environment can no longer be accrued. In view of the fact that many pharmaceuticals are currently being developed from plant species still being discovered this may be significant for the future.

organisation are taken and a role in deciding whether or not such actions can be justified, and if so at what cost to the organisation and to other stakeholders. It is inevitable therefore that there is a need for some form of mediation of the different interests in society in order to be able to reach a broad consensus on what is in the best interest of the whole community and how this can be achieved. As a general statement we can state that all organisations and institutions are accountable to those who will be affected by decisions or actions, and that this must be recognised within the governance mechanisms. This accountability must extend to all organisations – both governmental institutions as well those as the private sector and also to civil society organisations – which must all recognise that they are accountable to the public and to their various stakeholders. One significant purpose of this is to ensure that any corruption is eliminated, or at the very least minimised.

Systems of Governance

It is probably true to say that there is a considerable degree of convergence[8] on a global scale as far as systems of governance are concerned, and this convergence is predicated in the dominance of the Anglo-Saxon model of the state, the market and of civil society. As a consequence there tends to be an unquestionning assumption (see for example Mallin, 2004) that discussions concerning governance can assume the Anglo-Saxon model as the norm and then consider, if necessary, variations from that norm (see Guillen, 2001). In this chapter we take a very different position – which explains the significant contribution of this book – that there were historically three significant approaches to governance. Each has left its legacy in governance systems around the world and any consideration of global convergence cannot be undertaken seriously – certainly as far as any prognosis is concerned – without a recognition of this. Thus for us the Anglo-Saxon model is important but just one of the three models we wish to examine. The other two we have described as the Latin model and the Ottoman model. We start by outlining the salient features of each.

THE ANGLO-SAXON MODEL OF GOVERNANCE

The Anglo-Saxon model of governance is of course familiar to all readers of this book. It is founded on rules which must be codified and can therefore be subject to a standard interpretation by the appropriate adjudicating body. It

8 See Chapter 12 for a fuller discussion of this convergence.

has a tendency to be hierarchical and therefore imposed from above; and along with this imposition is an assumption of its efficacy and a lack therefore of considerations of alternatives. In this model therefore the issues of governance, politics and power become inseparably intertwined.

The abuses which have been revealed within this system of governance[9] have exposed problems with the lack of separation of politics from governance. This has led to the suggestion that there should be a clear distinction between the two. The argument is that politics is concerned with the processes by which a group of people, with possibly divergent and contradictory opinions can reach a collective decision which is generally regarded as binding on the group, and therefore enforced as common policy. Governance, on the other hand, is concerned with the processes and administrative elements of governing rather than its antagonistic ones (Solomon, 2007). This argument of course makes the assumption that it is actually possible to make the separation between politics and administration. For example both the UK and the USA have governance procedures to make this separation effective for their national governments – and different procedures in each country – but in both countries the division is continually blurred in practice. Many would argue, and we concur, that the division is not possible in practice because the third factor of power is ignored whereas this is more important. Indeed it is our argument that it is the operation of this power in practice that brings about many of the governance problems that exist in practice. We discuss this in greater detail later in the chapter but part of our argument is that theories and systems of governance assume that power relationships, while not necessarily equal, are not too asymetric. If the relationship is too asymetric then the safeguards in a governance system do not operate satisfactorily whereas one of the features of globalisation is an increase in such power asymetries. We will return to this later.

As we have already identified, the Anglo-Saxon model is hierachical but other forms of governance are allowed and even encouraged to operate within this framework. Thus the market form features prominently in the Ango-Saxon model while the network and consensual forms can also be found. It is therefore apparent that it is not the form of governance which epitomises

9 For example, in the UK there is at present (2007) an ongoing criminal investigation into the activities of the ex-Prime Minister, Tony Blair, his colleagues and senior members of the Labour Party with regard to the way in which the (national) Honours system has been used to reward people for donations made for political purposes. Similarly many people would, as far as the USA is concerned, blame failures in the governance system generally for the debacle of the Enron affair. These two countries are of course the principle exponents of the Anglo-Saxon model of governance.

the Anglo-Saxon model; rather it is the dependence on rules and adjudication which distinguishes this system of governance.

THE LATIN MODEL OF GOVERNANCE

The Latin model of governance tends to be less codified than the Anglo-Saxon model and finds less need for procedures for adjudication. This is because it is founded in the context of the family and the local community. In some respects therefore it is the opposite of the Anglo-Saxon model, being based on a bottom up philosophy rather than a hierarchical top down approach. Thus, this model is based on the fact that extended families are associated with all other family members and therefore feel obligated. And older members of the family are deemed to have more wisdom and therefore assume a leadership role because of the respect accorded them by other family members. As a consequence there is no real need for formal codification of governance procedures and the system of adjudication does not need to be formalised – it works very satisfactorily on an informal basis. Moreover, this model is extended from the family to the local community and works on the same basis.

In many ways the network form of governance described earlier is based on this Latin model, insofar as it is predicated in informal relationships of mutual interest, and without the need for codification: this need is not required because of the interest of all parties in maintaining the working relationships which exist. Thus tradition can be said to play a part in this model of governance – trust based on tradition because it has worked in the past and can be expected to continue working into the future. The network form however is based on a lack of significant power inequalities whereas the Latin model definitely does have a hierarchy and power is distributed unequally. The power is distributed according to age however, and therefore it is acceptable to everyone because they know that they will automatically rise up the hierarchy – thereby acquiring power – as they age. The process is therefore inevitable and deemed to be acceptably fair.

THE OTTOMAN MODEL OF GOVERNANCE

The Ottoman Empire existed for 600 years until the early part of the twentieth century. Although the Empire itself is well known, few people know too much about it. Throughout Europe, at least, the reality is obscured by the various myths which abound – and were mostly created during the latter part of the nineteenth century – primarily by rival states and for political propoganda

purposes. The reality was of course different from the myths and the Empire had a distinct model of governance which was sufficiently robust to survive for 600 years, although much modern analysis suggests that the lack of flexibility and willingness to change in the model was one of the principle causes of the failure of the Empire. We do not wish to enter into this debate and will restrict ourselves to an analysis of this distinct model of governance.

According to the fifteenth century statesman, Tursun Beg, it is only statecraft which enables the harmonious living together of people in society and in the Ottoman Empire there were two aspects to this statecraft – the power and authority of the rule (the Sultan) and the divine reason of Sharia (via the Caliph) (Inalcik, 1968). In the Ottoman Empire these two were combined in one person. The Ottoman Empire was of course Islamic, but notable for its tolerance of other religions. It has been argued (Cone, 2003), that the Islamic understanding of governance and corporate responsibility shares some fundamental similarities with the Rawlsian concept of social justice as mutual agreement among equals (motivated by self interest). All parties must be fully aware of the risks attendant on a particular course of action and be accepting of equal liability for the outcomes, good or bad. Muslims see Islam as the religion of trade and business, making no distinction between men and women and seeing no contradiction between profit and moral acts (Rizk, 2005). The governance system was effectively a form of patronage which operated in a hierarchical manner but with the systems and procedures being delegated in return for the benefits being shared in an equitable manner. This enabled a very devolved form of governance to operate effectively for so long over such a large area of Asia, Europe and Africa. It is alien to the Anglo-Saxon view because the systems involved payment for favours in a way that the Anglo-Saxon model would interpret as corrupt but which the Ottoman model interprets simply as a way of devolving governance. It is interesting to observe therefore that the problems with failure of governance in the current era could not have occurred within the Ottoman model because there was no space left for the necessary secrecy and abuse of power.

THE CONCEPT OF GLOBAL GOVERNANCE

All systems of governance are concerned primarily with managing the governing of associations and therefore with political authority, institutions, and, ultimately, control. Governance in this particular sense denotes formal political institutions that aim to coordinate and control interdependent social relations and that have the ability to enforce decisions. Increasingly however,

in a globalised world, the concept of governance is being used to describe the regulation of interdependent relations in the absence of overarching political authority, such as in the international system. Thus global governance can be considered as the management of global processes in the absence of a form of global government. There are some international bodies which seek to address these issues and prominent among these are the United Nations and the World Trade Organisation. Each of these has met with mixed success in instituting some form of governance in international relations but are part of a recognition of the problem and an attempt to address worldwide problems that go beyond the capacity of individual states to solve (Rosenau, 1999).

To use the term global governance is not of course to imply that such a system actually exists, let alone to consider the effectiveness of its operations. It is merely to recognise that in this increasingly globalised world there is a need for some form of governance to deal with multinational and global issues. The term global governance therefore is a descriptive term, recognising the issue and referring to concrete cooperative problem-solving arrangements. These may be formal, taking the shape of laws or formally constituted institutions to manage collective affairs by a variety of actors – including states, intergovernmental organisations, non-governmental organisations (NGOs), other civil society actors, private sector organisations, pressure groups and individuals). The system also includes of course informal (as in the case of practices or guidelines) or temporary units (as in the case of coalitions). Thus global governance can be considered to be the complex of formal and informal institutions, mechanisms, relationships, and processes between and among states, markets, citizens and organisations, both inter- and non-governmental, through which collective interests on the global plane are articulated, rights and obligations are established, and differences are mediated.

Global governance is not of course the same thing as world government: indeed it can be argued that such a system would not actually be necessary if there was such a thing as a world government. Currently however the various state governments have a legitimate monopoly on the use of force – on the power of enforcement. Global governance therefore refers to the political interaction that is required to solve problems that affect more than one state or region when there is no power of enforcing compliance. Improved global problem-solving need not of course require the establishing of more powerful formal global institutions, but it would involve the creation of a consensus on norms and practices to be applied. Steps are of course underway to establish these norms and one example that is currently being established is

the creation and improvement of global accountability mechanisms. In this respect, for example, the United Nations Global Compact[10] – described as the world's largest valuntary corporate responsibility initiative – brings together companies, national and international agencies, trades unions and other labour organisations and various organs of civil society in order to support universal environmental protection, human rights and social principles. Participation is entirely voluntary, and there is no enforcement of the principles by an outside regulatory body. Companies adhere to these practices both because they make economic sense, and because their stakeholders, including their shareholders (most individuals and institutional investors) are concerned with these issues and this provides a mechanism whereby they can monitor the compliance of companies easily. Mechanisms such as the Global Compact can improve the ability of individuals and local communities to hold companies accountable.

GOOD GOVERNANCE AND CORPORATE BEHAVIOUR

Good governance is of course important in every sphere of the society whether it be the corporate environment, or general society or the political environment. Good governance levels can, for example, improve public faith and confidence in the political environment. When the resources are too limited to meet the minimum expectations of the people, it is a good governance level that can help to promote the welfare of society. And of course a concern with governance is at least as prevalent in the corporate world.

Good governance is essential for good corporate performance and one view of good corporate performance is that of stewardship and thus just as the management of an organisation is concerned with the stewardship of the financial resources of the organisation so too would management of the organisation be concerned with the stewardship of environmental resources. The difference however is that environmental resources are mostly located externally to the organisation. Stewardship in this context therefore is concerned with the resources of society as well as the resources of the organisation. As far as stewardship of external environmental resources is concerned then the central tenet of such stewardship is that of ensuring sustainability. Sustainability is focused on the future and is concerned with ensuring that the choices of resource utilisation in the future are not constrained by decisions taken in the present. This necessarily implies such concepts as generating and utilizing renewable resources, minimising pollution and using new techniques

10 See www.unglobalcompact.org.

of manufacture and distribution. It also implies the acceptance of any costs involved in the present as an investment for the future.

A great deal of concern has been expressed all over the world about shortcomings in the systems of corporate governance in operation and its organisation has been exercising the minds of business managers, academics and government officials all over the world. Often companies' main target is to become global – while at the same time remaining sustainable – as a means to get competitive power. But the most important question is concerned with what will be a firm's route to becoming global and what will be necessary in order to get global competitive power. There is more then one answer to this question and there are a variety of routes for a company to achieve this. Corporate governance can be considered as an environment of trust, ethics, moral values and confidence – as a synergic effort of all the constituents of society – that is the stakeholders, including government; the general public etc; professional/service providers – and the corporate sector.

Of equal concern is the question of corporate social responsibility – what this means and how it can be operationalised. Although there is an accepted link between good corporate governance and corporate social responsibility the relationship between the two is not clearly defined and understood. Thus many firms consider that their governance is adequate because they comply with The Combined Code on Corporate Governance, which came into effect in 2003. Of course all firms reporting on the London Stock Exchange are required to comply with this code, and so these firms are doing no more than meeting their regulatory obligations. Many companies regard corporate governance as simply a part of investor relationships and do nothing more regarding such governance except to identify that it is important for investors/potential investors and to flag up that they have such governance policies. The more enlightened recognise that there is a clear link between governance and corporate social responsibility and make efforts to link the two. Often this is no more than making a claim that good governance is a part of their CSR policy as well as a part of their relationship with shareholders.

It is recognised that these are issues which are significant in all parts of the world and a lot of attention is devoted to this global understanding. Most analysis however is too simplistic to be helpful as it normally resolves itself into simple dualities: rules-based versus principles-based or Anglo-Saxon versus Continental. Our argument is that this is not helpful as the reality is far more complex. It cannot be understood without taking geographical, cultural and

historical factors into account in order to understand the similarities, differences and concerns relating to people of different parts of the world. The aim of this book is to redress this by asking subject experts from different parts of the world to explain the issues from their particular perspective.

Corporate Governance

Corporate governance can be considered as an environment of trust, ethics, moral values and confidence – as a synergic effort of all the constituents of society – that is the stakeholders, including government; the general public etc; professional/service providers – and the corporate sector. One of the consequences of a concern with the actions of an organisation, and the consequences of those actions, has been an increasing concern with corporate governance. Corporate governance is therefore a current buzzword the world over. It has gained tremendous importance in recent years. There is a considerable body of literature which considers the components of a good system of governance and a variety of frameworks exist or have been proposed. This chapter examines and evaluates these frameworks while also outlining the cultural context of systems of governance. Our argument in this chapter is that corporate governance is a complex issue which cannot be related to merely the Anglo-Saxon approach to business; indeed it cannot be understood without taking geographical, cultural and historical factors into account in order to understand the similarities, differences and concerns relating to people of different parts of the world. In part therefore this chapter also serves as an introduction which sets the scene for the other chapters in the book as well as outlining the purpose of the book and the contributions within this theoretical and practical context.

One of the main issues, therefore, which has been exercising the minds of business managers, accountants and auditors, investment managers and government officials – again all over the world – is that of corporate governance. Often companies main target is to became global – while at the same time remaining sustainable – as a means to get competitive power. But the most important question is concerned with what will be a firm's route to becoming global and what will be necessary in order to get global competitive power. There is more then one answer to this question and there are a variety of routes for a company to achieve this.

Probably since the mid-1980s, corporate governance has attracted a great deal of attention. Early impetus was provided by Anglo-American codes of good corporate governance.[11] Stimulated by institutional investors, other countries in the developed as well as in the emerging markets established an adapted version of these codes for their own companies. Supra-national authorities like the OECD and the World Bank did not remain passive and developed their own set of standard principles and recommendations. This type of self-regulation was chosen above a set of legal standards (Van den Barghe, 2001). After big corporate scandals, corporate governance has become central to most companies. It is understandable that investors' protection has become a much more important issue for all financial markets after the tremendous company failures and scandals. Investors are demanding that companies implement rigorous corporate governance principles in order to achieve better returns on their investment and to reduce agency costs. Most of the times investors are ready to pay more for companies to have good governance standards. Similarly a company's corporate governance report is one of the main tools for investor's decisions. Because of these reason companies cannot ignore the pressure for good governance from shareholders, potential investors and other markets actors.

On the other hand, banking credit risk measurement regulations are requiring new rules for a company's credit evaluations. New international bank capital adequacy assessment methods (Basel II) necessitate that credit evaluation rules are elaborately concerned with operational risk which covers corporate governance principles. In this respect corporate governance will be one of the most important indicators for measuring risk. Another issue is related to firm credibility and riskiness. If the firm needs a high rating score then it will also have to pay attention to corporate governance rules. Credit rating agencies analyse corporate governance practices along with other corporate indicators. Even though corporate governance principles have always been important for getting good rating scores for large and publicly-held companies, they are also becoming much more important for investors, potential investors, creditors and governments. Because of all of these factors, corporate governance receives high priority on the agenda of policymakers, financial institutions, investors, companies and academics. This is one of the main indicators that the link between corporate governance and actual performance is still open for discussion. In the literature a number of studies have sought to investigate the relationship between corporate governance mechanisms and performance (e.g. Agrawal and Knoeber, 1996; Millstein and MacAvoy, 2003) Most of the

11 An example is the Cadbury Report.

studies have showed mixed result without a clear-cut relationship. Based on these results, we can say that corporate governance matters to a company's performance, market value and credibility, and therefore that company has to apply corporate governance principles. But the most important point is that corporate governance is the only means for companies to achieve corporate goals and strategies. Therefore companies have to improve their strategy and effective route to implementation of governance principles. So companies have to investigate what their corporate governance policy and practice needs to be.

CORPORATE GOVERNANCE PRINCIPLES

Since corporate governance can be highly influential for firm performance, firms must know what are the corporate governance principles and how it will improve strategy to apply these principles. In practice there are four principles of good corporate governance, which are:

1. Transparency;
2. Accountability;
3. Responsibility;
4. Fairness.

All these principles are related with the firm's corporate social responsibility. Corporate governance principles therefore are important for a firm but the real issue is concerned with what corporate governance actually is.

Management can be interpreted as managing a firm for the purpose of creating and maintaining value for shareholders. Corporate governance procedures determine every aspect of the role for management of the firm and try to keep in balance and to develop control mechanisms in order to increase both shareholder value and the satisfaction of other stakeholders. In other words corporate governance is concerned with creating a balance between the economic and social goals of a company including such aspects as the efficient use of resources, accountability in the use of its power, and the behaviour of the corporation in its social environment.

The definition and measurement of good corporate governance is still subject to debate. However, good corporate governance will address all these main points:

- Creating sustainable value.
- Ways of achieving the firm's goals.
- Increasing shareholders' satisfaction.
- Efficient and effective management.
- Increasing credibility.
- Ensuring efficient risk management.
- Providing an early warning system against all risk.
- Ensuring a responsive and accountable corporation.
- Describing the role of a firm's units.
- Developing control and internal auditing.
- Keeping a balance between economic and social benefit.
- Ensuring efficient use of resources.
- Controlling performance.
- Distributing responsibility fairly.
- Producing all necessary information for stakeholders.
- Keeping the board independent from management.
- Facilitating sustainable performance.

As can be seen, all of these issues have many ramifications and ensuring their compliance must be thought of as a long term procedure. However,

firms naturally expect some tangible benefit from good governance, so good governance offers some long term benefit for firms, such as:

- Increasing the firm's market value.
- Increasing the firm's rating.
- Increasing competitive power.
- Attracting new investors, shareholders and more equity.
- More or higher credibility.
- Enhancing flexible borrowing condition/facilities from financial institutions.
- Decreasing credit interest rate and cost of capital.
- New investment opportunities.
- Attracting better personnel/employees.
- Reaching new markets.

GOOD GOVERNANCE AND SUSTAINABILITY

It is clear that all these long term benefits are also directly related to the sustainability of a firm and that firm's success. We can evaluate corporate governance from different perspectives, such as that of the general economy; the company itself; private and institutional investors; or banking and other financial institutions. Some research results show that the quality of the corporate governance system of an economy may be an important determinant of its competitive conditions (Fulghieri and Suominen, 2005). Authors suggest the existence of a reverse causality between corporate governance and competition and also examined the role of competition in the production of good corporate governance. Van de Berghe and Levrau (2003) on the other hand investigated from the perspective of companies, investors and banks. From the company's perspective, it can no longer ignore the pressure for good corporate governance from the investor community. Installing proper governance mechanisms may provide a company with a competitive advantage in attracting investors

who are prepared to pay a premium for well-governed companies. From an investor's perspective, corporate governance has become an important factor in investment decisions as it is recognised to have an impact on the financial risks of their portfolios. Institutional investors put issues of corporate governance on a par with financial indicators when evaluating investment decisions. From the creditor's perspective, there is a plea for increased attention for corporate governance in a bank's risk measurement methods: a plea which is supported by the new requirements put in place by Basel II.

Bøhren and Ødegaard (2004) also showed that corporate governance matters for economic performance; insider ownership matters the most while outside ownership concentration destroys market value; direct ownership is superior to indirect; and that performance decreases with increasing board size, leverage, dividend payout, and the fraction of non-voting shares. Black et al. (2005) investigated the relationship between governance and firm value. They found evidence that better governed firms pay higher dividends, but no evidence that they report higher accounting profits.

DEVELOPING A FRAMEWORK FOR CORPORATE GOVERNANCE

In the UK there have been a succession of codes on corporate governance dating back to the Cadbury Report in 1992. Currently, all companies reporting on the London Stock Exchange are required to comply with the Combined Code on Corporate Governance, which came into effect in 2003. It might be thought therefore that a framework for corporate governance has already been developed but the code in the UK has been continually revised while problems associated with bad governance have not disappeared. So clearly a framework has not been established in the UK and an international framework looks even more remote.

One of the problems with developing such a framework is the continual rules versus principles debate. The American approach tends to be rules-based while the European approach is more based on the development of principles – a slower process. In general rules are considered to be simpler to follow than principles, demarcating a clear line between acceptable and unacceptable behaviour. Rules also reduce discretion on the part of individual managers or auditors. In practice however rules can be more complex than principles. They may be ill-equipped to deal with new types of transactions not covered by the code. Moreover, even if clear rules are followed, one can still find a way to

circumvent their underlying purpose – this is harder to achieve if one is bound by a broader principle.

There are of course many different models of corporate governance around the world. These differ according to the nature of the system of capitalism in which they are embedded. The liberal model that is common in Anglo-American countries tends to give priority to the interests of shareholders. The coordinated model, which is normally found in Continental Europe and in Japan, recognises in addition the interests of workers, managers, suppliers, customers, and the community. Both models have distinct competitive advantages, but in different ways. The liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model of corporate governance facilitates incremental innovation and quality competition. However there are important differences between the recent approach to governance issues taken in the USA and what has happened in the UK.

In the USA a corporation is governed by a board of directors, which has the power to choose an executive officer, usually known as the chief executive office (CEO). The CEO has broad power to manage the corporation on a daily basis, but needs to get board approval for certain major actions, such as hiring his/her immediate subordinates, raising money, acquiring another company, major capital expansions, or other expensive projects. Other duties of the board may include policy setting, decision making, monitoring management's performance, or corporate control. The board of directors is nominally selected by and responsible to the shareholders, but the articles of many companies make it difficult for all but the largest shareholders to have any influence over the makeup of the board. Normally individual shareholders are not offered a choice of board nominees among which to choose, but are merely asked to rubber-stamp the nominees of the sitting board. Perverse incentives have pervaded many corporate boards in the developed world, with board members beholden to the chief executive whose actions they are intended to oversee. Frequently, members of the boards of directors are CEOs of other corporations – in interlocking relationships, which many people see as posing a potential conflict of interest.

The UK on the other hand has developed a flexible model of regulation of corporate governance, known as the 'comply or explain' code of governance. This is a principle-based code that lists a number of recommended practices, such as:

- the separation of CEO and Chairman of the Board;
- the introduction of a time limit for CEOs' contracts;
- the introduction of a minimum number of non-executive directors, and of independent directors;
- the designation of a senior non-executive director;
- the formation and composition of remuneration, audit and nomination committees.

Publicly listed companies in the UK have to either apply those principles or, if they choose not to, explain in a designated part of their annual reports why they decided not to do so. The monitoring of those explanations is left to shareholders themselves. The basic idea of the code is that one size does not fit all in matters of corporate governance and that instead of a statury regime like the Sarbanes-Oxley Act in the US, it is best to leave some flexibility to companies so that they can make choices most adapted to their circumstances. If they have good reasons to deviate from the sound rule, they should be able to convincingly explain those to their shareholders. A form of the code has been in existence since 1992 and has had drastic effects on the way firms are governed in the UK. A recent study shows that in 1993, about 10 per cent of the FTSE 350 companies were fully compliant with all dimensions of the code while by 2003 more than 60 per cent were fully compliant. The same success was not achieved when looking at the explanation part for non-compliant companies. Many deviations are simply not explained and a large majority of explanations fail to identify specific circumstances justifying those deviations. Still, the overall view is that the UK's system works fairly well and in fact is often considered to be a benchmark, and therefore followed by a number of other countries. Nevetheless it still shows that there is more to be done to develop a global framework of corporate governance.

In East Asian countries, the family-owned company tends to dominate. In countries such as Pakistan, Indonesia and the Philippines for example, the top 15 families control over 50 per cent of publicly owned corporations through a system of family cross-holdings, thus dominating the capital markets. Family-owned companies also dominate the Latin model of corporate governance, that is companies in Mexico, Italy, Spain, France (to a certain extent), Brazil, Argentina, and other countries in South America.

Corporate governance principles and codes have been developed in different countries and have been issued by stock exchanges, corporations, institutional investors, or associations (institutes) of directors and managers with the support of governments and international organisations. As a rule, compliance with these governance recommendations is not mandated by law, although the codes which are linked to stock exchange listing requirements[12] will tend to have a coercive effect. Thus, for example, companies quoted on the London and Toronto Stock Exchanges formally need not follow the recommendations of their respective national codes, but they must disclose whether they follow the recommendations in those documents and, where not, they should provide explanations concerning divergent practices. Such disclosure requirements exert a significant pressure on listed companies for compliance.

The Relationship between Corporate Governance and Financial Performance

In its 'Global Investor Opinion Survey' of over 200 institutional investors first undertaken in 2000 (and updated in 2002), McKinsey found that 80 per cent of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly outside directors, who had no management ties, undertook formal evaluation of its directors, and was responsive to investors' requests for information on governance issues. The size of the premium varied by market, from 11 per cent for Canadian companies to around 40 per cent for companies where the regulatory backdrop was least certain (e.g. those in Morocco, Egypt or Russia). Other studies have similarly linked broad perceptions of the quality of companies to superior share price performance. On the other hand, research into the relationship between specific corporate governance controls and the financial performance of companies has had very mixed results.

The Development of Corporate Social Responsibility

There has been considerable debate about the relationship between corporate social responsibility (CSR) and corporate governance but in recent years the term corporate social responsibility has gained prominence, both in business and in the press to such an extent that it seems to have become ubiquitous. There are probably many reasons for the attention given to this phenomenon

12 Such as, the UK Combined Code referred to earlier.

not least of which is the corporate excesses witnessed in recent years. For many people the various examples of this kind of behaviour – ranging from BCCI to Enron to Union Carbide to the collapse of Arthur Andersen – will have left an indelible impression among people that all is not well with the corporate world and that there are problems which need to be addressed[13] (Crowther and Rayman-Bacchus, 2004).

One of the implications of this current concern however is that this is a new phenomenon – one which has not been of concern previously. Issues of socially responsible behaviour are not of course new and examples can be found from throughout the world and at least from the earliest days of the Industrial Revolution and the concomitant founding of large business entities (Crowther, 2002) and the divorce between ownership and management – or the divorcing of risk from rewards (Crowther, 2004). Thus, for example, in the UK (where the Industrial Revolution began), Robert Owen (1816, 1991) demonstrated dissatisfaction with the assumption that only the internal effects of actions need be considered and the external environment was a free resource to be exploited at will. Furthermore, he put his beliefs into practice through the inclusion within his sphere of industrial operations the provision of housing for his workers at New Lanark, Scotland. Thus there is evidence from throughout the history of modernity that the self-centred approach towards organisational activity was not universally acceptable and was unable to satisfactorily provide a basis for human activity.

Since that time there has been a concern for the socially responsible behaviour of organisations which have gained prominence at certain times while being considered of minor importance to others. Thus during the 1970s, for example, there was a resurgence of interest it socially responsible behaviour. This concern was encapsulated by Ackerman (1975) who argued that big business was recognizing the need to adapt to a new social climate of community accountability but that the orientation of business to financial results was inhibiting social responsiveness. McDonald and Puxty (1979) on the other hand maintained that companies are no longer the instruments of shareholders alone but exist within society and so therefore have responsibilities to that society, and that there is therefore a shift towards the greater accountability of companies to all stakeholders. Recognition of the rights of all stakeholders and the duty of a business to be accountable in this wider context therefore has been

13 Some would argue that these cases are related to corporate social responsibility failures, some to corporate governance failures, and some to both. Our view is that the two are too inter-related to separate.

a recurrent phenomenon. The economic view of accountability only to owners has only recently been subject to debate to any considerable extent.[14] Indeed the desirability of considering the social performance of a business has not always however been accepted and has been the subject of extensive debate.

CSR therefore involves a concern with the various stakeholders to a business but there are several problems in identifying socially responsible behaviour:

- Research shows that the concern is primarily with those stakeholders who have power to influence the organisation. Thus organisations are most concerned with shareholders, less so with customers and employees and very little with society and the environment. CSR would imply that they are all of equal importance.

- The definitions imply that CSR is a voluntary activity rather than enforced though regulation whereas in actual fact it is an approach and the voluntary – regulated debate is irrelevant.

- Claiming a concern is very different to actually exhibiting that concern through actions taken (Crowther, 2004b).

Definitions of CSR abound but all can be seen as an attempt to explain and define the relationship between a corporation and its stakeholders, including its relationship with society as a whole. Many too are phrased in terms of the triple bottom line, in a way which we argue trivialises the concept. Because of the uncertainty surrounding the nature of CSR activity it is difficult to evaluate any such activity. It is therefore imperative to be able to identify such activity and Aras and Crowther (2007b) argue that there are three basic principles[15] which together comprise all CSR activity. These are:

1. sustainability;

2. accountability;

3. transparency.

For a few years now the concept of corporate social responsibility has gained prominence and is gaining increasing attention around the world among

14 See Crowther (2000) for a full discussion of these changes.
15 See Crowther (2002) and Schaltegger et al. (1996) for the development of these principles.

business people, media people and academics from a wide range of disciplines. There are probably many reasons (see Crowther and Ortiz-Martinez, 2006) for the attention given to this phenomenon not least of which is the corporate excesses which continue to become manifest in various parts of the world. These have left an indelible impression among people that all is not well with the corporate world and that there are problems which need to be addressed. Such incidents are too common to recount but have left the financial markets in a state of uncertainty and have left ordinary people to wonder if such a thing as honesty exists any longer in business.

More recently the language used in business has mutated again and the concept of CSR is being replaced by the language of sustainability. Such language must be considered semiotically (Barthes, 1973) as a way of creating the impression of actual sustainability. Using such analysis, when the signification is about inclusion within the selected audience for the corporate reports, on the assumption that those included understand the signification in a common way with the authors. This is based upon an assumed understanding of the code of signification used in describing corporate activity in this way. As Sapir (1949: 554) states: '… we respond to gestures with an extreme alertness and, one might almost say, in accordance with an elaborate and secret code that is written nowhere, known by none and understood by all'.

Defining Sustainability

Most analysis of sustainability (e.g. Dyllick and Hockerts, 2002) only recognises a two-dimensional approach of the environmental and the social. A few (e.g. Spangenberg, 2004) recognise a third dimension which is related to organisation behaviour. We argue that restricting analysis to such dimensions is deficient. One problem is the fact that the dominant assumption by researchers is based upon the incompatibility of optimizing, for a corporation, both financial performance and social/environmental performance. In other words financial performance and social/environmental performance are seen as being in conflict with each other through this dichotomisation (see Crowther, 2002). Consequently most work in the area of corporate sustainability does not recognise the need for acknowledging the importance of financial performance as an essential aspect of sustainability and therefore fails to undertake financial analysis alongside – and integrated with – other forms of analysis for this research.[16] We argue

16 Of course the fact that many researchers do not have the skills to undertake such detailed financial analysis even if they considered it to be important might be a significant reason for this.

that this is an essential aspect of corporate sustainability and therefore adds a further dimension to the analysis of sustainability. Aras and Crowther (2007a) therefore argue that the third dimension sometimes recognised as organisational behaviour needs to actually comprise a much broader concept of corporate culture. There are therefore four aspects of sustainability which need to be recognised and analysed, namely:

1. *Societal influence*, which we define as a measure of the impact that society makes upon the corporation in terms of the social contract and stakeholder influence;

2. *Environmental Impact*, which we define as the effect of the actions of the corporation upon its geophysical environment;

3. *Organisational Culture*, which we define as the relationship between the corporation and its internal stakeholders, particularly employees, and all aspects of that relationship; and

4. *Finance*, which we define in terms of an adequate return for the level of risk undertaken.

These four must be considered as the key dimensions of sustainability, all of which are equally important. Our analysis is therefore considerably broader – and more complete – than that of others. Furthermore we consider that these four aspects can be resolved into a two-dimensional matrix along the polarities of internal versus external focus and short-term versus long-term focus, which together represent a complete representation of organisational performance

A Typology of CSR

No matter whether the discourse is of corporate social responsibility or of sustainability there exists a high degree of scepticism about the reality of corporate activity. Accusations of greenwashing – presenting a false picture – abound. We argue that this is a legacy of past behaviour when such an accusation could reasonably be made about many organisations. Our argument is the CSR is a developmental process and changes as organisations mature in their behaviour and attitude towards both their stakeholders and their ideas concerning social responsibility. Of course we also acknowledge that there is a growing body of evidence to show that social responsibility behaviour

becomes reflected positively in the financial performance of a company, thereby providing a financial imperative for changing behaviour. Moreover, we argue that there are stages of growth as far as CSR is concerned which become reflected in corporate behaviour. These can be seen as increasing levels of maturity.

In order to consider the implications for CSR then the typology developed by Crowther (2006) provides a useful vehicle. As he argues, it would be relatively easy to develop a typology of CSR activity based upon the treatment of the various stakeholders to an organisation but as Cooper et al. (2001) show, all corporations are concerned with their important stakeholders and make efforts to satisfy their expectations. Thus a concern with employees and customers is apparent in all corporations, being merely a reflection of the power of those stakeholder groupings rather than any expression of social responsibility. Similarly in some organisations a concern for the environment is less a representation of social responsibility and more a concern for avoiding legislation or possibly a reflection of customer concern. Such factors also apply to some expressions of concern for local communities and society at large. It is therefore inappropriate to base any typology of CSR activity upon the treatment of stakeholders as this is often based upon power relationships rather than a concern for social responsibility and it is not realistic to distinguish the motivations.

Table 1.1 Stages of maturity of CSR activity

Stage of development	Dominant feature	Typical activity	Examples
1	Window dressing	Redesigning corporate reporting	Changed wording and sections to reflect CSR language (see Crowther, 2004)
2	Cost containment	Re-engineering business processes	Energy efficiency programmes
3	Stakeholder engagement	Balanced scorecard development	Customer/employee satisfaction surveys (see Cooper et al., 2001)
4	Measurement and reporting	Sophisticated tailored measures	CSR reports
5	Sustainability	Defining sustainability: re-engineering processes	Sustainability reporting
6	Transparency	Concern for the supply chain: requiring CSR from suppliers	Human rights enforcement: e.g. child labour
7	Accountability	Reconfiguration of the value chain	Relocating high value added activity in developing countries

Source: From Crowther (2006).

A different typology was therefore proposed – one which is based upon the three principles of social responsibility outlined earlier. Moreover it shows the way in which CSR develops in organisations as they become more experienced and more convinced of the benefits of a commitment to this form of corporate activity. The development of this typology is based upon research and interviews with CSR directors and concerned managers in a considerable number of large corporations, many of which are committed to increasing social responsibility. It demonstrates stages of increasing maturity.

This can be explained as stages of growth reflecting increased maturity. The stages can be elaborated as follows:

STAGE 1 – WINDOW DRESSING

The initial engagement with CSR was to change corporate reporting to indicate a concern for CSR without any actual change in corporate behaviour. This is the stage which led to accusations of greenwashing. It is also the stage which most observers of corporate activity continue to see even though in reality probably every organisation has progressed to a stage of greater maturity

STAGE 2 – COST CONTAINMENT

Corporations are always, of course, looking at their processes and seeking to operate more efficiently, thereby reducing costs. Organisations have realised that some of these can be represented as CSR activity – with things like energy efficiency or water efficiency being obvious examples. So there is a double imperative for this kind of activity – to improve financial performance and also improve the social responsible image. Not surprisingly therefore corporations quickly moved from Stage 1 to this stage – where action has been taken even though it is not necessarily motivated by a sense of social responsibility.

Much of this kind of activity is easy to undertake and requires very little in the way of capital investment. Naturally this activity has been undertaken first. Activity requiring capital investment has a longer payback period and tends to be undertaken more cautiously, with the threat of regulation often being needed to encourage such activity. All organisations have progressed through this stage also, although it must be recognised that the possible actions under this stage will probably never be completed by most organisations. Such cost containment remains ongoing even when the easy targets have been addressed.

STAGE 3 – STAKEHOLDER ENGAGEMENT

As stated earlier, all corporations are concerned with their important stakeholders and make efforts to satisfy their expectations. Thus a concern with employees and customers is apparent in all corporations, being merely a reflection of the power of those stakeholder groupings rather than any expression of social responsibility. Similarly in some organisations a concern for the environment is less a representation of social responsibility and more a concern for avoiding legislation or possibly a reflection of customer concern. Such factors also apply to some expressions of concern for local communities and society at large. For CSR though this concern has become formalised, often through the development of a balanced scorecard and such things as customer or employee satisfaction surveys. Most organisations have progressed through this stage also, with such activity being embedded into normal ongoing business practice.

STAGE 4 – MEASUREMENT AND REPORTING

Some companies have been practicing social and environmental reporting for 15 years but for many it is more recent. Now most companies – certainly most large companies – provide this information in the form of a report. Over time these reports have become more extensive and more detailed with a broader range of measures of social and environmental performance being included. So most organisations have reached this stage of maturity also. The problem with this stage though is that at the moment there are no standards of what to report and so organisations tend to report different things, thereby hindering comparability. Organisations such as AccountAbility, with its AA1000 standard, and the Global Compact have sought to redress this through the introduction of a standard but none have gained universal acceptance. Consequently it is probably true to state that this is the current stage of development for most organisations.

STAGE 5 – SUSTAINABILITY

The discourse of sustainability has become as ubiquitous as the discourse of CSR, and Aras and Crowther (2007c) report that every firm in the FTSE100, for example, mentions sustainability with 70 per cent of them focusing upon this. Any analysis of these statements regarding sustainability however quickly reveals the uncertainty regarding what is meant by this sustainability. Clearly the vast majority do not mean sustainability as defined by Aras and Crowther

(2007d), or as defined by the Brundtland Report. Often it appears to mean little more than that the corporation will continue to exist in the future. A full understanding of sustainability would imply radical changes to business practice and a significant amount of process re-engineering, and there is little evidence that this is happening. So we argue that most companies are only starting to reach this stage of maturity and to grapple with the issues involved.

STAGE 6 – TRANSPARENCY

One of the biggest issues of the moment – certainly in Europe – is the question of firms accepting responsibility for what happens further along their supply chain. This is something that has been brought about largely because of customer pressure and has come about because of the revelations made about such things as child labour, slavery and other human rights abuses. So it is no longer acceptable for a firm to say that what happens in a supplying firm – or even the supplier of a supplier – is not their responsibility. Popular opinion says that companies, and so we wait for them to become sufficiently mature to enter this stage, are responsible for ensuring socially responsible behaviour among their suppliers as well as in their own company. Thus there have been examples of some very large companies – such as *Gap* or *Nike* – acknowledging responsibility and taking appropriate action to ensure change.

This is an issue which is growing in importance and is being addressed by the more mature (in CSR terms) companies. Thus it is claimed that some companies are at this stage in their maturing, but still a minority of companies.

STAGE 7 – ACCOUNTABILITY

The final stage represents our wishes rather than actuality – at least so far! It is based upon the fact the multinationals can decide where to locate their operations and that all high value added operations are located in developed countries. For many it would be relatively easy to transfer to less developed countries and if that happened then the company would be making a real contribution towards effecting change. And we argue that there is no real cost involved

Essentially the argument we have made (see particularly Aras and Crowther, 2007e) is that CSR must be considered as a process of development for every organisation – a process which is still taking place. Furthermore every organisation goes through the same stages in the same chronological order.

Thus the leading exponents of CSR are only now beginning to address Stage 6 and possibly consider Stage 7. Less developed corporations are at lower stages of development. What is significant about this however, in the context of this paper, is that our argument is that sustainability only starts to be recognised once a company has reached Stage 5 of its development. More significantly Stages 6 and 7 are essential for true sustainability as it is only then that an organisation recognises – and acts upon the recognition – that it is an integral part of a value chain and that sustainability depends upon the actions of the complete value chain. In others words an organisation cannot be sustainable without its suppliers and customers. At the moment it is doubtful if organisations recognise this and whether any organisation is (yet) truly sustainable.

The Relationship Between CSR and Business Financial Success

Often the more significant the power that multinational corporations and some groups of stakeholders in a firm have, the more is spoken about corporate social responsibility. Thus a concept that was some kind of luxury years ago, nowadays has reached the top of the public opinion discussion. Some steps taken in the corporation's development, in the environment, and in human values can be the guilty causes of this CSR fashion. If in the beginning firms were small and there was no distinction between ownership and management, the economic development made that there was a necessity to join more capital to set up bigger enterprises. Thus, there were owners, who gave the funds, and experts in management, who managed the company and were paid by the owners. Agency Theory establishes this relationship between the principal, the shareholder, and the agent, the manager, bearing in mind that the goals of the shareholders must be got through the management of the agents. But, which are the shareholders´ objectives? Obviously to increase the enterprise value through the maximisation of profits.

But a company's structure is nowadays more complex than before and there have appeared other people, not owners, directly or indirectly implied in the company's operations – known as stakeholders. Multinational corporations have sometimes even more power than governments in their influence, and stakeholders have gained more power through the media and public opinion in order to require some kind of specific behaviour from companies. Within this new environment, although explained in a very simple way, the primary objective of the company has become wider. Although generally speaking, the assumption may be that the first goal is to get financial performance in the

company, after it the next step will be to comply with other socially responsible policies. That is because to pay attention to social objectives, or to show an orientation to multiple stakeholder groups, could be considered a luxury, because it must have meant that the other basic company's goal had been met. This argument is the basis of the first hypothesis about the relationship between CSR, linked to pay attention to stakeholders, and business success: 'Better performance results in greater attention to multiple stakeholders' (Greenley and Foxall, 1997, p. 264). While the other hypothesis about this relationship will run in the opposite direction: 'that orientation to multiple stakeholder groups influences performance' (Greenley and Foxall, 1997, p. 264), which means to 'attend' to social policies in a better way.

This double-sided relationship increases the difficulty to try to empirically prove it. Intuitively it seems as if there is a clear relationship between CSR and business success, but although the measurement of business success may be easy, through different economic and financial tools, such as ratios; the measurement of the degree of compliance of a company with social policies is really difficult. We can have in mind some kind of indicators such as funds donated to charitable objectives, but a company can spend immeasurable quantities of money on charitable questions and have problems in the relationship with labour unions because of bad working conditions, or low wages, for example. In this sense there are, since a long time ago, some companies whose objectives include philanthropic aims. We can highlight in this point the Spanish example of the saving banks, which emerged with the peculiar distinction of including in their aims charitable purposes. But finally, if they want to survive in the competitive market they have to bear in mind the 'traditional' objectives of profit maximisation. It may be understood as the initial values are ones, and then the market and the capitalism forces the firm to change them in order to survive in this maelstrom. Although at the same time the double-sided relationship operates, because people socially concerned, bear in mind these basic aims and the image of the saving banks is improved, which has got a direct relationship with the economic performance. This example may be only one speaking about the market inefficiencies[17] and the trend to acquire human values and ethics that must be forgotten when we are surrounded by this society and the market.

In this attempt to satisfy the necessities of the stakeholders there can appear other conflicts between the interests of the different groups included in the wider concept of stakeholders. Sometimes due to this conflict of interests and to

17 See Baumol and Batey (1993).

the specific features of the company it tries to establish different levels between the stakeholders, paying more attention to those ones that are most powerful, but are there some goals more socially responsible than others? In the end the hierarchy will depend on the other goals of the company, it will give an answer to those stakeholders that can threaten the performance of the economic goals.

The difficulties in measuring the social performance of a company are also due to the ownership concept. This is because the concept of corporate social responsibility is really comprehensive. There are companies whose activities are really different but all of them have to bear in mind their social responsibility, and not only companies, but also people in whatever activity they do. From a politician to a teacher: ethics, code of conducts, human values, friendship with the environment, respect to the minorities (what should not be understood as a dictatorship of the minorities) and so on, are values that have to be borne in mind and included in the social responsibility concept. A good example of this diversity can be seen in this directory where are included opinions of different experts in such different topics as 'building and construction' or 'auditing', although everyone has got a deep relationship with the other. The same can be said about the regions, besides the classification according to topics in the directory, there has been included another classification of CSR in accordance with regions. The point of view of the concept can vary depending on the country or the region, because some important problems linked to basic human values are more evident in some countries than in others. These social problems cannot be isolated because they have got an important relationship with the degree of development of the country, so in the end it is the economy that pushes the world. Capitalism allows the differences between people, but what is not so fair is that these differences are not only due to your effort or work but are also due to have taken advantage of someone else's effort. And this can be the case with multinational corporations, which sometimes abuse of their power, closing factories in developed countries and moving them to developing countries because the wages are lower, or because the security and health conditions are not so strict and therefore cheaper to maintain for the company. And then the same companies obtain big amounts of profits to expense in philanthropic ways.

Development conditions of regions can determine the relationship between CSR and business success, as we have highlighted, if it is allowed in some developing countries to damage the environment or there are no appropriate labour unions and so on. Because lack of requirements or government´s attention, the global players use these facilities to obtain a better economic

performance although they can be aware of their damaging policies. But not only the development degree has to do with CSR, countries or regions are deeply associated with human values through education and culture. The values are so deep inside us that even it is said that people from different regions of the world who have shared the same education, for example, ethics courses at university, do not share the same human values, because they are marked by their origins. Perhaps it should be understood as the inclusion of ethics courses as university degrees is useless because finally people will go on thinking what they thought at the beginning, depending on the values of their origin culture. But everything is not so simple, because there have been proof of situations where different values have been imported from one culture to another and accepted as their own values without any problem (only point out the success of McDonalds food all over the world and even in the former communist countries, can be understood a McDonalds restaurant in the Red Square in Moscow?). So, it shows that the questions related to CSR are complicated and not so simple as they can seem at first glance.

This complexity can be argued as a disadvantage to take into account when speaking about the creation of global standards about companies' socially responsible behaviour: there are so many different cases that to establish a general regulation may be really difficult. But at the same time this diversity can be argued to require this regulation, because there have been different initiatives, most of them private, and they have added diversity to the previous one and the subject requires a common effort to try to tackle the problem of its standards and principles. The latest financial scandals have proved that it is not enough for a business to work with its own codes or human values, that it is necessary to reach an agreement to establish a homogeneous regulation at least at the level of global players, multinational corporations that play globally.

GOVERNANCE SYSTEMS AND CSR

Most people would say that corporate social responsibility is an Anglo-Saxon concept which has been developed primarily in the UK and the USA. Critics however would say that it is only under the Anglo-Saxon model of governance that there could ever be a need for CSR. They would argument that the Cartesian dichotomy is a peculiarly Anglo-Saxon development which led directly to the notion of a free market as a mediating mechanism and the acceptance of the use of power for one's own end, in true utilitarian style. This has led to the loss of a sense of community responsibility which removed any sense of social responsibility from business. This therefore necessitated its reinvention in the

form of corporate social responsibility, just as it necessitated the development of codes of corporate governance.

The Latin model of governance however is founded in the context of the family and the local community and is therefore the opposite of the Anglo-Saxon model, being based on a bottom up philsophy rather than a hierarchical top down approach. Thus, this model is based on the fact that extended families are associated with all other family members and therefore feel obligated. In such a model of governance the sense of social responsibility remains strong and is applied to firms just as much as individuals. This sense of social responsibility has never therefore been really lost and consequently there has been no need for its reinvention.

As we have seen, the Ottoman model is an Islamic model and built into the principles of the Ottoman religion are a sense of the conservation of the environment and the concept of helping rather than exploiting one's fellow human beings (Rizk, 2005; Zurcher and van der Linden, 2004). Thus in this model also there is no need for the concept of corporate social responsibility as it was never lost; indeed such behaviour is so entwined in societal norms that the very idea is alien.

The Anglo-Saxon system of governance is of course the dominant model throughout the world and as a consequence the concern with corporate social responsibility has spread to other systems of governance. It would be reasonable therefore to argue that the concept now permeates all business models and all systems of governance, no matter what the antecedents or the necessity might be. Consequently we are able to address global perspectives on the issues of corporate governance and corporate social responsibility in this volume without fear of being regarded as Anglo-centric.

Relating Corporate Governance and Corporate Social Responsibility

It is of course no longer questioned that the activities of a corporation impact upon the external environment and that therefore such an organisation should be accountable to a wider audience than simply its shareholders. This is a central tenet of both the concept of corporate governance and the concept of corporate social responsibility. Implicit in this is a concern with the effects of the actions of an organisation on its external environment and there is a

recognition that it is not just the owners of the organisation who have a concern with the activities of that organisation. Additionally there are a wide variety of other stakeholders who justifiably have a concern with those activities, and are affected by those activities. Those other stakeholders have not just an interest in the activities of the firm but also a degree of influence over the shaping of those activities. This influence is so significant that it can be argued that the power and influence of these stakeholders is such that it amounts to quasi-ownership of the organisation.

Central to this social contract is a concern for the future which has become manifest through the term sustainability. This term sustainability has become ubiquitous both within the discourse globalisation and within the discourse of corporate performance. Sustainability is of course a controversial issue and there are many definitions of what is meant by the term. At the broadest definitions sustainability is concerned with the effect which action taken in the present has upon the options available in the future. If resources are utilised in the present then they are no longer available for use in the future, and this is of particular concern if the resources are finite in quantity. Thus raw materials of an extractive nature, such as coal, iron or oil, are finite in quantity and once used are not available for future use. At some point in the future therefore alternatives will be needed to fulfil the functions currently provided by these resources. This may be at some point in the relatively distant future but of more immediate concern is the fact that as resources become depleted then the cost of acquiring the remaining resources tends to increase, and hence the operational costs of organisations tend to increase.

Sustainability therefore implies that society must use no more of a resource than can be regenerated. This can be defined in terms of the carrying capacity of the ecosystem and described with input – output models of resource consumption. Viewing an organisation as part of a wider social and economic system implies that these effects must be taken into account, not just for the measurement of costs and value created in the present but also for the future of the business itself. Such concerns are pertinent at a macro level of society as a whole, or at the level of the nation state but are equally relevant at the micro level of the corporation, the aspect of sustainability with which we are concerned in this work. At this level, measures of sustainability would consider the rate at which resources are consumed by the organisation in relation to the rate at which resources can be regenerated. Unsustainable operations can be accommodated for either by developing sustainable operations or by planning for a future lacking in resources currently required. In practice organisations

mostly tend to aim towards less unsustainability by increasing efficiency in the way in which resources are utilised. An example would be an energy efficiency programme.

This shows a change in understanding of the resources of the organisation which must be taken care of. No longer is it merely the financial resources of entrusted to the managers of the company by its owners; this is reflected in the traditional view of stewardship referred to earlier. Indeed no longer is it merely the physical resources of the organisation. Which must be conserved. Now a concern has been extended beyond the organisational boundary to incorporate all the physical resources of the planet. Thus sustainability – one of the most important subject of the present – requires a very different understanding of the concept of stewardship and therefore a very different understanding of the governance mechanisms which safeguard such stewardship. In the modern world the scope of governance has been significantly extended although understanding of this, and the concomitant governance codes, have often not expanded as quickly or as extensively. Thus there are deficiencies in this respect which need to be addressed by the managers of many organisations; as always however the best companies are leading the way in this.

Not only does such sustainable activity however impact upon society in the future; it also impacts upon the organisation itself in the future. Thus good environmental performance by an organisation in the present is in reality an investment in the future of the organisation itself. This is achieved through the ensuring of supplies and production techniques which will enable the organisation to operate in the future in a similar way to its operations in the present and so to undertake value creation activity in the future much as it does in the present. Financial management also however is concerned with the management of the organisation's resources in the present so that management will be possible in a value creation way in the future. Thus the internal management of the firm, from a financial perspective, and its external environmental management coincide in this common concern for management for the future. Good performance in the financial dimension leads to good future performance in the environmental dimension and vice versa. Thus there is no dichotomy between environmental performance and financial performance and the two concepts conflate into one concern. This concern is of course the management of the future as far as the firm is concerned.

Similarly the creation of value within the firm is followed by the distribution of value to the stakeholders of that firm, whether these stakeholders are

shareholders or others. Value however must be taken in its widest definition to include more than economic value as it is possible that economic value can be created at the expense of other constituent components of welfare such as spiritual or emotional welfare. This creation of value by the firm adds to welfare for society at large, although this welfare is targeted at particular members of society rather than treating all as equals. This has led to arguments concerning the distribution of value created and to whether value is created for one set of stakeholders at the expense of others. Nevertheless if, when summed, value is created then this adds to welfare for society at large, however distributed. Similarly good environmental performance leads to increased welfare for society at large, although this will tend to be expressed in emotional and community terms rather than being capable of being expressed in quantitative terms. This will be expressed in a feeling of well-being, which will of course lead to increased motivation. Such increased motivation will inevitably lead to increased productivity, some of which will benefit the organisations, and also a desire to maintain the pleasant environment which will in turn lead to a further enhanced environment, a further increase in welfare and the reduction of destructive aspects of societal engagement by individuals.

GLOBAL PERSPECTIVES

The 2008 financial crisis has shown us that good governance is related to good corporate performance and the sound management of a company. Earlier we have described this as stewardship and in doing so we have extended the definition of such stewardship beyond that of merely preserving the assets of the owners of the business and entrusted to the managers. This is the basic accounting principle upon which agency theory is based, in the modern environment though the definition of stewardship has to be extended to cover all aspects of the business and all stakeholders to that business – a much broader definition with significant implications for governance. This is absolutely essential for sustainability and any concern for the future operations of both the organisation and the global economy in which it is operating.

Good governance therefore is extended in meaning and this book is concerned with the extension of that meaning and the implications for the operating of a company in an increasingly global environment. Moreover, it demands an understanding of the cultural context in which a firm is operating and there are considerable regional differences which it is important to understand. At this point however we simply which to signify that good governance, as depicted through the concept of stewardship, has been extended

in meaning and that the firm must also consider, alongside the stewardship of its own resources, the stewardship of both societal resources and of environmental resources located external to the organisation. This of course implies changes to operational practice as well as changes to governance requirements.

Of equal concern is the question of corporate social responsibility – what this means and how it can be operationalised. Although there is an accepted link between good corporate governance and corporate social responsibility the relationship between the two is not clearly defined and understood. Thus many firms consider that their governance is adequate because they comply with The Combined Code on Corporate Governance, which came into effect in 2003. Of course all firms reporting on the London Stock Exchange are required to comply with this code, and so these firms are doing no more than meeting their regulatory obligations. Many companies regard corporate governance as simply a part of investor relationships and do nothing more regarding such governance except to identify that it is important to investors/potential investors and flag up that they have such governance policies. The more enlightened recognise that there is a clear link between governance and corporate social responsibility and make efforts to link the two. Often this is no more than making a claim that good governance is a part of their CSR policy as well as a part of their relationship with shareholders.

It is recognised that these are issues which are significant in all parts of the world and a lot of attention is devoted to this global understanding. Most analysis however is too simplistic to be helpful as it normally resolves itself into simple dualities: rules-based versus principles-based or Anglo-Saxon versus Continental. Our argument (see also Aras and Crowther, 2007a, 2007b) is that this is not helpful, as the reality is far more complex. It cannot be understood without taking geographical, cultural and historical factors into account in order to understand the similarities, differences and concerns relating to people of different parts of the world. The aim of this book is to redress this by asking subject experts from different parts of the world to explain the issues from their particular perspective.

In the review undertaken in this chapter we have sought to show the extent of the scope of the concepts of corporate governance and of corporate social responsibility as well as the diversity of views of what is important. We have also shown the ubiquity of the concepts in that they permeate business life as well as civil society but are understood differently in different environments and different cultures. Thus we argue that a global framework does not exist but

in our increasingly globalised world it is something which would be beneficial to international interactions and will inevitable emerge. Furthermore we argue that different cultures have something to offer in the development of this global framework. In this book therefore we explore these issues from a number of different perspectives as a means of contributing towards the development of this global system.

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PART 1

Regional Perspectives and Diversity

In the first chapter we explored different systems of corporate governance and their relationship to corporate social responsibility. Moreover, we recognised that there is a strong cultural component which determines how these concepts are applied in different parts of the world, something which has been explored in detail elsewhere.[1] It is therefore important to start our analysis by exploring what happens in various parts of the world in order to understand the diversity and the place taken by culture. We start this book therefore by doing just this, as various writers, experts on various regions, explore the issues.

In the first chapter of this section, Aluchna looks at Europe, or rather the European Community. She states that the comparative analysis of corporate governance systems that evolved in Europe may seem to be a relatively easy task due to the assumed harmonisation or unification of solutions adopted across Europe. She then elaborates that an analysis of the current stage of control structure, the development of the regulatory framework and predominantly the historic experience and recent reform efforts of the various countries shows that there is actually a great variety of the existing systems. Europe is therefore an interesting region to analyse – and ideal to start our analysis in this book because such a comparative analysis of corporate governance in Europe shows the variety of possible solutions applied. The differences depicted in national systems are substantial and their analysis deliver interesting insights into the control mechanisms development process and efficiency.

A completely different analysis is undertaken by Daidj who considers corporate governance in Japan and in particular concentrates her attention

1 See the book edited by Aras and Crowther 2008.

on the case of vertical *keiretsu* groups. She states that over the last decade these vertical *keiretsu* have undergone restructuring plans designed to better prepare them to face the competition especially in the automobile industry, brought about by markets becoming more open and therefore the increasing attraction of Japan for foreign direct investment (FDI). Indeed, as she points out, foreign companies made acquisitions of large stakes in *keiretsu* such as Nissan and Mitsubishi Motors. These foreign ownership operations create a threat to the erstwhile stable shareholdings and close banking ties that represent the cornerstones of the *keiretsu* links. At the same time increasing internationalisation has created pressure to change the traditional governance systems more toward a shareholder-oriented model of governance.

In the following chapter Lima Bandeira and López-Parra consider Latin America and focus more upon corporate social responsibility rather than corporate governance. They argue that the Latin American situation is very different to those of North American or the European Community. For them there are very significant differences in the context, encompassing historical, cultural, social, economic, political differences, so that Latin America differs in that there is no single form of social responsibility discourse. Because of these differences they discuss what should be corporate social responsibility in Latin America and contrast this with how this movement and this discourse were constructed in an academic context in the European and North American regions.

In the final chapter in this section Obalola, Omoteso and Adelopo investigate the African context of corporate governance and corporate social responsibility. They too argue that these are concepts which have their roots in the Western economies where their practices have developed tremendously in the last two decades and that the idea has subsequently been exported to other parts of the globe largely through the activities of Multinational Enterprises (MNEs). They state that there are those who believe that the concepts of CG and CSR are intrinsically alien to Africa and have no bearing to these economies, arguing that differences in socio-cultural and political antecedents of the economies of Africa compared to the Western economies demand that the concepts of CG and CSR be construed and interpreted with cognisance of these facts. In this chapter therefore they consider the historical developments of CG and CSR in the African contexts as a way of understanding the current trends in CG and CSR practices in African countries.

The different views expressed in these diverse chapters show both the similarities and the differences which exist in different parts of the world. Globalisation features prominently and does the Anglo-Saxon hegemony. But so too does culture as a very important factor in defining local differences. The strength of the differences tends to indicate that the prospects of global harmonisation are quite remote, and this is something we will return to towards the end of the book.

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2

Applying Corporate Governance in Europe

Maria Aluchna

Introduction

The analyses of corporate governance systems remain one of the most fascinating research topics. They deliver even more interesting insights and observation when they refer not to individual countries but when they attempt to track characteristics or differences of the wider geographical region. The comparative analysis of corporate governance systems that evolved in Europe may seem to be a relatively easy task due to the assumed harmonization or unification of solutions adopted across Europe. However, the deeper discussion on the current stage of control structure, the development of the regulatory framework and predominantly the historic experience and recent reform efforts become an evidence for great variety of the existing systems. Thus the comparative analysis of corporate governance in Europe shows the variety of possible solutions applied. The differences depicted in national systems are substantial and their analyses deliver interesting insights on control mechanisms development process and efficiency.

Corporate governance, its shape and efficiency has been for many years, and remains, up-to-date in the centre of management research and business debate. Comparative analysis of national systems deliver more insights and understanding to what corporate governance really is, how it is created as well as what challenges it needs to face within the nearest future (Morck, 2002). It must be, however, emphasized that the majority of research conducted so far refers predominantly to the most developed countries including the United States, United Kingdom, Germany and Japan (Kojima, 1997). Recently there has been more work on other countries of Western Europe as well as

South East Asia (Wallace and Zinkin, 2005). Nevertheless some regions, like Latin America or Eastern Europe, lack expansive analysis of their respective corporate governance systems. The demand and interest for worldwide research, global approach and comparative analysis are rooted first of all in the globalization process and the need for knowledge concerning increasing number of economies (Cornelius and Kogut, 2003). Successful corporations are no longer recruited only from US, UK or Germany, they are more and more often of Chinese, Indian or Russian origin. Moreover, comparative analysis has proven to be the best tool of tracking the patterns of governance mechanisms and confronting the efficiency problems. Additionally research conducted on the sample of transition of developing countries deliver a unique opportunity to observe the process of control mechanisms' emergence and creating institutional order. Developed economies have been forming their corporate governance systems for many years and today researchers may only investigate the existing structure. Developing and transition countries have to build this system literally from scratch and their experience may explain the whole process, dynamics indicate the most and the least efficient solutions and verified formulated hypothesis (Estrin, 2001; Svejnar, 2001). Finally, the comparative analysis and the interest in global approach to corporate governance research can be justified by the unification, harmonization and internalization process of the economic, legal and social systems. All existing models of governance had to face some effectiveness questions and problems and even their widely recognized strengths did not prevent them from corporate scandals and efficiency failures. International research and comparative analysis give the opportunity to learn and use different experience and solutions applied in various countries (Allen and Gale, 2000; Cornelius and Kogut, 2003). This vast, shared experience leads to improved control structure, mitigates the most problematic shortcomings and provides for better corporate performance.

This chapter presents corporate governance mechanisms applied in different countries in Europe. Europe may be sometimes perceived as the 'old' continent where majority of economic theories have been tested and all valuable solutions providing for growth and development are already in place. The current stage of the corporate governance development process however reflects the imminent differences in terms of approach, business practice, culture and history between Western, Central and Eastern parts of Europe. Despite the learning potential and the dynamics of development of different European regions, the analysis of corporate governance delivers evidence which probably would have been revealed in other scientific, historic or social

research. The length of communist doctrine in the Soviet Union (1918–91) and other countries of Central and Eastern Europe (1945–89), the time of split of Europe in two opposite political and economic blocks (1945–89), the difference of transition reforms paths and programs (since 1989) as well as the accession to the European Union by 12 new members (2004, 2007) is mirrored in the control structure, development of institutions and efficiency of governance mechanisms as well as legal systems.

Thus, the comparative analysis of corporate governance in Europe shows the variety of possible solutions applied. The differences depicted in national systems are substantial and their analysis deliver interesting insights on control mechanisms development process and efficiency. The Western continental Europe is characterized by the significant ownership concentration with the dominance of institutional investors as well as families (Murphy, 2002; Frohlin, 2002; Aganin and Volpin, 2002; Högfeldt, 2003). The groups of companies, pyramidal structures and state involvement still are quite popular. It must be however mentioned that such countries as France, Germany or Italy undertook substantial efforts towards implementing far reaching reforms in the area of stock market efficiency, investor protection, best practice codes and harmonization process. The United Kingdom characterized by dispersed ownership, strong capital market, and transparency and investors protection is pictured as a unique island in Europe. Central European countries (Poland, Hungary, the Czech Republic, Baltic states, and to a lesser extent Bulgaria and Romania) have been transforming their economies from central planning to market economy since 1989 (Svejnar, 2001; Estrin, 2001) and are currently in the stage of economic development, strengthening their corporate governance systems with improving investor protection and transparency as well as introducing EU laws and recommendations as the ultimate goals for the nearest future. Eastern Europe represented in research mostly by Russia and Ukraine reveals far different corporate governance characteristics with the strong ownership concentration, poor investor protection and the dominance of powerful oligarchs closely related to politicians.

This chapter is devoted to the detailed analysis of corporate governance systems that evolved in Europe focusing on the different historic experience and starting point, the process of governance mechanisms and the current challenges that Europe has to face in line with the globalization and integration. The aim of this chapter is to provide understanding for the dynamics of European development processes and its abilities to cooperation and harmonization despite significant differences in culture, business

practice and applied solutions. The paper discusses the historic approach to the emergence of corporate governance systems referring to the economic development after WWII in the Western Europe and centrally planned economy in the Eastern Europe, transition and the EU enlargement and the current process of harmonization and cooperation. The paper analyses the key elements of control system taking into account the ownership structure, board model, executive compensation, capital marker development, law, transparency and national codes of best practice.

The paper is organized as follows – the first section delivers insights in the divided Europe seen from its Western part and efficient path for economic growth and corporate governance development. The picture of hybrid control system in centrally planned economy as well as the transition process and creating a corporate governance system from scratch in Central and Eastern Europe are discussed in the second section. The third section identifies current challenges for Europe emphasizing the need for cooperation and harmonization processes. The conclusion section summarizes the analysis.

Corporate Governance in Divided Europe – View from the West

In 1945 Western Europe (as well as its Eastern part) was heavily destroyed not only in terms of ruined cities and towns, but also in terms of lost human capital, economic potential, institutional order and motivation. Dramatic experience was to be replaced quickly by the efforts towards recovery and reconstruction. Western Europe was the member of the coalition which relied upon the assistance granted by the US mostly within the so called Marshall Plan. In result Western European countries received substantial funds for the recovery and managed to rebuild their economic and social potential. The consequent and steady economic reforms, institutional development and increased regional cooperation resulted in the emergence of the powerful economic block of the European Economic Cooperation, today the European Union is characterized by high living standards.

The after-war time resulted also in recovery and development of corporate governance systems. The analysis of Western European national systems revealed significant differences between countries due to various control approaches, regulatory role of the state as well as different legal systems (Company Act, accounting procedures, listing requirements), history and business practice. Therefore, corporate governance of Western European

systems before 1990 showed strong national specificities and solutions. The comparative analysis pointed at the following aspects:

OWNERSHIP CONCENTRATION

Continental European countries are characterized by significant ownership concentration (Allen and Gale, 2000; Murphy, 2002; Frohlin, 2002; Aganin and Volpin, 2002; Högfeldt, 2003) which results in the limited number of shareholders and the dominance by powerful owner over the company. Hence, the mean of the biggest stake in terms of voice was estimated at *c.*40–50 per cent depending on the country. Apparently the ownership concentrations remained lower in the case of blue chip companies or as presented in Table 2.1 in the case of the biggest companies included in the main indices in European stock markets.

As shown in Table 2.1 the ownership concentration was characteristic for continental Europe, whereas the UK data revealed the dispersed ownership with the mean of the biggest stake of voice calculated at 10 per cent. Thus, the ownership structure of British companies corresponding with the features of American corporations. The data on ownership structure leads to the further conclusion that the continental European companies had predominantly to face the conflict between dominant and minority shareholders whereas the UK companies had to deal with the classic principal-agent problem between managers and dispersed owners. The aspects of ownership concentration in continental Europe and ownership dispersion in the UK are even more visible in the comparative analysis including 49 countries worldwide as presented in Table 2.2 (based on La Porta et al., 1998).

Table 2.1 Ownership concentration in selected countries

Country	Number of companies	Mean of the biggest voice stake
Austria	50	52.0
Belgium	121	50.6
Germany	374	52.1
Spain	193	34.2
France	40	20.0
Italy	216	54.53
The Netherlands	137	43.5
UK	250	9.9
US	4140	0.0

Source: Based on Becht and Röell (1999), p. 1052.

SHAREHOLDER IDENTITY

Continental European companies are often controlled by families as well as by institutional investors (financial and industrial) whereas the involvement of individual owners remains marginal. Moreover, as shown in Table 2.2, the state appeared to be an important shareholder in continental Europe (Austria, Norway, and Italy) as compared with the sample of 49 countries. Again, the UK characteristics relating to ownership concentration as well as shareholder identity remains closer to the American characteristics.

Table 2.2 Ownership structure of 20 biggest companies in selected countries expressed as per cent

Country/ownership structure	Dispersed	Family	State	Dispersed – financial	Dispersed – companies	Others
Argentina	0.00	0.65	0.15	0.05	0.15	0.00
Australia	0.65	0.05	0.05	0.00	0.25	0.00
Canada	0.60	0.25	0.00	0.00	0.15	0.00
Hong Kong	0.10	0.70	0.05	0.05	0.00	0.10
Ireland	0.65	0.10	0.00	0.00	0.10	0.15
Japan	0.90	0.05	0.05	0.00	0.00	0.00
New Zealand	0.30	0.25	0.25	0.00	0.20	0.00
Norway	0.25	0.25	0.35	0.05	0.00	0.10
Singapore	0.15	0.30	0.45	0.05	0.05	0.00
Spain	0.35	0.15	0.30	0.10	0.10	0.00
UK	1.00	0.00	0.00	0.00	0.00	0.00
US	0.80	0.20	0.00	0.00	0.00	0.00
Austria	0.05	0.15	0.70	0.00	0.00	0.10
Belgium	0.05	0.50	0.05	0.30	0.00	0.10
Denmark	0.40	0.35	0.15	0.00	0.00	0.10
Finland	0.35	0.10	0.35	0.05	0.05	0.10
France	0.60	0.20	0.15	0.05	0.00	0.00
Germany	0.50	0.10	0.25	0.15	0.00	0.00
Greece	0.10	0.50	0.30	0.10	0.00	0.00
Israel	0.05	0.50	0.40	0.00	0.05	0.00
Italy	0.20	0.15	0.40	0.05	0.10	0.10
South Korea	0.55	0.20	0.15	0.00	0.05	0.05
Mexico	0.00	1.00	0.00	0.00	0.00	0.00
The Netherlands	0.30	0.20	0.05	0.00	0.10	0.35
Portugal	0.10	0.45	0.25	0.15	0.00	0.05
Sweden	0.25	0.45	0.10	0.15	0.00	0.05
Switzerland	0.60	0.30	0.00	0.05	0.00	0,05
Average	**0.36**	**0.30**	**0.18**	**0.05**	**0.05**	**0.05**

Source: Based on La Porta et al. (1998), p. 59.

More detailed research on the ownership structure identify higher dispersion in continental Europe in big global corporations. Referring to the identity of shareholders research shows dominance of institutional owners, including financial institutions as well as strategic investors. Table 2.3 presents data on shareholder identity in three European countries – United Kingdom, France and Germany. Non-financial institution, i.e. industrial companies, appeared to be the dominant shareholder in Germany, whereas individual investors are more often involved in France and not surprisingly in the UK (Allen and Gale, 2000). Interestingly, only in Anglo-Saxon countries pension funds constitute a strong shareholder group whereas in Germany and France pension funds do not play any major role. It is also important to mention that the involvement of foreign investors (mostly American pension and investment funds) revealed to be similar in all three European countries

PYRAMIDAL STRUCTURES

The ownership concentration, involvement of families or financial and industrial companies as well as the preferred shares which companies are allowed to use resulted in specific multi-level, pyramidal structures of continental European companies. Figure 2.1 presents the pyramidal structure.

Not surprisingly, the characteristics of pyramidal structures, preferred shares and multi-level connection between different shareholders limited the transparency of continental European companies and was heavily criticized by Anglo-Saxon and pro-investor representatives. Pyramidal structures and groups of companies were a characteristic feature of economies of Germany, France, Sweden as well as Italy.

Table 2.3 Shareholder identity in selected countries (%)

Country	Individual investors	Pension funds	Financial institutions	Non-financial institutions	State	Foreign investors
US	50	20	5	14	0	5
UK	20	31	30	3	4	12
Japan	23	0	41	25	1	4
France	34	0	23	21	2	20
Germany	17	0	22	42	5	14

Source: Allen and Gale (2000), p. 104.

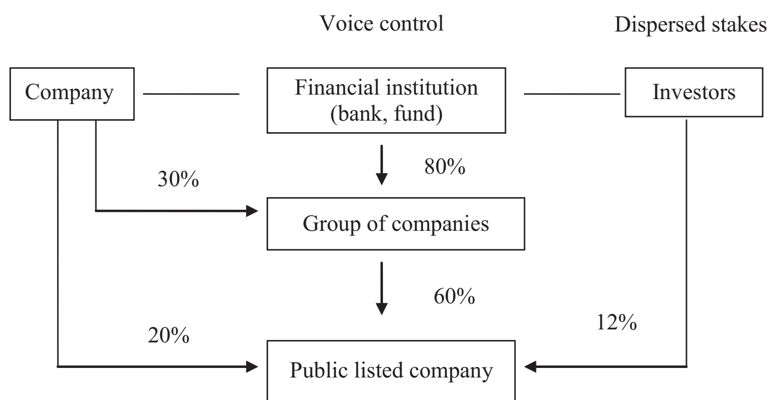

Figure 2. 1 Model of pyramidal structure
Source: Based on Becht and Röell (1999), p. 1052.

CROSS SHAREHOLDINGS

Cross shareholdings are the dominant feature of Japanese companies however, some of these relations can also be found in Europe. Cross shareholding is understood as capital relations between given companies. Cross shareholdings were popular for the economies of Germany, France and Sweden. Table 2.4 presents the example of cross shareholdings identified in Allianz, Germany's biggest financial company.

Table 2.4 The example of cross shareholdings identified in Allianz

The analysis on Allianz AG, the biggest German financial company in 1990 revealed that:

- Allianz held substantial stakes in 11 large German companies and financial institutions (37.7 per cent in Beiersdorf AG, 11 per cent in Linde, BASF, RWE, Veba, Reinelektra, Leifheit, Schering each, up to 5 per cent in Continental, Bayer, Thyssen, Siemens, DaimlerCrysler, Volkswagen);
- Allianz held stakes also in Hochtief, MAN, Mannesmann as well as substantial stakes in five foreign companies;
- Allianz was the owner of 25 per cent shares of Münchner Rück, while Münchner Rück held a stake of 26 per cent in Allianz at the same time;
- Allianz and Münchner Rück were owners of shares of Deutsche Bank, while Deutsche Bank held stakes in Münchner Rück as well as in Allianz;
- in 1998 Klaus Liesen was sitting at the supervisory board of Allianz (Chairman) and Volkswagen (Chairman) as well as at the supervisory board of Ruhrgas, Mannesmann, Deutsche Bank, Veba and Preussag – i.e. companies in which Allianz held stakes;
- companies in which Allianz held stakes were considered safe investments characterized by low risk.

Source: Own analysis.

BOARD

Corporate governance practice distinguished two types of board (Mallin, 2004) – unitary board (one-tier system and board of directors) and dual board (two-tier system and supervisory and management board). Not surprisingly rich in history and practical experience, Europe allows for these two solutions – board of directors dominate across the region (UK, Ireland, Sweden, Norway), whereas the model of supervisory and management board is stipulated by law in Germany and Austria. However, in France and Italy corporate law allows for both board models leaving the choice to corporations. Moreover, the company decision can be reversed. The analysis shows that *c.*85 per cent of French companies and *c.*90 per cent of Italian companies adopted the board of directors as the main control and monitoring corporate body. In terms of the identity of the board members the analysis covering the period before 1990 showed the dominance of members related to the dominant shareholder (as the result of ownership concentration) or bank (Charkham, 1994), whereas the presence of contingency and independent directors was marginal. The highest proportion of independent members was disclosed in the British boards of directors.

CODETERMINATION

Codetermination remains the unique feature of German companies where according to law employees should have their representative on the supervisory board, exerting control over executives. Thus in companies hiring between 500 and 2,000 employees it is 30 per cent, whereas in companies hiring more that 2,000 employees it is 50 per cent of board mandates guaranteed for employees' representatives (Roe, 1994; Roe, 2003). The discussion on the efficiency of codetermination is beyond the scope of this paper, however it is important to mention that the active employee participation with the real power in the control body is negatively assessed by many investors. Therefore in 2,000 the most pro-investor German company (Daimler-Chrysler) was ranked at 200. Interestingly, currently none of the former communist countries in Central and Eastern Europe that were characterized by active participation of workers in corporate bodies does not provide for such strong codetermination in public listed companies (in some cases of state owned companies the employee participation accounts for c. 25 per cent).

CAPITAL MARKET V. BANK AND PUBLIC INFORMATION V. PRIVATE INFORMATION

Significant differences in corporate governance across Western Europe were, before 1990, to a large extent rooted in the structure of external financing and the origin of legal system. Continental European countries based their sources of external financing mainly on banks with the small importance of capital market. This pattern was interdependent on the strong creditor rights versus relatively weaker investor rights and hence lower transparency. Thus, for instance corporate governance system of Germany is known as bank based which is proved by the data presented in Table 2.5.

Table 2.5 Percentage of voting rights exercised by banks in GSM of the largest widely held stock corporations in 1992

No/corporation	Own shares of banks	Subsidiary investment funds shares	Depositary proxy votes	Total
1 Siemens		9.87	85.61	95.48
2 Volkswagen	0.09	8.89	35.16	44.05
3 Hoechst	6.77	10.74	87.72	98.46
4 BASF	8.67	13.61	81.01	94.07
5 Bayer	40.65	11.23	80.09	91.32
6 Thyssen	10.92	3.62	34.98	45.37
7 VEBA	13.65	12.62	78.23	90.85
8 Mannesmann	61.19	7.76	90.35	98.11
9 Deutsche Bank	0.05	12.41	82.32	94.73
10 MAN	33.29	12.69	26.84	48.20
11 Dresdner Bank	3.22	7.72	83.54	91.26
12 Preussag	59.56	4.51	54.30	99.46
13 Commerzbank	74.45	15.84	81.71	97.55
14 VIAG		7.43	30.75	49.10
15 Bayr.Vereinsb.		11.54	73.15	84.69
16 Degussa		8.65	38.35	60.65
17 AGIV		15.80	22.10	99.09
18 Bayr. Hypo		10.69	81.38	92.12
19 Linde		14.68	51.10	99.07
20 Dt.Babcook		11.27	76.09	90.58
21 Schering		19.71	74.79	94.50
22 KHD		3.37	35.06	97.96
23 Bremer Vulkan		4.43	57.10	61.53
24 Strabag		3.62	21.21	99.28
Average	**13.02**	**10.11**	**60.95**	**84.09**

Source: Baums and Fraune, 1995 as cited Schmidt et al. (1997), p. 197.

Protected by law, powerful banks became an important mechanism for control over management due to the rights derived from granted loans, held stakes and members present on the board. Moreover, in Germany banks follow the proxy right to represent all shareholders in the GSM who deposited their shares in banks (Prevezer and Ricketts, 1994; Allen and Gale, 2000). It is important to mention that the patient financing by banks allowed continental Europe (mostly Germany, France, Austria) to develop so- called control market economy characterized by strong regulatory role of the state, protection of jobs, vocational training and internal labour market praising firm-specific investment (Hall and Soskice, 2001). The legal analysis refers the structure to the stronger rights of shareholders v. investors and calls the continental European model as internal control system of private information, concentrated ownership and dealer market.

The UK system is on the other hand based on transparent and efficient capital market which provides strong investor protection, public information and supervision over capital market. According to Table 2.6 the British model is described by the external control system. Thus, the highly developed stock market of the UK is the important source of external financing. The liberal economic approach provides more flexibility (but as well as more volatility), low state involvement and external labour market. Additionally, it is important to mention that Scandinavian countries characterized by ownership concentration and efficient legal system and investor protection should be placed in-between typologies presented in Table 2.6.

Table 2.6 Control systems

Aspect	Internal control system (ICM)	External control system (ECM)
Ownership structure	Concentrated	Dispersed
Shareholder property rights	Minorities versus dominant shareholders Legal assessment of decision undertaken during GSM Informal control of managerial decisions	Shareholders versus executives Formal control of managerial decisions including legal assessment
Investor protection rules	Private information (for shareholders) Weak investor protection Weak supervision over capital market	Public information (for investors) Rules of law on insider trading and corporate frauds Strong supervision over capital market
Capital market type	Dealer marker	Auction market
System type according to economic perspective	Internal system, relation based stakeholder oriented system	External system, market based shareholder oriented system
Country representatives	Continental Europe (Germany, France)	US, UK

Source: Based on Pistor (2001), p. 13.

In sum, the major differences of corporate governance systems before 1990 could be revealed between the continental and the British model. The characteristics of British corporate governance is based on strong external mechanisms, important role of the stock market and market for corporate control, significant investor protection and corporate transparency as well as relationship between executive pay and performance. The UK model characteristics are rooted in common law, an efficient court system, dispersed ownership and the role of London as the world financial centre. In result, referring to features of corporate governance the UK system could be placed close to the American solutions and in terms of investors protection, financial market liberalization, transparency and corporate reporting standards could be perceived as a pattern. Moreover, it is important to mention that the UK was the first country where the code of best practice of corporate governance known as the Cadbury Report was formulated. Although corporate governance system of continental Europe differs significantly they have much in common as compared to the British model. Corporate governance of continental Europe was based on ownership concentration with the dominance of families (Italy, Spain, and Germany) and industrial companies (Sweden, Germany) in the ownership structure. Therefore the institutional investors dominated over the individual shareholders. Additionally, the regulatory role of the state remained significant in Austria and France. Banks granted the loans for companies becoming the most important source of external financing and providing the long term investment strategies, whereas the role of capital market was weaker. The boards of directors or supervisory boards in the case of Germany and Austria were controlled mostly by representatives of the dominant shareholders with marginal presence of independent directors. In result, the corporate governance of continental Europe is described as relation based, stakeholder oriented and internal system versus market based, shareholder oriented and external model of UK.

Corporate Governance in Central and Eastern Europe

CORPORATE GOVERNANCE IN CENTRALLY PLANNED ECONOMY

The picture of Central and Eastern European countries (CEEC) is far from the emerging Western European model of corporate governance due to opposite economic doctrine. Before 1989 CEE countries followed communist regime, the doctrine of central planning, social solidarity and equality based on the main assumption of property rights shared amongst all members of the society. In

result their economies faced the lack of private ownership as well as – what is even more important – the lack of meaning of private ownership what created the system of so called ‘destroyed capitalism’ (Balcerowicz, 1995). It must be however mentioned that CEE countries varied significantly in terms of depth of applied communist regime as well as the level of economic development. The collective farms and full state ownership were characteristic for the Soviet Union, Romania, and Bulgaria. A slightly lighter version was adopted in Poland, where some private initiatives, mostly in agriculture, services and craft existed and the state involvement was estimated at *c*.80 per cent of GDP. The Czech Republic and Hungary revealed higher economic standards whereas former Yugoslavia joined West European countries in adoption of the Marshall plan. Nevertheless, CEE countries revealed investment mostly in so called strategic sectors, i.e. heavy industry such as power generation and coal mining. Corporate activities reflected the interference of three agents: charismatic leader of the socialistic party, state and party bureaucracy and enterprise management although their roles were not clearly defined (Mihalyi, 1997).

From the perspective of corporate governance theoretical approach (e.g. agency theory) the socialistic economy was based on multi-level system of agents, acting as intermediaries and the extremely dispersed ultimate principles. According to the fundamental rule of socialism all the assets were owned by the members of the society, thus the ownership was heavily dispersed. The assets were managed indirectly by the state, meaning the socialistic party that played the function of the intermediary and directly by executives and directors appointed by the party. The general characteristics of the ‘hybrid’ system of corporate governance depicted in CEE countries before 1989 include the following aspects (Aluchna, 2008):

- there were no market mechanisms and all the decisions were made by the corresponding ministries on the basis of privately collected information;

- there was no financial reporting in the way it is submitted nowadays, the real market value of companies was practically unknown;

- therefore no information was disclosed publicly about the company as it is now available to the shareholders on neither the stock market nor the private information as collected today by credit institutions. Some private information was collected by the state, but the core of

the information referred to achieving or failing to achieve the goals of the central plan;

- no information could have been collected from the consumer market or the competition as there was neither market for corporate control nor product market. The so-called producer economy was characterized by the demand surplus over supply and permanent goods shortage. Competition was very weak due to the huge concentration of the market structure: leading firms' share accounted for 30 per cent in 60 per cent of the markets at a 3-digit level and over 60 per cent in 25 per cent of the markets (Commander et al., 1999; Estrin, 2001);

- all companies functioned according to non market rules and all production decisions were made with the reference to the central plan designed by the state institutions and ministries.

Therefore the control mechanisms were fully based on the private information and private decision making executed by the state. The control function of financial markets were not used since the state – either in the form of loans from state owned banks or in the form of subsidies and tax exemption – provided the external finance and the companies could not go bankrupt. Moreover the state owned banks' loans or internally retained profits were the sources of finance and the equity market was practically non-existent. Thus there were no shareholders *sensu stricto*, whereas the stakeholders – some with the real power – included trade unions, management and the socialistic party. Employees as well as managers could potentially exert some control over the mega intermediary of the state. However many of them were locked in the party structure and even if they would be positioned to criticize any moves it could only refer to the central plan and no market economy criteria. In sum the socialistic economy structure resulted in severe agency problems, inefficient decision making and control rights allocation as well as inefficient incentives mechanisms, thus the reforms aimed at creating a sound control system as one of the most crucial transition goals.

The problem of analysis of control structure is heavily rooted in the limited data as well as the completely different research approach and economic doctrine of Central and Eastern European countries. An attempt to present the socialist/communist model of corporate governance is shown in Figure 2.2.

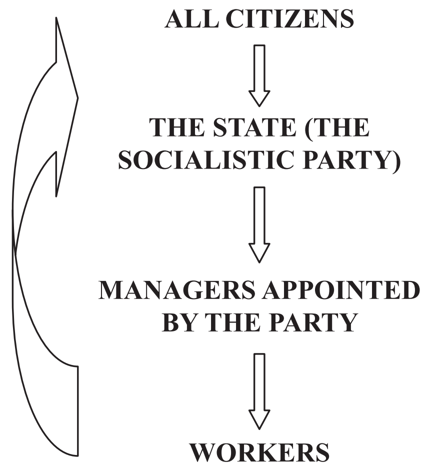

Figure 2.2 The socialistic model of corporate governance
Source: Own analysis.

From the perspective of the control system typology the socialist economy could be referred to as a hybrid structure with the dominance of extreme relation based characteristics and private, central plan-related information.

Although the results of CEE countries were relatively promising in the early years after WWII, the inefficient decision making rights allocation and the non-market driven economic decision contributed to economic stagnation in the 1970s. Disappointing economic results were additionally deepened by soft fiscal policy, long vacation periods for workers, significant pension and social benefits, and long maturity leave for women. Low living standards led to disappointments and relatively frequent social protests and strikes. The situation differs across CEE but the growing social disappointment and continuous economic slow-down led to the capitulation of the ruling communist party and fall of communism begun by Round Table negotiations in Poland in 1989.

TRANSITION IN CENTRAL AND EASTERN EUROPE

Transition process which began in CEE countries starting from 1989 was aimed at establishing market economy features by strong mechanisms, efficient institutions and low state involvement. From the perspective of transition only the creation of adequate governance framework would reinforce the reform effort and provide efficient environment for further development. The

development of the governance system was highly interdependent on other issues in transition agenda which included (Svejnar, 2001):

1. Type I reforms related to the macroeconomic stabilization, price liberalization, the reduction of direct subsidies, the break-up of trusts, state-owned enterprises and the mono-bank system, the removal of barriers to the creation of new firms, carrying out small-scale privatization and introduction of a social safety net. The exposure to the international economy, especially to the international trade induced a more efficient resource allocation;

2. Type II reforms referred to rebuilding institutional framework, large-scale privatization, the development of a commercial banking sector and effective tax system, labour market regulations and institutions related to the social safety net and establishment and enforcement of a market-oriented legal system and accompanying institutions. These reforms appear to be crucial from the perspective of the development of corporate governance structure and are explored below.

3. The restructuring of existing activities and the reallocation of resources that relates to the market structure, law and institutional settings are crucial for the development of corporate governance structures (Estrin, 2001). In the case of transition economy the regulatory functions previously fulfilled by the state must have been taken over by institutions of private property, a set of institutions ensuring an enforceable allocation of responsibility (commercial codes, collateral, bankruptcy), institutions that control and monitor the behaviour of those who hold the property of others (Murrell, 1999; Frydman et al., 2000) (banking regulators, stock markets, security regulators). Therefore reforms implemented by the state discussed below refer to different methods of privatization supported by large capital inflow in the form of direct foreign investment, development of a commercial banking sector, creating the framework for newly established companies and building the stock market as well as reforming law on books.

4. Due to the specific economic and legal situation CEE countries reveal their own specificity of corporate governance system. First of all, the shape of corporate governance system results from

the political economy – the role of different interest groups that pressured for given regulations and legal provision. For instance powerful stakeholders led to delays in privatization in Poland and Hungary which followed mostly the case-by-case privatization method, that now results in dominant versus minority shareholders conflicts (Aussenegg, 1999). Moreover, the Czech Republic and Slovakia chose the mass privatization programs that allowed for a fast shift of assets from public to private hands but also led to dispersed ownership in the early stages of the scheme (Coffee, 1999). The rights given to managers to buy-out the previously state owned companies (so called loans for shares) resulted in significant ownership concentration in the hands of powerful oligarchs in Russia and Ukraine. Second, corporate governance in a given CEE country varies between companies depending on their owner (state or private), origin (commercialized, private or privatized), status and role in the economy (strategic versus less important). Third, the shape, efficiency and stability of corporate governance are heavily rooted in the developed institutional order, i.e. institutions and regulations that built framework for corporate activity (for instance strength of stock market, stability of banking system). Despite reforms of institutional order, corporate governance in CEEC still is lagging behind the level of developed economies. Research indicates that gradual reforms are believed to allow corporate governance mechanisms to develop, whereas rapid mass privatization (as in Russia or Ukraine) relying of MEBOs is not able to create such mechanisms (Svejnar, 2001). Referring to the most significant features of corporate governance that emerged in CEEC within the last 18 years it is crucial to mention the following issues:

- generally speaking corporate governance is based mostly upon internal mechanisms, that is hierarchies such as ownership structure and board, whereas external mechanism, i.e. markets such as stock market, market for corporate control are weaker and do not play important governance functions (Pajuste, 2002);
- ownership concentration in CEE countries is highly concentrated (Berglof and Pajuste, 2002) as a result of weak investor protection (investors want to secure their position in the company buying larger stakes of shares), civil law and catch-up stages of transition

economies. Moreover, the so called founding privatization, i.e. entrepreneurial spirit leads to many new companies established and in result substantial managerial ownership in case of IPOs conducted in recent years (particularly 2004–2007). Therefore the rights of shareholders (and private information) dominate over rights of investors (Pistor, 2001);
- transparency of public listed companies is inadequate (Pajuste, 2004);
- boards of companies in transition economies are dominated by representatives of shareholders and creditors, the participation of representatives of workers (usually in state owned or commercialized companies) and independent directors is marginal (Aluchna, 2007);
- owners vary in terms of type and origin – insiders do have strong position in Russian companies, investment funds appear to be relatively strong in the Czech companies, whereas strategic investors play important role in Poland and Hungary. Additionally, foreign investors usually held *c.*30 per cent of share of publicly listed companies;
- compensation of executives is usually tied to size of companies and less to the corporate performance.

Facing Globalization and Integration – Current Challenges for Unified Europe

The processes of globalization, economic integration and increasing capital mobility had significant impact on both – stabile, developed and efficient Western Europe as well as for the developing, transforming and catching-up Central and Eastern Europe. The dramatic changes observed in economic and social environment, the growing power and pressure from mostly institutional investors and finally the waive of corporate frauds changed the direction of reforms agenda in many European countries. The reforms of rigid systems of Western Europe focused on the improvement of investor protection, strengthening investor rights and increasing corporate disclosure as well as liberalization of capital markets (listing, takeovers) and enhancing role of independent directors in Germany, France, Italy or Spain. In late 1990s national systems of Western Europe began their transformation towards shareholders, increase transparency and accountability (Höpner and Jackson, 2001). In result, the role of banks and industrial companies decreased in favour of pension and investment funds, stock market became more transparent and

more flexible. Code of best practice (Monks and Minow, 2004; Mallin, 2004) recommended development of corporate information policy (e.g. disclosure of executive compensation), establishing certain committees (audit, nomination, remuneration) and more participation of independent directors on board (e.g. German CG Kodex, Vienot Report, Cadbury, Hampel, Greenbury Committees).

The 1990s reforms undertaken in Central and Eastern Europe aimed at finishing privatization schemes and creating strong institutional order (protection of investor and shareholder rights), improvement of stock market functioning (supervision, laws) as well as strengthening control structure. In the second phase of late 1990s CEE started to adopt the best practice recommendations and implement them on the national capital markets. Although CEEC were lagging behind in terms of economic indices the fast developing economies, booming entrepreneurial spirits and growing private sector demanded access for equity financing and hence, corporate governance standards. The process of economic development and surge in number of rapidly growing private companies even accelerated after the EU enlargement and capital inflows. For instance in 2004 Warsaw Stock Exchange was the second stock market in Europe in terms of IPOs (LSE was ranked first) with 36 new entrants whereas the number of IPOs in 2007 exceeded 100.

The EU enlargement of 27 different developed countries and creating the economic zone of *c.*400 million people requires harmonization of law and unification of standards and procedures. The extensive reforms referred to the most essential issues of corporate governance and included the following:

- European Commission resolution (adopted in June 2002) on financial reporting (IFRS) according to international accounting standards (IAS) which allowed for harmonization of the accounting procedures use to enable quick assessment of corporate performance for investors;

- *Modernizing Company Law and Enhancing Corporate Governance in the European Union – A Plan to Move Forward* which undertakes measures to draft a company act for small and medium enterprises (SMEs) operating on the European market;

- Prospectus Directive (adopted in July 2003) on harmonization rules and standards of company prospectus which provided the

possibility for a company listed in one member state to list its share in other state without the need of preparing a new prospectus;

- Transparency Directive (adopted in late 2004) which identified the scope and content of corporate information that should be disclosed to the public;

- The Directive of takeover bid (adopted in 2004) which was aimed at liberalization of capital market functioning and increasing its competitiveness;

- Two recommendations of European Commission on board members compensation and role and position of independent directors (adopted in February 2005) which defined the importance of committees (audit) and set the minimum requirement of two independent directors on board;

- The Directive on exercise of shareholder's rights (adopted in February 2007) which provides standards for shareholders to receive all important corporate information before the GSM as well as to have the possibility to use the voting right at a distance.

Apparently, all these reforms and legal acts will not provide a unified EU corporate governance system and as a matter of fact such a harmonization is not the goal of the EU itself. The main idea is formulate a set of frameworks and standards of corporate governance which allows creating the integrated, flexible, efficient and competitive financial system able to face pressure from all over the world. Hence, the European models of corporate governance will be connected with the integrated financial system retaining some of their national specificities.

Conclusions

The currently existing national systems of corporate governance in Europe result from different origin, historical processes, development paths as well as economic and political approaches. Therefore they present a wide spectrum of business practice and characteristics, yet function in neighbouring countries and demand cooperation. The transition process from central planning to market economy and from communist regime to democracy initiated in

Central and Eastern Europe in 1989 changed the global dynamic of politics and economics. Not only it lead to the dismantling of the superpower of the Soviet Union, emergence of new independent countries, enlargement of the EU and the change of political balance in Europe. The transition process of Central and Eastern Europe enabled the unification of European economic systems, capital markets, harmonization of law and business standards (best practice) and emergence of different corporate governance models. It is absolutely impossible to describe the European corporate governance systems since the existing structures range from the Anglo-Saxon model of dispersed ownership, common law and strong exchange market in the UK, through the ownership concentrated in the hand to families (Italy) and companies (Sweden), significant importance of banks (Germany) and strong interlocks (France) to young control structures of Central Europe characterized by the surge in IPOs, enthusiastic entrepreneurial spirit and relative lack of transparency and Eastern Europe dominated by weak shareholder protection and powerful oligarchs connected to the state. However, currently researchers and practitioners observed similar reform efforts undertaken by all European countries aimed at increased investor protection, transparency, accountability and professional board work. The reforms of European corporate governance address the challenges of globalization and economic integration.

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3

The Evolution of Corporate Governance in Japan: The Case of Vertical *Keiretsu* Groups

Nabyla Daidj

Introduction

This chapter analyses the evolution of corporate governance and ownership of *keiretsu* focusing on vertical manufacturing *keiretsu* and highlighting structural changes affecting governance modes. Since the end of the 1990s, vertical *keiretsu* have undergone restructuring plans designed to better prepare them to face the competition especially in the automobile industry. Foreign direct investment (FDI) has increased, foreign companies made acquisitions of large stakes in *keiretsu* such as Nissan, Mitsubishi Motors.

These foreign ownership operations 'threaten' the stable shareholdings and close banking ties that represent the cornerstones of *keiretsu* links. While the *keiretsu* still exist, they are not as centralized or integrated as they were before the 1990s. Consequently, the role of *keiretsu* as a relational corporate governance – whether a group clustered around a main bank or one formed by a manufacturer and its production chain – is diminishing. Internationalization has created pressures to move toward a more-based and shareholder-oriented model of governance.

To have a better understanding of the *keiretsu* corporate structure, it is necessary to analyse its industrial organization evolution and the main stages of the change that has affected vertical *keiretsu,* together with the factors that have contributed to this change. The evolution of *keiretsu* is illustrated *via* a case study: the Nissan *keiretsu*.

Research on corporate ownership in Japan focus mainly on corporate networks: horizontal and vertical *keiretsu*. Horizontal *keiretsu* are networks of firms whose small individual equity stakes in each other collectively sum to control blocks structured around a main bank. Vertical (manufacturing) *keiretsu* are similar structures that encompass the suppliers and customers of a single large firm, such as Nissan and Toyota Motors.

These networks, representative of long-lasting and stable relationships, (especially in the Japanese car industry) are undergoing drastic changes. Many authors insist on the significant changes observed within *keiretsu* since the end of the 1990s. The role of *keiretsu*, seen as networks structured around a financial institution or a manufacturer and its production chain, seem to be less important. As a result, the relationships between the partners are weakened and corporate governance issues are quite different.

The organizational structure of *keiretsu* has been considered as a relational system to be opposed to the Anglo-American transactional model. The Japanese recession in the 1990s had profound effects on the *keiretsu*. In addition, with the multiplication of alliances/mergers mainly with foreign partners in the 1990s, it is possible to review the main developments and specific aspects of the *keiretsu*.

This chapter aims to situate the *keiretsu* within the existing strategic management and economics of institutions literature on company networks and governance. It addresses the changes of vertical manufacturing *keiretsu* and highlights structural changes affecting governance modes in Japanese *keiretsu*. Since the end of the 1990s, vertical *keiretsu* have undergone restructuring plans designed to better prepare them to face the competition (*Value Creation 21* – Matsushita; *S21* – Fuji Electric; *Vision 2000* – Marubeni; *Reform Package* – Sumitomo and *Nissan Revival Plan*).

To have a better understanding of the *keiretsu* corporate structure, it is necessary to analyse its industrial organization evolution. We will first situate the Japanese organizational structure and we will present a review of the main stages of the change that has affected vertical *keiretsu,* together with the factors that have contributed to this change. Finally, we analyse the evolution of corporate governance and ownership of *keiretsu*. We will illustrate the evolution of keiretsu *via* a case study: the Nissan *keiretsu*.

The Historical and Economic Development of the Japanese Industry and its Keiretsu

Whether called *zaibatsu* or more recently *keiretsu*, corporate groupings have been a distinctive part of Japan's industry for decades.

FROM *ZAIBATSU* TO *KEIRETSU*: HISTORICAL BACKGROUND

The *keiretsu* has its origins in the Meiji era.[1] At the end of the 19th century, the Meiji government wanted to quicken the industrialization of Japan by creating family-controlled large industrial and financial enterprises (banking, insurance, mining, shipbuilding, manufacturing of cement, paper) known as the *zaibatsu*. They emerged in response to market failures: the inability of capital markets to allocate efficiently resources, to mobilize savings and to facilitate risk assessment for investment in new business ventures (Todeva, 2005).

Each *zaibatsu* owned by a family whose interests became diversified such that they were almost self-sufficient (Cooke, Sawa, 1998). These giant conglomerates, controlled by ten families[2] (or clans), became the drivers of the pre-World War II Japanese industry and economy. *Zaibatsu* did have central direction, often through a dominant family, exercised via a holding company that had a controlling interest in *zaibatsu* companies. In that respect, they were similar to the *chaebol* (Ostrom, 2000). They were very powerful groups (among them Mitsubishi, Mitsui, Sumitomo and Yasuda) recognized as large monopoly firms owning interests in several companies. These were involved in industries such as steel, shipbuilding, international trading and banking.

During World War II, *zaibatsu* produced a large part of the country's weaponry. In addition, they were seen to be monopolies by the Americans after the war. Consequently, between 1946 and 1948, following the American occupation forces, the *zaibatsu* dissolution program was imposed by different laws (The Antimonopoly Law of 1947, the Law January of 1948 banning all members of the ten *zaibatsu* families, imposing a five per cent ceiling on bank holdings in the stock of any firm and prohibiting inter-firm shareholdings).

1 *Zaibatsu* and *keiretsu* are the result of the ancient relationship between feudal landlords, or *daimyo*, and their samurai. In these organizational structures the paternalism of feudal times has survived. In the past, during the feudal period Takagawa (1603–1868), Japan was divided into feudal fiefdoms called *han* 'controlled' by the *daimyo*.

2 These families developed very close links with politicians, government members and the military.

But in the end of the 1940s, the allied forces changed policy. This resulting change in occupation policy is often called the 'reverse course' focusing on the economic recovery and political rehabilitation of Japan. Japan became a strong ally of the US during the Korean War (1950–53). Consequently, to prevent the weakening of its economy, the Japanese government concerned with concentrating on scarce industries crucial to Japan's long-term economic security encouraged the re-formation of the old zaibatsu known as *keiretsu*. Several *keiretsu* emerged from the *zaibatsu,* whereas others were new groupings of companies. These enterprise groups interlock ownerships, stock shares amongst industrial enterprises, banks and other financial establishments on the one hand and close buyer-supplier relationships on the other hand.

HORIZONTAL VERSUS VERTICAL *KEIRETSU*

The term *keiretsu* is not approved unanimously (Gerlach, 1992; Fujiki, 2002) because is difficult to define it. Considered generally as an 'enterprise group', this concept indicates also that corporations engaged in commercial transactions are bound in a financial relationship. Consequently, other notions are used such as 'inter firm alliances', 'network of industrial organizations', 'clusters of firms', relationship companies (*kankei gaisha*), related companies (*kanren gaisha*), 'keiretsu of capital', 'group of affiliates' (Aoki, 1988) and 'J-Firm Group' (Aoki, 1986).

Most large Japanese firms are connected to affiliated companies with which they form a system called *keiretsu*. There are mainly two[3] types of *keiretsu* (Miyashita, Russel, 1994), which may be horizontal (conglomerate) or vertical (many suppliers – subcontractors under the 'umbrella' of a large industrial firm).

Horizontal (financial) *keiretsu* include a large number of major companies belonging to a wide range of unrelated industries (which may encompass manufacturing, electronics, construction, cement) with common ties to a main and powerful bank (*shuryoku ginkô*). The main bank provides debt financing to member firms with favourable conditions (law interest rates, long term loans) and owns large amounts of their common stock.

3 Some authors consider that a third type of *keiretsu* exists: the distributional *ryutsu (*or marketing *keiretsu)* where a manufacturer owns or controls its own distribution channel including wholesalers and retail outlets. These three distinct patterns are not exclusive. For example, a vertical *keiretsu* can occur within a horizontal *keiretsu*. In this paper, we will focus mainly on vertical k*eiretsu*.

The entire *horizontal keiretsu* structure includes the *shuryoku ginkô* (a 'city bank' or a 'long term credit bank'), a trading company (*Sogo syosha*) often supported by other financial institutions such as: a trust bank, a life insurance firm and/or a non-life insurance company and firms in non-competing lines of business[4] (Nivoix, 2002).

Most analysts focus on the so-called Big Six groups and their banks: Mitsui (with Sakura Bank), Mitsubishi, Sumitomo, Sanwa, Fuyo (Fuji Bank) and Dai-Ichi. They are the strongest and most representative of all the horizontal keiretsu. More recently, in 2002, the Mitsui and Sumitomo Banks merged to form the Mitsui Sumitomo Financial Group and in 2003 the Fuji Bank, DKB and the Industrial Bank of Japan merged to create the Mizuho Financial Group.

Vertical ('production' or non financial) *keiretsu* are quite different. They represent a pyramidal structure of intercorporate equity holdings. Some of them are industrial *zaibatsu* that escaped dissolution (Morck, Nakamura, 2003). They are generally industry-based (mainly manufacturing such as automobile, steel and electronics industries but also trading activities and financial services) with a large manufacturing company having equity (controlling in some cases affiliated suppliers) and other links to firms up and down the 'production chain' and along the value chain. As much of value creation occurs in the supply and distribution chains, vertical *keiretsu* managers have to understand the value network, the set of inter-organizational links and relationships that are necessary to create products and/or services (Johnson et al., 2008).

A vertical *keiretsu* consists of tiers, with a company like at the top, followed by a secondary tier of major suppliers, and then a tertiary tier of smaller manufacturers. Staff and loans can flow from the lead company to these suppliers. The second tier is allowed to use the parent company name and reputation to promote its own activities. The parent company is responsible for the coordination. This organization is perceived to be highly hierarchical, hence the name vertical *keiretsu*.

Toyota Motor Company is a classic example of a vertical *keiretsu* having at least half a dozen major subsidiaries, which in turn have hundreds of firms below them. Each firm produces a part or sub-assembly which is used in the production of a final product for the 'parent' company.

4 As Nakamura (2003) explains, it is not the rule. A number of companies belong to several groups such as Hitachi Ltd belonging to three groups.

The difference between horizontal and vertical *keiretsu*:

> *is the glue that holds the group together as well as the strength of that bond. Members of horizontal keiretsu are linked by the power and the obligations of the large bank at the center of the organization and, to a lesser extent, by the group's trading companies; in some instances, they are tied together by a shared history. The position of the keiretsu bank is particularly strategic. It is the nucleus of a keiretsu financial institution, and, in terms of pooling resources, it maintains a control power based on the provision of funds and share ownership and provides guidance to corporate investment behaviour and opportunities. The cohesiveness of vertical keiretsu, by contrast, depends on one or more large non-financial companies that hold substantial equity positions in affiliates and that serve as important customers and suppliers to the rest of the group (Ostrom, 2000, introduction).*

THE IMPACT OF *KEIRETSU* ON JAPAN'S ECONOMIC PERFORMANCE

The Japan spectacular growth originated partly in *keiretsu*. *Keiretsu* and more specifically 'vertical *keiretsu*' have been widely recognized as an important source of strength in Japanese industries. They contributed largely to boost the Japanese post-World War II growth. They were a key feature of Japan's economy, affecting directly or indirectly economic transactions within and across industries. They also structured the Japanese industrial system. They can be analyzed as both an organizational phenomenon and a means which has enabled Japanese firms to expand their production capacities, their competitiveness and their exports growth (Aoki, 1988) until the 1990s. The following characteristics of *keiretsu* can explain Japan's economic success.

A 'PYRAMIDAL' STRUCTURE BASED ON LONG TERM AGREEMENTS AND A NEXUS OF RELATIONSHIPS

Vertical *keiretsu* represents a group of independent firms developing complementary resources (human, technological) and competencies, organized around a prime manufacturing company, the main company (*motouke*). The cohesion of the *keiretsu* is based on a long term commitment between the main manufacturer and other firms and on regular (formal and informal) relationships (supply chain, production, financial, commercial) between members. The economic logic is based on mutual trust and self-enforcing commitments. The contracts are generally determined for several years and are adjusted every six

months depending of the economic evolution and the respect of quality and costs conditions by subcontractors. They help to ensure consistent and reliable quality, dependable delivery etc.

Exchanges within *Keiretsu* between the leading firm and the second-tier and third-tier contractors concern mainly 'human resources' (engineers, technicians) and 'physical and technological assets'. The main company has a great impact on its suppliers' major decisions about price, quality, adoption and diffusion of new technologies in order to increase productivity gains and quality improvement of each segment. It may also invest capital, technology and facilities in smaller companies.

As *keiretsu* is based on stable and vertical relationships (long term subcontracting relationships), this network induces transaction costs reduction. This system operating within an increasing competitive context is based more and more on cooperative links between the main partners (see Table 3.1).

CORPORATE GOVERNANCE AND STABLE SHAREHOLDING[5] (KABUSHIKI ANTEI HOYUU)

Cross-shareholding is at the centre of business-to-business relationships (*keiretsu*), of business-to-bank relationships (main bank relationships) and business-to-employee relationships (Okabe, 2001), representing a system of mutual support and of 'institutional complementarity' (Aoki, 1995; Aoki, Okuno-Fujiwara, 1996).

Each *keiretsu* member holds some of the shares issued by the others and agrees not to trade them (around 70 per cent of a firm's equity is never traded[6]). These stable shareholders (e.g. banks, financial institutions, industrial firms) explain partly why there is no market for corporate control (Nakamura, 2003; Jackson, Moerke, 2005). Sheard (1994) emphasizes the importance of reciprocal

5 As Okabe (2001, p. 7) explains it: 'cross-shareholding is a concept relating to the owner of the stocks, while stable shareholding relates to the motivation and duration of holding stocks. That is, stable holding means the kind of investment attitude in which an investor, once he acquired stocks, does not sell them in principle and holds them for a long time, regardless of the market price of the stock after its acquisitions'.

6 In early 1990, around two-thirds of the stock market's tradeable shares were locked up in *keiretsu* and fell to 50 per cent in late 1998 (Bremner, 1998). Cross-shareholdings still account for around 65 per cent of the capitalization of large groups (Abrahams et al., 1999).

shareholdings and other transactional ties to the stability[7] of the Japanese system.

Due to the interlocking ownership, *keiretsu* firms do not need to sacrifice the long-term corporate goals in favour of short-term profits. The result is that Japanese firms can focus on longer term policies and investments, rather than the short term dividends and annual profit statements. In this context, the *keiretsu* structure was successful in preventing hostile take-overs (Berglof, Perotti, 1994). The power of the *keiretsu* makes it virtually impossible for a firm to be taken over by an external one, which again adds stability to the firm. It has been analyzed as a form of market protectionism as foreign groups are unable to penetrate markets.

CLOSE RELATIONSHIPS BETWEEN GOVERNMENT AND FIRMS

The Japanese government has been playing a crucial role in the economy for years. It was the case in 1952 when the Ministry of International Trade and Industry (MITI) encouraged the formation of *keiretsu*. Since groups and government relations have traditionally been close, and structured inter-firm exchanges. These relations were often encouraged by the government to promote new technologies, technical standards, to increase competitiveness and to foster exports as well.

In addition, *keiretsu* appointed bureaucrats from different ministries such as the MITI, the Ministry of Post and Telecommunications (PT). In *keiretsu* boards, high-ranking retired bureaucrats (*amakudari*) – the 'Old Boy' (OB) networks – have played an important role in the past (Moerke, 1997). '*In Japan, a company president is careful to attend the advice and counsel of former ministry officials who form the core of the OB network and act to coordinate and harmonize relations between business and government*' (Schaede 1994, p. 317). Those 'Old Boys' ensure smooth information flow between bureaucracy and industry and are loyal to both sides (Moerke, 1997). Their role is more limited today.

Structural Changes

The dramatic changes in the Japanese economy in the last decade linked with the economic recession, the burst of the financial bubble, the deregulation of

7 Another factor that contributes to the network stability concerns long term employment practices.

domestic capital markets and finally the slow recovery since the early 1990s have had a great impact on firms' competitiveness. Japanese groups have to compete more and more in sectors where traditionally they were very competitive for many years such as automobiles, chemicals, and consumer electronics. Both horizontal and vertical *keiretsu* are directly concerned. In particular, stable shareholders (around a main bank), closer suppliers' relationships have finally inhibited fair competition among firms in Japan and have led to market share reductions on worldwide scale.

The slowing of growth opportunities for Japanese firms and the 1990s mergers' wave (the increasing part of foreign acquisitions) across vertical *keiretsu* (see Table 3.1) may have weakened the governance mechanism in the *keiretsu* groups. These changes in share ownership affect the management of Japanese firms, foreign investors attach a great importance on their return on investment and equity (ROE) accelerating a trend toward the dissolution of cross-holdings (Okabe, 2001).

Since 2000, vertical *keiretsu* tend to break up, in the automobile industry for example, the nine manufacturers (except Toyota and Honda) are now partially in the hands of foreign capital, which reduces their connections with Japanese banking establishments. The agreement between Mitsubishi Motors and DaimlerChrysler AG could have jeopardized its relationship not only with Tokyo-Mitsubishi bank and Mitsubishi Steel Manufacturing Co., but also with members of its own network of suppliers.[8] This situation has already occurred, the restructuring of Nissan, under the watchful supervision of Renault, involved a drastic downsizing in the number of its suppliers (see second section). The banks themselves seem to encourage the disappearance of *keiretsu*.

From *Keiretsu* Affiliation to Corporate Governance Issues

The distinctive nature of Japanese capitalism has been mentioned in several studies (Gerlach, 1992; Fruin, 1998). Such distinctiveness refers in particular to the structure of the Japanese market and to the 'network organization' (*keiretsu*). This section assesses the specificities of Japanese corporate governance practices and examines more precisely the effects of the changing Japanese economy on a vertical *keiretsu*, Nissan Motors.

8 The break-up between DaimlerChrysler and Mitsubishi in 2004 put a halt to this trend as Tokyo-Mitsubishi bank intervened once more to save the group from bankruptcy.

Table 3.1 Factors of change affecting manufacturing (vertical) *keiretsu*

	Zaibatsu	***Keiretsu***		
	1868–1945	**1952–late 1980s**	**1990–2000**	**since 2000**
	Creation of conglomerates	**Emergence and development of *keiretsu***	**Shift toward closer cooperation amongst partners**	**Shift toward more complex and global network system**
General context	Meiji era: fast industrialization of Japan (significant need for capital).	Dismantling of the *zaibatsu* after 1945 driven by the United States: anti-monopoly law, ban on holdings.	Stronger competition within a global context: increase in number of relocations, multiplication of alliances.	Acceleration in technological changes and increase in shares bought by foreign companies.
Internal structure and governance	Creation of *zaibatsu:* pyramidal groups controlled by a family council *Shacho-kai.* The holding company exerted authority over the different units through stocks, centralized purchasing and sales functions and despatching directors to manage subsidiary units.	Creation of *keiretsu*, vertical and (horizontal) groups. The companies are independent and publicly owned. But they are linked through cross-shareholding investment and the exchange of personnel, through shared debt and equity and mutual strategic plans. The strategic leadership resides within the president's club *Shacho-kai.*	Evolution toward a real partnership between the prime manufacturer and certain first tier subcontractors who possess specific competences based on strategic resources.	Weakening of the pyramid structure and creation of a network structure within which the relations between the partners are no longer exclusive (possibility of supplying to other *keiretsu*). The speed of dissolution of cross-shareholding in several cases will accelerate changes of Japanese corporate governance structure.

Source: Adapted from Todeva (2005), Daidj et al. (2008 forthcoming).

CORPORATE GOVERNANCE PRACTICES: THE SPECIFICITIES OF THE JAPANESE MODEL

The concept of corporate governance refers to systems by which companies are directed and controlled and to the structures of control by which managers are held accountable to those who have a legitimate stake in an enterprise (Johnson et al., 2008). Corporate governance attempts to regulate the decision-making power of executives to ensure that they do not serve their own *interests* to the detriment of *shareholders*, but also of *creditors*, employees and the company in general. It refers also to the activities of control and coordination that compose

the internal regulation in compliance with external obligations (Solomon et al., 2004). Different mechanisms are used to ensure that managers act in accordance with shareholders' interests, monitoring and incentives devices (linking promotion or pay to the performance of the firm), indirect means of corporate control such as that provided through the discipline of the capital market and finally increasing shareholders' and creditors' roles through their ability to monitor the company results or through their institutional rights such as the power to replace management (Jones, Tsuru, 1997).

As governance practices differ around the world depending on national laws and societal norms, the literature places emphasis on comparing countries from the most developed capital markets to the less developed capital markets. Several models of corporate governance have been indentified by researchers with a special interest for three of them: the Anglo-US model (integrates mainly the UK, the US, Australia, Canada, New Zealand), the German model (governs German and Austrian companies, some corporations in the Netherlands, Scandinavia, France and Belgium have adopted some elements of the German model) and the Japanese model. Different elements[9] have been identified to characterize each of them; key players, the share ownership pattern in the given country, the composition of the board of directors, the regulatory framework, disclosure requirements for publicity-listed stock corporations, corporate actions requiring shareholder approval and interaction among key players (see Table 3.2).

Prowse (1992) suggests that two distinct corporate governance systems exist in Japan: independent firms and *keiretsu*.

Independent firms have more arm-length relationships with their suppliers, customers and financiers and their management appears to be disciplined in part by large shareholders taking larger equity positions. Within *keiretsu*, management is disciplined through a complex interaction of monitoring and control conducted by suppliers, customers, financiers who have long-term relationships with the firm in addition to being major creditors and shareholders. The author expects that if *keiretsu* firms become more and more independent of their main banks as sources of capital, the governance mechanism will be similar to the mechanism that operates in independent companies.

9 These elements have been adapted from an article published on the website of the United States Agency for International Development (USAID). This organization established the Partners for Financial Stability (PFS) Program in 1999 as a public private partnership to help complete reforms necessary in the eight Central and Eastern Europe (CEE) countries that have since joined the EU (http://www.pfsprogram.org/index.ht).

Table 3.2 Models of corporate governance

	Models		
Key features	**The Anglo-US model**	**The German model**	**The Japanese model**
Key players	'The corporate governance triangle' with three major players: management, directors and shareholders.	German banks and to a lesser extent corporate shareholders.	The main bank (a major inside shareholder), the financial *keiretsu* (a major inside shareholder), management and government.
Share ownership pattern	Increase in ownership by institutions.	German banks and corporations are the dominant shareholders.	Financial institutions and corporations hold ownership of the equity market.
Composition of the Board of Directors	– 'insiders' (an executive, manager or employee). – 'outsiders' (person or institution which has no direct relationships with the corporation or corporate management).	German corporations are governed by a supervisory board (Aufsichtsrat) and a management board (Vorstand). The supervisory board is set by law and cannot be changed. It includes labour/employee representatives.	Insiders (executive managers, usually the heads of major divisions of the company and its central administrative body).
Regulatory framework	Regulation of the Securities industry by the US SEC (Securities and Exchange Commission) a government agency. In the UK, rules are established by self-regulatory organizations.	Both federal and state (Laender) law influence governance. Establishment of a federal regulatory agency for the securities industry.	The regulatory bodies are the Securities Bureau of the Ministry of Finance and the Securities Exchange Surveillance Committee established in 1992.
Disclosure requirements	The US has the most comprehensive disclosure requirements.	They are relatively stringent. Since 1995, German corporations have been required to disclose shareholders holding more than five per cent of the total share capital.	They are relatively stringent.
Shareholder rights	Elections of directors and appointment of auditors require shareholder approval. In the US, shareholders do not have the right to vote on the dividend proposed by the Board of directors. In the UK, shareholders vote on the dividend proposal.	The actions requiring shareholder approval are: allocation of net income, ratification of the acts of the management board and the supervisory board for the previous fiscal year, election of the supervisory board and appointment of auditors. Shareholders do not possess the authority to alter the size or composition of the supervisory board.	Payment of dividends and allocation of reserves, elections of directors and appointment of auditors require shareholder approval.
Interaction	Several regulatory and independent organizations, specialized investment funds, venture-capital funds, rating agencies, auditors play an important role in corporate governance.	The framework is designed to include the interests of banks, shareholders, labour, corporations.	Interaction links and strengthens relationships. Corporations rely on long-term shareholders, affiliated parties. Outside shareholders are largely excluded from the process.

Source: Adapted from http://www.pfsprogram.org/index.ht.

Japanese law recognizes the limited liability firm (Sarl) and the public limited company (SA), the most common and best considered legal form (see Table 3.3). The board of Directors is a key governance structure. It is elected at the shareholder's meeting, includes the Chairman (*kaichô*), the President (*shachô*), Senior Managing Directors (*senmu torishimariyaku*), Managing Directors (*jômu torishimariyaku*) and the Directors (*torishimariyaku*). Every position is not necessarily found in every firm. Representative Directors (*daihyô torishimariyaku*) are chosen among the top level directors (Moerke, 1997). Board members are considered generally as managers and thus subordinate to the CEO (Yoshikawa, Phan, 2001). The number of outside Directors is limited. In the 1990s, a typical *keiretsu* has around 25 board members, 6 representative Directors, a top management of 13 persons and 3 auditors (Moerke, 1997).

Table 3.3 The bodies of a Japanese PLC (SA)

Body	Role
General meeting of shareholders	Major decisions: approval of the accounts and of the dividend payment proposals; appointment of Board members and of the internal auditor. Meets at least once a year. Decision making: simple majority with a quorum of minimum 50 per cent; a two-third majority is required for any decision requiring a change in the by-laws => the blocking minority is 33 per cent.
Directors	Appointed by the Shareholders' meeting. Do not need to be shareholders. In charge of management (directors are almost all VPs of the major functions within the firm) => confusion between management and control. Represent the firm (joint signatures are required).
Board of Directors	Theoretically vested by shareholders with the necessary powers to decide the firm's policy and to control the performance achieved by the firm's management. In reality, the Board usually meets once a month to rubberstamp the decisions made by the Management Team.
The Management Board	Meets in parallel with the Board and is composed of members recruited among them. Includes the CEO and some of his direct reports (the closest and most competent, who offer him their expertise and advice). It is the real decision-making body. It is theoretically in charge of implementing the general policy decided by the Board of Directors. But in truth, it is the de facto decision-making body, as policy decisions are made here and submitted to the Board which rubberstamps them. Usually meets once a week. Makes decisions by majority voting. Controls the Directors' individual management performance (operational executives).
Internal auditors	Control the Directors' management by auditing the accounts.

Source: Adapted from Yoshimori (1984) and Langefeld-Wirth (1992).

In fact, most of the discussion on Japanese corporate governance has been driven by researchers that focus attention on the *keiretsu* network. The literature on comparative governance considers generally two main systems.[10] Jacoby (2000) describes the first one as a 'shareholder governance system' (representing the 'stock-market capitalism' and the Anglo-American model) with Boards of Directors supposed to represent shareholders' interests and to exercise a monitoring and control function against the opportunistic behaviour of managers. This 'traditional' model of American corporate governance presented a corporation characterized by a separation of ownership and management resulting in particular from the need of growing enterprises for capital (Berle, Means, 1965). The second one is a 'relational-insider governance system' with Boards of Directors that comprise the largest investors, management directors engaged in collaborative decision-making and other shareholders such as allied corporations on a reciprocal basis. The notions of 'welfare capitalism' or 'alliance capitalism' (Gerlach, 1992) are very often used to describe this relational governance system in Japan (*keiretsu)* and to a lesser extent in Germany. The system of Japanese corporate governance '*can only partially be explained by classic governance theory. The most important influence on Japanese corporate management is through a mechanism combining administrative and personal guidance*' (Schaede, 1994, p. 320).

Corporate governance mechanisms in Japan are different from those that govern American firms but have some similarities with the German system[11] (Cooke, Sawa, 1998; Jackson, Moerke, 2005) among them the concentration of corporate ownership within a stable network of banks (and other industrial firms), the central external governance role played by banks and a long-term employment system[12] (Cooke, Sawa, 1998; Jackson, Moerke, 2005).

Until the early 1990s, the literature emphasized the advantages of the German-Japanese bank-centred financial system (best practices) in comparison with the Anglo-American capital markets-centred financial system. But more recent research explores on the one hand, the issues involved in choosing between a large diversity of firm-level corporate governance practices within

10 Jacoby (2000) explains their emergence by differences in the legal protection of ownership rights: in Common Law countries such as US and UK, the Courts, were effective in protecting investors' rights. It was not the case of the Civil Law countries, leading to a more concentrated ownership and control by the Banks.

11 The Japanese Commercial Code (introduced in the late 19th century) has been influenced in particular by the German code (Cooke, 1991).

12 In Japan, the large companies traditionally provided 'lifetime' employment, high wages and a sure career path. Since the early 1990s, these practices have been changing in a context of economic recession (Nakamura, 2003).

national systems and on the other hand, the arguments for international convergence of corporate governance systems with a challenging question: *should* Japan and Germany move closer to the Anglo-American in order to assure the accountability of top managers and good corporate results? (Jackson, Moerke, 2005).

KEIRETSU AFFILIATION, CORPORATE GOVERNANCE AND AGENCY COSTS

In the 1990s, the *keiretsu* concept has been extended to include inter-firm relationships and governance structure issues (Womack et al., 1990; Gilson, Roe, 1993). In general, the literature focuses on horizontal *keiretsu*, which has traditionally represented the corporate structure of Japan. *Keiretsu* is often considered as a governance mechanism by the means of cross shareholding and long term relationships among members. Cross-holding constitutes a subset of stable shareholdings. As mentioned before, a relational governance system has emerged from the Japanese corporate network.

The relationships can be understood in terms of the principal-agent model.[13] Agency relationships exist when one or more individuals (the principals) delegate decision-making authority to another individual (the agent). The notion of agency can be applied generally to situations in which incomplete information and monitoring do not allow the principal to write complete contingent contracts.

In the context of managerial economics and strategic management, the most important agency relationship is the relationship between stockholders (owners) and managers. All of the stakeholders in a company (shareholders, managers, and creditors) do not pursue a single goal (value creation). Their diverging interests and objectives generate a number of agency costs: the cost of monitoring managers' efforts (control procedures, audit systems, performance-based compensation) and agents' bonding performance and expenditure, the cost of constructing contracts designed to minimize agency conflicts. There

13 The agency theory (Jensen, Meckling 1976; Fama, Jensen 1983) represents a major stream of The New Institutional Economics which integrates transaction-cost economics (Williamson, 1975, 1985), property-rights theory (Alchian, Demsetz, 1972). If property-rights economics and agency theory focus on *ex ante* incentive means, transaction-cost economics analyses *ex post* governance structures to reduce the costs of negotiating, monitoring and enforcing contracts (Williamson, 1991). They assume bounded rationality and opportunistic behaviour by managers. There are two different approaches of the agency theory, normative (how agency problems can be reduced?) and positive (what are the main problems associated with incomplete contracts?).

are several mechanisms (Fama, 1980; Fama, Jensen, 1983) that may reduce the agency problem between managers and shareholders: the board of Directors and the presence of outside members, direct action by large shareholders (institutions), performance-based compensation, the takeover market.

Sheard (1991, 1994) and Aoki (1990) suggest that the *keiretsu* system (both vertical and horizontal) based on formal and informal links[14] between firms, customers and suppliers, and financial institutions reduce agency costs and provide financial and strategic flexibility. A few important institutional shareholders exercise direct control, supported by stable and concentrated shareholding, among them the main bank. These stable shareholdings provide 'quasi inside' information for member firms. Less formal ties, which link *keiretsu* members without significant ownership stake in the firm include; historical links, personnel ties, flexible ties with sources of financing in order to facilitate inter-firm operations (investment and other transactions) within *keiretsu*.

The literature on *keiretsu* focuses on several institutions of the *keiretsu* governance system engaged in different functions contributing to agency costs reduction:

- The main bank, in the centre of a horizontal *keiretsu*, is usually the largest bank shareholder (offering payment settlement facilities) of the client firm and its largest bank lender. In addition, it facilitates the bonds issued by the firm and supplies information and management personnel. These functions 'enable the bank to integrate three types of monitoring: *ex ante* – basically, screening the company's applications for loans; interim – gathering information on the continuing performance of borrowers; and *ex post* – intervening in the affairs of firms in difficulties.' (Jones, Tsuru, 1997, p. 41). Close ties with the main bank may have allowed Japanese firms greater access to external financing at lower cost and risk, making their investment patterns less subject to the availability of internal funding (Hoshi, 1994). The main bank represents an 'active' principal in the agency relationship (Aoki, 1990; Sheard, 1989).

14 Several authors, among them McGuire and Dow (2003), consider that the understanding of the more informal aspects of inter-corporate networking is a key issue for two main reasons, these ties play a critical role in Japanese networks and they may also be less subject to external and internal pressures than more instrumental exchange relationships.

- The large hub firm plays a key role by holding minority and sometimes majority shares in member firms in the case of vertical *keiretsu*. Because of the close relations between the hub firm and its suppliers and subcontractors, the hub firm may exert a direct and indirect control. The effectiveness of the disciplinary mechanism is directly linked with the extent of business and stockholding between member firms in the network (Gilson, Roe, 1993).

- The 'President's Club'[15] (*Shacho-kai)* is an association of Presidents (CEO) and/or Directors of *keiretsu* firms meeting monthly to discuss group strategy and to manage intra- and inter-corporate relationships. It gathers information on member firms' activities, supports group solidarity and cohesion, mediates intra-group activities and settles intra-group conflicts (Todeva, 2005). They work together developing mutual interest and trust. The links between the President's Club and the boards of Directors are very close.

THE EVOLUTION OF CORPORATE GOVERNANCE AND OWNERSHIP NETWORKS: THE NISSAN CASE STUDY

The corporate governance structure is dynamic, developing in response to country-specific factors and new market conditions (Kester, 1990). Until the 1990s, the consortium of *keiretsu* members led to an exclusion of foreign competitors from the Japanese market. But more recently in the automobile industry, one of the most exposed to the competitive global market, three major firms had been taken over by foreign concern; Mazda by Ford in 1996, Nissan by Renault in 1999, and Mitsubishi by Daimler-Chrysler in 2000. These operations have had a great impact on *keiretsu* and more specifically on supplier relationships (Daidj et al., 2008) and corporate governance leading to a reorganization/dissolution of *keiretsu*. We analyze the Nissan case to illustrate the implications of changes in corporate governance practices.

15 As early as 1946, executives formalized such contacts through what have become known as Presidents' Clubs.

The Main Purposes of the Renault–Nissan Alliance

Nissan Motor,[16] created in 1933 is a vertical *keiretsu* affiliated to the horizontal *keiretsu* Fuyo but largely independent. At the origin, Nissan was a small maker of cars and components and progressively became, in 1980s, one of the automobile world leaders. But in the late 1990s, Nissan ran a global financial loss (its debt climbed to USD 22 billion in 1999) and its domestic market share which peaked at 34 per cent in 1972 declined to below 19 per cent in 1999. In this context, an agreement is signed in Tokyo on 27 March 1999 between Nissan and the French automobile manufacturer Renault, giving birth to the Renault–Nissan alliance. The first meetings were initiated as early as June 1998 and that Louis Schweitzer, Renault's CEO, had been looking for an Asian partner since 1997. According to Louis Schweitzer, Nissan was a 'weak *keiretsu*' (see Appendix 1 and 2).

The objective of the alliance is to combine the strengths of both companies and developing synergies through common organizations, cross company teams, shared platforms and components. The main complementarities can be analysed in terms of market breakdown, technology and costs reduction: Renault is strong in Europe and is mainly a European manufacturer, Nissan has a presence in Asia and the US, design is Renault's strong advantage (offers conceptually innovative car models, such as; Espace, Twingo, Kangoo, Vel Satis), while Nissan's production and engine technology could benefit Renault. Combining platforms and purchasing will cut costs.

The Impact of the Alliance on Equity, Management and Corporate Governance

The Renault–Nissan set up joint project structure covering most of both companies' activities. In July 1999, a Charter signed sets out the principles of 'a shared ambition, mutual trust, respect of each partners of the Renault–Nissan Alliance, completed by operating and confidentiality rules'. It promotes the common values of the new Group and common work rules for everyday.

The agreement calls for an equity investment of Renault in Nissan (see Figure 3.1). Renault holds a 44.3 per cent[17] stake in Nissan, while Nissan owns

16 Data and information for this case were collected from annual reports, articles published in the press, research papers with review on EBSCO database.

17 Subsequent to this equity investment, Nissan's equity is split as follows in the Appendix 3.

15 per cent of Renault shares (each company has a direct interest in the results of its partners). Renault–Nissan bv (RNBV), was founded on 28 March 2002 to oversee the strategy of the alliance and all activities undertaken by the two firms. Renault–Nissan bv is jointly and equally owned by Renault and Nissan and hosts the Alliance Board, which met for the first time on 29 May 2002.

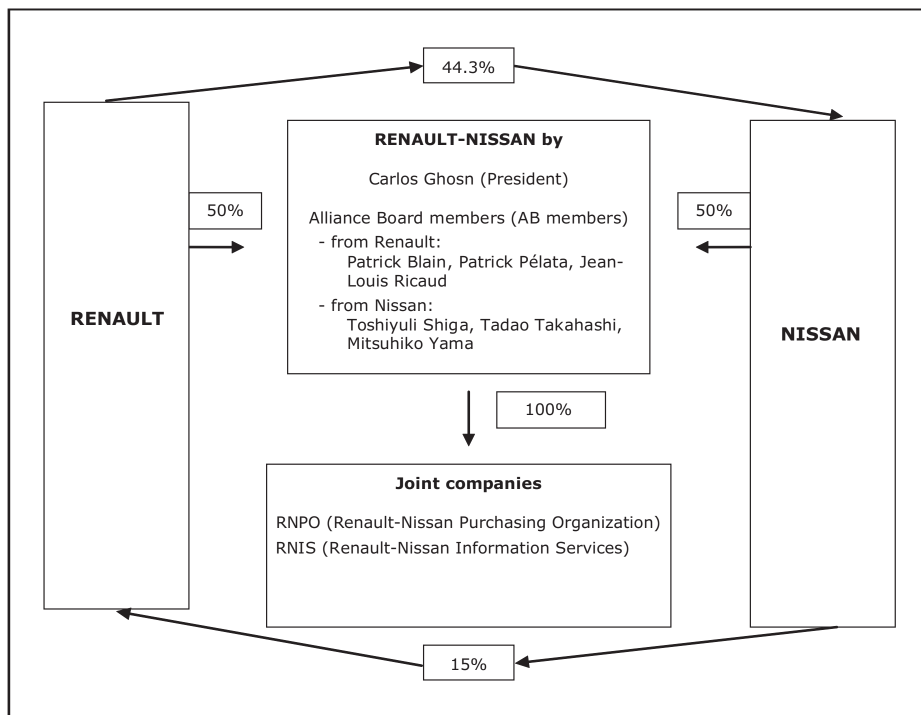

Figure 3.1 The Renault–Nissan Alliance

Note: Bv (*Besloten vennootschap*) is a closed limited liability company under Dutch law. In 1999, as described in this figure, Toshiyuki Shiga, Tadao Takahashi, Mitsuhiko Yama were members of the Alliance Board. In 2007, Nissan members are Toshiyuki Shiga, Mitsuhiko Yamashita, Hidetoshi Imazu.

Source: Adapted from 'Alliance facts and figures 2007' (pp. 16–21) available on Renault website.http://www.renault.com/renault_com/en/images/Alliance-F-F_2007_tcm1120-707767.pdf.

Carlos Ghosn[18] (former deputy CEO of Renault) was appointed to the position of Chief Operating Officer and member of Nissan's Board (27 June 1999) upon leaving Renault, C. Ghosn hired twenty Renault managers who joined him in Japan and launched the Nissan Revival Plan (NRP) based on development of new automobiles, cost reduction, reinvestment in Research & Development and improvement of Nissan's brand image. This plan included the closure of five plants (in Japan), the cutting of 21,000 jobs all around the world and a reduction of the number of suppliers by half. One year later (20 June 2000), C. Ghosn was appointed CEO of Nissan and imposed a new management structure; Nissan's management team was completely reshaped (see Figure 3.2). Nissan reduced the number of its members of the Board from 37 to ten.

With respect to the structure of the relationship between the two partners, the agreement outlines the setting up of a decision body, technical committees or implementation structures and supporting and liaison bodies. Consequently, the corporate governance structure is organized as follows[19] (see Figure 3.3).

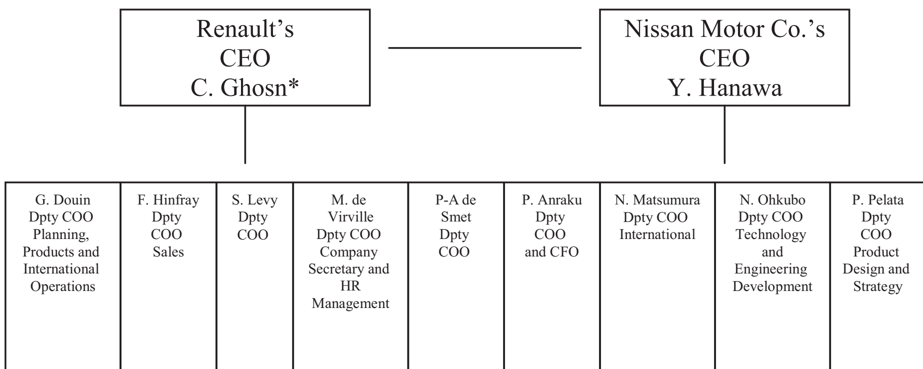

Figure 3.2 Nissan new management structure (June 1999)
* Louis Schweitzer then Carlos Ghosn.

Source: Adapted from 'Alliance facts and figures 2007' (pp. 16–21) available on Renault web site. http://www.renault.com/renault_com/en/images/Alliance-F-F_2007_tcm1120-707767.pdf.

18 He represented the «embodiment of foreign influence» (Bremner *et al.*, 1999).

19 All these elements are described in 'Alliance facts and figures 2007' available on Renault' website. http://www.renault.com/renault_com/en/images/Alliance-F-F_2007_tcm1120-707767.pdf.

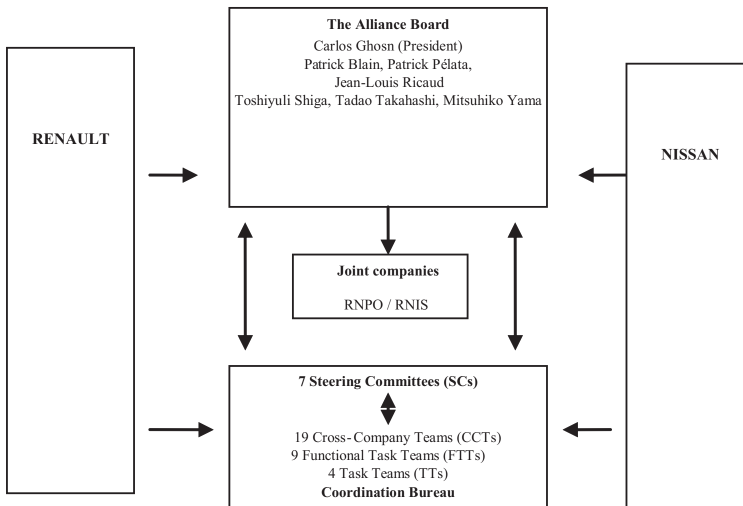

Figure 3.3 The new corporate governance structure

Source: Renault, 'Alliance facts and figures 2007'; http://www.renault.com/renault_com/en/images/Alliance-F-F_2007_tcm1120-707767.pdf.

A DECISION BODY (GLOBAL ALLIANCE COMMITTEE, GAC OR STRATEGIC COMMITTEE)

It was the Alliance's governing structure defining joint strategy and deciding on cooperations or synergies as proposed by the CCTs during monthly meetings. The different members were the co-chairmen, Renault's CEO (Louis Schweitzer then Carlos Ghosn) and Nissan Motor Co.'s CEO (Yoshikazu Hanawa), five Renault executives (G. Douin, Dpty COO Planning, Products and International Operations; F. Hinfray, Dpty COO – Sales; S. Levy, Dpty COO; M. de Virville, Company Secretary and HR Manage; P-A de Smet, Dpty COO), five Nissan executives (C. Ghosn, COO before becoming CEO; K. Anraku, Dpty COO and CFO; N. Matsumura, Dpty COO International; N. Ohkubo, Dpty COO Technology and Engineering Development; P. Pelata, Dpty COO, Product Design and Strategy).

AN ALLIANCE BOARD

The Alliance Board steers the Alliance's strategy and coordinates joint activities at the international level. Alliance Board members (AB members) are Carlos Ghosn, the President and CEO of Renault and President and CEO of Nissan,

three Renault Executive Vice Presidents (EVPs) and three Nissan EVPs. Members of the Renault CEG (Renault Group Executive Committee) and the Nissan EC (Executive Committee) also participate in the Alliance Board Meeting (ABM). Renault and Nissan run their operations under their respective Executive Committees, accountable to their Board of Directors, and remain individually responsible for their day-to-day management.

AN ALLIANCE COORDINATION BUREAU

This structure (with one office in Renault – Paris and one in Nissan –Tokyo) coordinates the work of the Steering Committees (SCs), Cross-Company Teams (CCTs), Functional Task Teams (FTTs), and Task Teams (TTs) and prepares the meetings of the Alliance Board.

The Steering Committee (SC) handles cross group orientations under their responsibility and proposes the priority subjects for the ABM agenda and coordinates CCT/FTT/TT activities within the specific scope of the SC. The SC will decide on operational matters which cannot be solved at the CCT level and reports progress to the ABM and requests arbitrage or a decision confirmation. Seven SCs covering specific fields support the CCTs/FTTs that are responsible for the implementation of Alliance Projects. The SC coordinates work accomplished by each CCT (brings together all managers or deputy-managers of all CCTs within the company, every fortnight) so as to prepare the GAC meetings, under the aegis of a coordination team. It is chaired for Renault by G. Douin (with the help of a deputy from Nissan) and for Nissan by P. Pélata (with the help of a deputy from Renault). The seven SCs are: Planning, Product Development and Manufacturing, Control and Finance, Sales and Marketing, Information System, Support Function, General Overseas Market.

The structure of joint projects and synergies is primarily based on the work of 19 Cross-Company Teams (CCTs), made up of employees of both companies. Their mission is to act as opportunity hunters and problem solvers. They are also responsible for following up on the implementation of action items. CCTs explore opportunities for synergies between Renault and Nissan (with each proposal based on a technical and quantified evaluation, including its financial impact), draw up joint projects and monitor their implementation (including allocation of responsibilities, business plans, draft agreements as well as recommended organizational changes, monitoring and control systems), follow up and implement action plans and decisions of each party and finally report to the SC or Executive Vice President/Senior Vice President responsible.

Functional Task Teams (FTTs) assist the work of the CCTs and contribute to synergies between Renault and Nissan in support functions (process, standards, management and information tools, etc). They solve the issues raised by the CCTs or the GAC (especially in the area of Information Systems, quality, tax, legal issues), align procedures and tools for an effective implementation of the alliance and develop exchanges on best practices. In addition, whenever a specific subject arises, a task team (TT) is assigned to work on it until its accomplishment.

The impact of the change in ownership pattern has been particularly important in the case of Nissan. It represents ‘an extreme case of ownership change’ (Yoshikawa, Phan, 2001). The ownership changes have led Nissan to reform its corporate governance practices leading to the reduction of the number of board members and to the redefinition of its links with its major financial institutions based more and more on arms-length transactions rather than relationship.

In addition, another component of the NRP was the structure reorganization toward cross-functional departments, which each focusing on one product line leading for staff a better visibility of the business process. For higher-level members, C. Goshn created a matrix organization within the assigned each staff two responsibilities: functional and ‘regional.’ He introduced also a performance based incentive system (included cash incentives and stock options for achievements) very different from the traditional Japanese compensation system (Millikin, Fu, 2003).

The Impact of the Alliance on Economic and Financial Corporate Results

Nissan, under Carlos Ghosn’s leadership, had improved its finances dramatically and was rapidly re-emerging as a major player in the global auto industry. Moreover, the alliance partners were in line with their initial forecast of 3.3 billion dollars in cost savings and synergies promised by 2002, according to their internal reporting.

The business practice developed with the objective of maintaining a stable and long term relationship with those they do business and also the exclusiveness of *keiretsu* (or group) transactions has begun to diminish because of pressure to reduce costs. *Keiretsu* companies are buying goods and services

more from companies outside the *keiretsu* group than probably at any other time over the last 30 years (Cooke, Sawa, 1998) and it is the case of Nissan. Restructuring of Nissan has resulted in a breakdown of the *keiretsu* system of preferred supplier agreements across the whole of Japanese industry opening up opportunities for new suppliers to break into this market.

Within the Alliance, both companies share in the design of car bodies and platforms as well as jointly developing power trains and refining manufacturing processes. Each company also designs its own products, enabling both to strengthen their product lines independently. Nissan and Renault's combined global sales for 2006 reached more than 5.9 million vehicles; around 3.5 million for Nissan, and 2.4 million for Renault. That gave the Alliance a total market share of nine per cent in 2006, placing it fourth among the major automobile groups. These results show that the French and Japanese automakers had complementary skills and their respective geographical strengths balanced each other's weaknesses. Both companies are planning complementary operations in various regions worldwide to take further advantage of their partnership.

Conclusion

The *keiretsu* system was one of the driving forces behind Japan's industrial and economic success for decades until the mid-1990s. More recently, several academic researches have begun to question the continued viability of this system. In fact, Japan has faced strong pressures to change its corporate governance practices. Different factors explain these new trends; globalization of financial markets, deregulation of Japanese securities markets, international standards growing role (such as international accounting standards or the application of the US Sarbanes-Oxley Act), Asian economic downturn and increased internationalization. Because of global competition, several domestic industries (automobile, electronics, etc.) are less and less protected and are more exposed to global capital markets. Foreign direct investment has increased, foreign companies made acquisitions of large stakes in *keiretsu* such as Nissan, Mitsubishi Motors.

These foreign ownership operations 'threaten' the stable shareholdings and close banking ties that represent the cornerstones of *keiretsu* links. While the *keiretsu* still exist, they are not as centralized or integrated as they were before the 1990s. Consequently, the role of *keiretsu* as a relational corporate governance – whether a group clustered around a main bank or one formed by

a manufacturer and its production chain – is diminishing. Internationalization has created pressures to move toward a more-based and shareholder-oriented model of governance. International changes could suggest growing 'convergence' between the Anglo-American and Japanese models of industrial organization; the traditional stakeholder model of the Japanese firm may be evolving toward more North American shareholder models.

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Appendix

Appendix 1 The structure of the vertical *keiretsu* Nissan Motors before the Renault–Nissan Alliance

Appendix 2 Nissan and Renault equity structure in 1999

Appendix 3 Nissan principal shareholders (As of 30 September 2007)

Appendix 1

THE STRUCTURE OF THE VERTICAL *KEIRETSU* NISSAN MOTORS BEFORE THE RENAULT–NISSAN ALLIANCE

Subsidiaries and affiliated cos.	Characteristics
Consolidated Japanese subs	
Aichi Machine Industry	• Production and sale of vehicles and engines
Autech Japan	• Development, production and sale of vehicles in small series
JATCO	• Automobile equipment manufacturer
Kinugawa Rubber Industrial	• Automobile equipment manufacturer
Nissan Finance	• Financial services for the Group's companies
Nissan Kohki	• Engine maker for cars and boats
Nissan Motor Car Carrier	• Automobile exports
Nissan Shatai	• Assembly of small cars and utility vehicles
Tennex	• Automobile equipment manufacturer
Vantec	• Shipping by sea
Consolidated overseas subs	
8 subsidiaries in North America	• 1 North American (USA) • 2 financial services subs (Canada, USA) • 1 car sales subs (Canada) • 1 car design center and 1 car R&D center (USA) • 2 car production facilities (Mexico, USA)
12 subsidiaries in Europe	• 1 European HQ (Netherlands) • 7 car sales subs (France, Italy, UK, Switzerland, Germany, Spain, Netherlands) • 1 financial services subs for Europe (UK) • 2 car production facilities (Spain, UK) and 1 R&D center for Europe (UK)
2 subsidiaries in Australia	• 1 car sales subs • 1 production plant (aluminium smelting)
1 subsidiary in the Mid-East	• 1 car sales subs
1 subsidiary in Asia	• 1 car sales subs • + 2 non-consolidated shareholdings (manufacturing in Taiwan)
1 subsidiary in Africa	• production plant (South Africa)
Shareholdings in Japan (non consolidated)	
Calsonic and Kansei	• Automobile equipment manufacturer
Ikeda Bussan	• Automobile equipment manufacturer
Nissan Diesel Motor (Cr.1935)	• Specialized in heavy industrial and utility vehicles • 40 per cent owned by Nissan Motors
Unisia JECS	• Automobile equipment manufacturer

Source: Moreau (1994); Nissan annual report 1999.

Appendix 2

NISSAN AND RENAULT EQUITY STRUCTURE IN 1999

Renault shareholders	**% of equity**	**% cumul.**
French State	44.22%	44.22%
Public	47.69%	91.91%
Group of associated shareholders (institutional investors' agreement)	3.24%	95.15%
Staff	2.75%	97.9%
Self-control	2.10%	100%

Source: www.renault.com.

Nissan shareholders	**% of equity**	**% cumul.**
The Dai-Ichi Mutual Life Insurance Company	5,1	5,1
The Fuji Bank	4,6	9,7
The Industrial Bank of Japan	4,3	14,0
Nippon Life Insurance Company	4,0	18,0
The Asahi Bank	3,0	21,0
The Chase Manhattan Bank	2,8	23,8
Sumitomo Trust and Banking	2,5	26,3
State Street Bank and Trust Company	2,3	28,6
The Sumitomo Bank	2,3	30,9
The Nissan Fire and Marine Insurance Co	2,0	32,9

Source: Nissan annual report (1999), www.nissan-global.com.

Appendix 3

NISSAN PRINCIPAL SHAREHOLDERS (AS OF 30 SEPTEMBER 2007)

Name of Shareholders	Number of shares held (Thousands)	Number of shares held as a percentage of shares issued (%)
Renault (Standing agent: The Bank of Tokyo-Mitsubishi UFJ, Ltd.)	2,004,000	44.33
Moxley and Co. (Standing agent: Sumitomo Mitsui Bank)	111,310	2.46
Japan Trustee Services Bank Ltd. (Trust account)	95,901	2.12
The Master Trust Bank of Japan Ltd. (Trust account)	95,117	2.10
Nippon Life Insurance Company	93,000	2.06
The Dai-ichi Mutual Life Insurance Company (Standing agent: Trust and Custody Service Bank, Ltd.	89,000	1.97
Tokio Marine and Nichido Fire Insurance Co., Ltd.	70,076	1.55
Sompo Japan Insurance Inc.	63,528	1.41
State Street Bank and Trust Company (Standing agent: Mizuho Corporate Bank)	53,191	1.18
State Street Bank and Trust Company 505103 (Standing agent: Mizuho Corporate Bank)	43,344	0.96
Total	**2,718,469**	**60.13**

Notes:

1. The number of shares shown above is in thousands. Fractional figures under 1,000 have been omitted.
2. The Company holds 123,109 thousand shares of treasury stock other than those listed in the table above. There are 1,000 shares titled to the Company but are not substantially owned by the Company.
3. The Company received a copy of the Significant Share Holdings Report from Alliance Bernstein Japan Ltd reporting that the latter has the Company's shares shown in the table below as of 28 September 2007. However, its company name is not included in the 'Name of Shareholders' as the Company could not confirm the number of shares substantially held by Alliance Bernstein Japan as of the end of the period, or 30 September 2007.

4

Corporate Social Responsibility in Latin America: Multiple Realities, Different Perspectives[1]

Mariana Lima Bandeira and Fernando López-Parra

Introduction

Social responsibility has been studied under different perspectives. Some of them are naïve descriptive studies; others have a more critical focus. The concept is very ambiguous and it doesn't have a consensus about it. Probably this is because we are living in a diverse world, with multiple realities and very different cultures and, of course, different social and economic conditions.

In Latin America alone, the region which is considered the most unequal in the world, we can find much differences in the way of doing business and, consequently, in social responsibility manifestations.

This paper is constructed with this principal concern: understanding what constitutes corporate social responsibility in Latin American context, we mean, what are the different meanings we can find in their corporate social practices.

In this sense, we analyzed secondary data and we conducted bibliographic research, as sources of our analysis. Our intention was to answer the following questions, or at least, think and reflect on them:

- Can Corporate Social Responsibility be a protagonist in Latin America?

1 We would especially like to thank Mario Hill, a student from Antigua, who participated in this research as a free-assistant and helped us in the review of this chapter.

- Should Social Responsibility be an exclusive attribute of entrepreneurial companies?
- Should Social Responsibility discourse be adjusted to each country's idiosyncrasy?
- Must companies be responsible for constructing services for the society, as education, health, etc.?
- What are limitations of responsibility for each social actor?

Some results point to a plural reality, in which it is possible to find all kinds of interpretations, meanings and practices about the subject. In fact, we can't compare Latin American reality to North American or European conjunctures. There are very significant differences among the context – historical, cultural, social, economic, political differences – where we can find a singular configuration of social responsibility discourse.

Based on these antecedents, we intended on one hand, to discuss what should be corporate social responsibility; on the other hand, we showed how this movement and this discourse were constructed in academic context of Europe and North America regions. Finally, we present the results of our bibliography and documental research, indicating the plural and the complexity of Latin America reality of corporate social responsibility.

How Corporate Social Responsibility Should be Considered

In the text Economy and Society, Max Weber (1984) sought to define social action according to four criteria of rationality: the rational in relation to the objectives, the rational in relation to values, affection and traditional.

Weber was, in fact, the first thinker to treat the question of rationality in organizations upon analyzing the bureaucratic organization and preponderance in this type of human organization from instrumental rationality. In Brazil, the work of the most well known critic in this area is that of Guerreiro Ramos, *The New Science of Organizations* (Ramos, 1989). According to this sociologist from Bahia, the administrative theories would not evolve from Taylor to Simon in what is said with respect to the question of rationality and the concept of rationality continues to reduce the economic category.

What upset Ramos (1989) the most was the primacy of the economic dimension above the other dimensions of human life. To overcome this 'difficulty' he proposed his *substantive theory of associated life*:

> *A substantive theory of associated human life is something which has existed for a long time and its systematic elements can be found in the works of thinkers throughout time, past and present, harmonized to the significance that common sense attributes to reason, regardless whether any of them have ever chosen the substantive reason expression (Ramos, 1989, p. 27).*

It is upon the *substantive theory of associated life* that Ramos signals the definition of *Substantive Organization*. For him, substantive organizations are those which construct themselves in an axle which if possible could be separated from the mercantile sphere or at least is not subordinated to it. On the other hand, formal organizations are different from substantive ones in that they are founded on calculations and create systems which act directly to optimize economic results.

It can be seen that Ramos (1989) conceived a dual organizational model: on the one hand, formal organizations (which he equated to bureaucracies in a Weber sense) ruled by instrumental rationality; on the other side, substantive organizations were ruled by substantive rationality.

Serva (1993) attempted to show which would be the characteristics of substantive organizations, in a pragmatic vision. According to this author, substantive organizations possess the following characteristics (Serva, 1993, p. 36–43):

- they are guiding for logically inter-related principles: primacy of collective action, respect for individual differences, search for balance between men and organization, calculated action in value identity;
- they are organizations in which there are intense and strong interpersonal relations;
- in these organizations if the collective reflection regarding the daily part of the organization is constant and intense;

- the hierarchical structures are extremely flexible or non-existent;
- only new members are accepted which identify with the values and greater cause of the organization;
- in these organizations there is a free circulation of information which facilitates the collective process of making decisions;
- the individuals are remunerated according to the activity that they execute and the compliance with the organization (which includes voluntary work);
- the work schedules are flexible;
- the profit of individuals is collectively checked and in periodic meetings there is an opening for dialogue and for negotiation;
- the organization expresses itself in social terms through the values that it exhibits;
- the mechanisms to systematically evaluate the satisfaction of the users are precarious;
- the organization always looks to society for support of its actions.

Tenório (2002), basing himself on the thinking of Ramos and in the work of the School of Frankfurt, explains the substantive rationality in the organizations in the following manner:

> *… Substantive rationality is an individual perception – rational from the interaction of facts in determining moments. What the social actor means within the organizations (administrators or administrative) should develop its relations through the form of producing according to the particular manner of perceiving rational action with relation to the end result. However, this does not occur when due to 'reasons' which only through functional reasoning can be explained (Tenorio, 2002, p. 33).*

It is suggested that the concept of substantive rationality be influenced by the rationality of Habermas, once the subject is conscious about its role in the

making of decisions which refer to the community in which it is part. This consciousness and valuing of the subject indicate possibilities of the construction of citizenship. The discourse of social responsibility can be concluded at this point if there were active and reflective participation from individuals and other social agents.

Bringing the proposal of Habermas to the subject of this chapter, we can affirm that social responsibility should bring to a shared discussion in which interaction and exchange could sustain and expand responsibilization through social responsibility. In a dialogue constructed and opened to constructions between society, the State, companies, the principles of the market, the society and State can form a consensus and in balance all three of these actors can assume part their share of responsibility.

Still, however, this discussion remains incomplete once the valid legislation needs to be rushed. Possibly the need to regulate corporate action originates in the difficulties of finding this space for interaction and sharing.

Observing such differences under another lens, we can conclude that the demand for regulated responsibility is inserted in a hegemonic institutionalized model in which the social is substantive. For Santos (1998), the functioning of hegemonic space supposes a desperate demand for rules without which the circumstances change and the demand no longer is desperate.

In this form, it can be seen that the regulated is associated with the objective and institutionalized dimension of social responsible behaviour, representing an act of legal regulation for executing legally foreseen compromises in which the social is directly linked to the subjective and substantive. This makes social responsibility much more significant than what is really regulated, requiring a substantial transformation in the organization which should not be based on imposition, control, regulation, but in the attitude of vigilance, motivation, and in the compromise of the effective improvement of social aspects as much as in the internal perspective as in the external part of the organization.

It would be wishful to understand that social responsibility can be permeated and constituted by three types of rationality: corporate or instrumental one, from Weber ideas; regulated rationality, focused on regulating movement; and substantive rationality, in which the human and social dimensions are valued. This space of intersection between the rationalities embraces social responsibilities in its multiple motivations.

The Actual Configuration of Corporate Social Responsibility

Besides the previous discussion, social responsibility is understood in different ways. One of the versions regarding the appearance of the term 'social responsibility' draws on a manifesto written by 120 industrial Englishmen at the end of the eighteenth century. The document defined the responsibility of the company heads as the search for and the maintaining of equilibrium of public interest, consumers, employees, stockholders, and thus would reach the largest possible contributions to the wellbeing of the nation as a whole.

Despite the inclusion of the social side between the concerns of the companies, besides the profit of stockholders, the times did not grant the acceptance of this dimension. Only in 1953, beginning with the US release of the Howard Bowen book 'Responsibilities of the Businessman', is what can be considered the initial point for the study and debate of social responsibility.

In the eighties, social responsibility has come to be discussed more largely by diverse sectors of society, becoming relevant in that it looked to better the understanding of the role of the State in current society, further questioning which social and economic objectives should be pursued by companies.

Although its importance is recognized, there has not been a consensus in order to define the term social responsibility that has caused a series of different interpretations. If, for some, the term means legal responsibility or social obligation, for others it signifies socially responsible behaviour in which ethics or mere contributions of charity can be observed in companies. There are also those who argue that social responsibility is only an obligation to pay employees well and ensuring the compliance of labour rights. There are still even those that believe that social responsibility is an evasive 'battle' for contemporary capitalism. This lack of consensus probably denotes how many values and motivations are behind the movement, which becomes many times more dominant in the capitalist discourse.

According to Carroll (1999), the social responsibility of businessmen can be defined as 'obligations of businessmen to pursue politics, make decisions or follow the lines of action that are beneficial in terms of objectives and values in society' (Bowen[2] *apud* Carroll, 1999). Bowen's work had as a base the belief that the large companies were vital centres of power and decision-making and that their actions affected in many aspects the lives of citizens.

2 Bowen, H.R., *Social Responsibilities of the Businessman*, New York: Harper Brothers, 1953.

Therefore, the liberal focus counts on the opposition of a more conservative current. The neoclassic economy argues that the objectives of companies should restrain themselves to the efficient allocation of scarce resources in the production and distribution of products or services in the free market. Thus, according to the most expressive authors, businessmen practice actions of social responsibility to profitably administer their companies (Tomei, 1984).

The authors that are most characteristic of this current were Levitt and Friedman. According to Levitt (1958), the efforts to increase social responsibilities of companies result in the destruction the capitalist system. It can be observed that this positioning is very much the opposite of Boltanski and Chiapello (2002), which justly argue the contrary: that the movement of social responsibility presents itself as the necessary justification to manage capitalism.

In his terms, Friedman (1962) argued that social responsibility of the company should only be based on the profitable use of resources and in the environment of activities conducive to the increase of profitability, always following 'the rules of the game'. This author used the idea of Adam Smith, in the sense that the company should only look for profit, since an 'invisible hand' will try to do the rest (Oliveira, 1984).

Even in the era of Chamberlain (Oliveira, 1984) it was believed that social responsibility could be satisfied by the good pledge of obligations for individuals, in particular, and not for society as with all. Krautz (Oliveira, 1984) also followed the same line of thought in terms that the companies should concern themselves with being productive and with generating profit, since only that way they will be responsible for society.

Under this perspective, the beginning of the market would be the support of society, independent of the harm that could be caused. Corporate responsibility would be restricted to maintaining a functional system as long as capital would be accumulated.

In this sense Henderson (2000) argues that assuming a socially responsible attitude by part of the company is an enticement since behind the discourse of social responsibility there is an incessant search for the maximization of profit. Thus, the discourse can be understood to serve for capitalistic purposes even if not clearly defined. Henderson (2000) considers social responsibility to be an idiom which is incapable of understanding the rationality of capitalism.

Furthermore, a socially responsible stance is never free and once it provokes costs for the company it can bring the consequences of raising prices.

On this aspect Carroll (1999) assures that the costs of socially responsible actions are at times more relevant than the behaviour by itself or the qualitative results created by the decision. In this case what is really important is the cost-benefit relationship as opposed to the ethical process. The subjacent values at reach are completely instrumental.

Paradoxically, it was Samuelson, an American economist in the age of Levitt and Friedman who elaborated the concept of social responsibility (Carroll, 1999). For him, companies cannot just assume responsibility for the consequences of their decisions and actions for society. From this idea new theoretical constructs were proposed. Among them, the work of Davis distinguished itself as the concept of social responsibility referred to as 'the considerations and answers by the company to questions that to further than strict economic, technical, or legal demands' (Davis as cited by Carroll 1999). Davis even proposed the known 'iron law of responsibility', according to which the company is a social institution that should utilize its power in a responsible form because if not, society can take it from its hands (Litz, 1996).

Among the defenders of social responsibility in the heart of the corporate world, Frederick (*apud* Oliveira, 1984) indicated that social responsibility was a concern of companies with expectations from the public. Afterwards, this would have as a base the use of human, fiscal, and economic resources for ample social ends and not simply just to satisfy the interests of particular people or organizations.

There are also conceptual contradictions that also raise and are accentuated from the basis of the social responsibility movement. This discourse is permeated by the historical movements which constructed them and mixed them with the perception of the authors that classified them. Whether social responsibility assumes a role as a representative of capitalism or as a means to build citizenship, the fact is that the discourse finds itself being crossed by many other discourses and presents rationales that at first hand may seem conflictive (López-Parra and Bandeira, 2006).

Some authors tried to identify the fundamental principals, the processes, and the results that embrace the study of business and society in such a way

that it integrates the approaches. Depending on their intentions, the authors were not always successful.

Srour (1998) compares social responsibility with the concept of the construction of citizenship, as much in the external sense as in the internal part of the company. The author combines here two dimensions of social behaviour by a company – the internal and the external. It can be observed that Srour (1998) transports the concept of citizenship to be define workers' rights which employees process, giving a limited and reduced vision, once the author in mention does not even minimally consider the necessary political, cultural, and historical elements which are fundamental to understand the idea of citizenship.

In Brazil, Neto and Froes (1999) also refer to these two dimensions. – the internal and the external – upon affirming that the leant support for community development and the preservation of the environment are not sufficient to attribute to a socially responsible company's condition. It would never be necessary to invest in the well being of its employees, dependents, and in a healthy work environment, besides promoting clear communication, giving a return to stockholders and assuring synergy among the various third parties and guaranteeing the satisfaction of clients and consumers.

Neto and Froes (1999) argue, however, that the company should offer something to society in exchange for what was usurped by the company. Thus, social responsibility would be seen as: 'a compromise from the company in relation to society and humanity in general and as a way to give back what was based on the appropriation and use of resources that did not originally belong to it' (Neto and Froes, 1999, p. 84).

In terms of social objectives, one can observe a very instrumental relation in these concepts: offering something in exchange, obligations to maximize positive impact and to reduce the negative one for stakeholders, giving satisfaction to clients and a return to stockholders are the terms that denote an instrumentality behind the concept. Supposedly what is most important is not the values, ethical ideas or ethical process.

Moreira (2001) agreed that the ethical-social functions of the business world do not become reduced by actions of corporate social responsibility. The author defines several criteria which designate an action of socio-economic responsibility: complying with social rights with regards to society, respecting

the environment, complying with laws and regulations such as payment of taxes and social contributions. Besides this, Moreira argues that pure corporate responsibility counts on the responsibility of public agents as well as central and local administrations. The author even argues for a freer exercise by all citizens, whose actions or lack of, are based on socially responsible behaviour.

For Moreira (2001), it can be noted that there are a series of regulations, criteria, and norms that give organizations the title of socially responsible. Ashley (2002) understands that other obligations, which aren't just those defined by law, should be assumed by the organization in such a way that they contribute to the quality of societal life.

Rego (2002) includes another variable, the compromising of the members of organizations. The author calls attention to the fact that organizations only function efficiently if the people that make up part of them do more than just what is only required by their jobs. For this to happen it is necessary that they believe that something besides the accumulation of capital matters, as Boltanski and Chiappello (2002) argue. In this sense, there exists a need to introduce justifications that make them compromise with the spirit of capitalism. One of these justifications, as earlier mentioned, is the discourse of social responsibility and even its correlations as the corporate volunteering with respect to social questions.

Santos (1998) argues that neoliberal globalization, the bearer of social exclusion, of the precariousness of work, the decline of public politics, the destruction of the environment and biodiversity, unemployment, the violation of human rights, pandemics and ethical prejudice, is about to be confronted by another type of globalization which is alternative and counter-hegemonic in addition to being organized from the bottom to the top of society. One of the arms of this new form of globalization is precisely the movement that has been generated in social terms.

Most of all, social responsibility movement is similar to a philantropic discourse, especially in Latin American countries. The asistentialist vision seems to be the more important justification for the social actions in our countries.

Tenorio (2000) views this position favorably, affirming that a society marked by scientific-technological evolution and by the globalization of the economy, the value of citizenship arises as a means to promote a new organizational paradigm based on management which involves dialogue and participation.

Tenorio (2002) adds that the epistemological basis of social management should be the intersubjectivity based on dialogue. Only this way can citizenship be solidified in the private sphere and in front of the most involved management of human resources.

This idea goes to the sources of the definition of social responsibility as introduced by the Commission of European Communities (2001) in which dialogical social management becomes a part of the internal dimensions of social behaviour in companies. According to the Green Book, 'social responsibility of companies is essentially a concept according to which companies decide on a voluntary basis to contribute to being fairer to society and a cleaner environment' (page 9). In this way, being socially responsible does not restrict itself to legal obligations, implying going beyond and including a 'larger investment' in human capital, environment and in relation to communities in general.

The support base of this conceptual affirmation is the following: organizational strategy has to be committed with the stockholders and employees and, of course, with community wellbeing, in a solidaritary way. However, practices are not always like this dialogic relationship, in which citizenship is embedded and there should be a strong conscience about peoples' rights and obligations. We observe there are so many 'faces' of corporate social responsibility. As a result, there are more than one rationality in the discourses about it. Following, we intend to analyze how this discourse is constructed in the Latin America region.

Latin American Nuances of Corporative Social Responsibility

The tradition of corporative social responsibility appears to have originated from European countries and North America, at least this is what Berger, Cunningham and Drumright (2007) state. These countries have studied the different forms of developing social responsibility in practice along time ago and, according to Haslam (2004), the debate on the cases, better practices, philosophical and moral arguments about the adoption of the CSR codes originated in the rich countries of the world and are only now finding resonance in the developing world.

Latin America is the region with the highest rate of inequality in terms of the distribution of resources, according to data from CEPAL and Hoffman and Centeno (2003), who identified three critical factors in order to explain

this 'title': its position in relation to the global economic system, its internal colonialism and racial division and its underdevelopment in state structures.

Justino and Acharya (2003) developed a broader analysis on the subject: they understand inequality as a multidimensional process in which the economic, political and social variables are constantly influencing and sharing the responsibility for the inequality in three different social groups: regional, rural/urban and among population groups classified according to gender, ethnicity and race. In the economical dimension, the authors included income, employment and access to goods and services; in the social dimension, there are access to health, education and social security; and the political aspect includes access to political power and legal institutions.

Among the most important findings of Justino and Acharya (2003) is the indication that social, economic and political and inequalities can be traced to the diverse and unequal distribution systems, to the existence of different opportunities and possibilities for different population groups and to different forms of discrimination.

Under this panorama, social responsibility cannot be exclusively the State's, but the responsibility for social responsibility ought to be shared among the public, private and social sector. In the world's most unequal region, there is an urgent need to look for models of sustainable development in which the actors of each country are involved, in a conscious manner and developing citizenship.

As Vives (2006) states, the characteristics of the region demand another type of managerial and social action, and the author defends the point that the determinants of corporative social responsibility depend on the environment in which the business operates.

In a research utilizing secondary data about the promotion system and of the defence of the CSR movement in Latin America and the Caribbean, Haslam (2004) sought to identity the degree of commitment and importance of the theme, by establishing a comparison between the different levels of CSR in private sector companies, the government and civil society. The author used the Canadian ranking of (Aaronson and Reeves 2002).[3]

3 Aaronson, S.A. and Reeves J.T., *Corporate Responsibility in the Global Village: The Role of Public Policy*. NPA Report No. 306. Washington, D.C.: National Policy Association, 2002.

In comparison with the Latin American and Caribbean region, Haslam (2004) creates four-level CSR classification, in which the countries considered more developed are placed in the 'Catching-up' level (Argentina, Chile and Mexico), suggesting an important activity in CSR, while Canada and the USA are considered to within the 'Running' level. The other countries of Latin America and the Caribbean have little or almost null activity of social responsibility.

The main goal of the study performed by RIRSE and VINCULAR (2005) aimed to identify the situation of managerial social responsibility in Latin America and the Caribbean, in which Argentina, Brazil, Chile, Colombia, El Salvador, Guatemala, Mexico, Panama, Peru, Uruguay and Venezuela participated. It is important to note that Brazil and Uruguay did not form part of the research carried out by Haslam (2004), which could cause some slating in the results, since Brazil possesses a significant contribution to the CSR movement, especially in relation to big companies (RIRSE and VINCULAR, 2005).

One of the main conclusions is that the CSR practice is not aligned to organizational strategic objectives. Within this instrumental approach, the CSR does not enter the 'competitive tool' list. The authors of the study emphasize as an exception countries that possess a more consolidated managerial base – Mexico, Brazil and Chile – in which the notion of CSR begins to appear, albeit in quite a disperse way.

In order to illustrate this dispersion, Vives (2006) states that the Inter-American Bank of Development, together with the IKEI, a consulting Basque firm, carried out a survey in 1,300 SAMB,[4] in Latin America and a large number of activities were classified as managerial responsibility: from philanthropic actions to results of efficient managing practices, even how a natural reaction to environmental pressures, especially referring to actions on the community and environment.

Many authors agree that CSR discourse is actually in its initial stage in our countries (RIRSE and VINCULAR, 2005; Peinado-Vara, 2006; Vives, 2006) and that it is generally associated to philanthropic and charity actions.

Vives (2006) analyzes that in Latin America this philanthropic tradition was greatly influenced by the history of colonization, whose main characteristics are the assistencialist and paternalist-authoritarian vision. In agreement with the quoted author, the companies are normally family run, from small to

4 Small and Medium Business.

medium sized and are strongly influenced by European immigrants. Since they were forced to emigrate from their country, these businessmen were more prone to have a greater social conscience, aiming to contribute to a society with which they feel identified. Nevertheless, Vives (2006) agrees that, in spite of a relatively efficient market, the same is not observed in conditions to motivate managerial responsibility.

To this respect, the study carried out by RIRSE and VINCULAR (2005) states that the existing unified legislation in the region orientated the CSR, but each country has some form of regulation in questions related with the subject such as labour, tributary, commercial and environmental legislation etc. Nevertheless, according to Lopez-Parra (2004), to this effect, social responsibility mainly reflects a regulated responsibility which changes completely the discourse of social responsibility.

In the same way, when it is mentioned, corporative social responsibility within philanthropic discourse, it is not possible to also talk of social responsibility, even though in the Peinado-Vara (2006) version this has usually been a small first step toward more responsible behaviours. The quoted author suggests that in some cases these actions arise from a response to economic crises, Argentina and Peru – or as a result of structural social crises – Brazil and Colombia.

In fact, managerial social responsibility in Latin America possesses a configuration which is different from the practices in so-called developed countries and, therefore comparisons between them according to the posture defended by Vives (2006) supposedly should not be made.

The author suggests that 99.8 per cent of Latin American companies are micro, small and medium sized and that Chile appears to be the country with the highest level of corporative social responsibility, followed by Argentina and Mexico. The data from Brazil is surprising: the small and medium sized businesses do not have large participation in socially responsible actions; nevertheless, it is the country with the greatest social activity in large companies.

RIRSE and VINCULAR's (2005) study concludes that the largest multi-national companies have shown themselves to be more prone to include policies which are socially responsible, since they receive directives from their parent companies that usually have standards which are internationally established.

In spite of the recognition that they may have, many of these stated 'socially responsible' actions are separated from the expectations and interests of local reality.

Generally large private companies that are immersed in the CSR discourse receive recognition from the communities where they participate (Bimbo – Mexico; Gerdau – Brazil); on the other hand, large state owned companies have little or no participation in socially responsible actions. The Latin American public sector has removed itself from social responsibility, leaving debates about the topic out of the political agenda.

As one can observe, the distinct criteria and conceptual framework in which the models of management are based do not result only from the diverse histories and economic-social development of the countries, but also from its different cultural traditions. Accordingly, the discourse of corporative social responsibility is equally inserted under distinct interpretative schemes. Peinado-Vara (s/d) emphasizes that there are contradictory situations in CSR actions, in accordance to the following table.

In spite of the obvious contradictions, Vives (2006) proclaims that discourse is gaining strength in Latin America: in each of the 35 countries of the region, there is at least one organism which promotes social responsibility. Nevertheless, given the characteristics of our region, the role that RSC plays in Latin America is different if we compare it with Europe or the United States. Vives (2006)

Table 4.1 Contradictions in CSR discourse

Country	Contradiction
Brazil	In spite of having the most active organizations of the private and social sector in relation to CSR actions, the results of some studies of paper industries do not only show lack of responsible behaviour, but they could also be considered irresponsible both socially and environmentally.
Chile	There is a very active RSE movement in its textile industry. Moreover, the Latin American Organization which comprises many of the national associations that deal with the promotion of the theme is located in Chile and enjoys significant success. Paradoxically, we find foreign mining companies that avoid paying taxes and rely on practices which have a negative impact on sustainable economic development.
Mexico	On one hand environmental certification and the application of efficient and respectful processes which take into account the environment have increased – in part by pressure of the Free Trade Treaty and adherence to the OCDE. On the other hand, many companies are transferring their operations from urban zones to areas with more fragile ecosystems, where environmental regulation is almost nonexistent.

Source: Adapted from Peinado-Vara, s/d.

suggests an analysis of the general characteristics of each region (see Table 4.2) and, in this sense, rejects attempts of comparison between Latin America and Europe, for example.

Apart from these characteristics presented in Table 4.2, Vives (2006) comments on the promotion of social responsibility in Europe, while the institutionalization of the discourse is 'still very incipient'. In agreement with the same author, contamination in Latin America – for example – does not

Table 4.2 Determinants of RSE

Factors That Affect CSR in Europe
• Mature economies
• Consumer intensive; need to increase savings; recycling
• Limited territorial expanse; need to import raw materials
• Regional policies (health, welfare, environment, labour, etc.)
• Lobbying for good governance
• Stakeholders exert their influence
• 'Competition' among countries
• Good infrastructure (infrastructure is not a limiting factor)
• Governments are pressured to make sustainability efforts
• Globalization is natural
• High income
• Trust in the private sector
• Skilled workers
• CSR is promoted throughout Europe
• Countries have signed the Kyoto Accord
• Efficient public services with wide population coverage
• Long history of political and economic stability
• Enterprises are 'close' to the government
Factors That Affect CSR in Latin America
• Emergent economies
• Subsistence efforts
• Wide territorial expanse, less of a need to conserve
• Unstable policies; poor or limited sustainability policies
• Inefficiency is tolerated; there is corruption
• Underdevelopment of CSR stakeholders
• Each one for himself
• Main concern is resolving daily problems
• Sustainability is not a luxury, but it is not a priority
• Some sectors are isolated and look within
• Inequality in the population is a problem (it defines consumption)
• Lack of trust
• Make do with what you have
• Incipient CSR institutions
• No restrictions on greenhouse gas emissions
• Government failure in providing basic services
• Stability is a recent phenomenon
• Enterprises are 'inside' the government

Source: Vives, 2006, p. 4.

present so many restrictions as in Europe, even though it might be the source of some concern.

Among the results provided by RIRSE and VINCULAR (2005), the SAMB in Latin America are adjusting bit by bit in the discourse, incorporating social practices with less intensity than the large companies. This is due to the interpretation that social practices ought to be restricted to the taxation of the community.

Taking into consideration these antecedents, the topic is not completely unknown, but it does present nuances. Vives, Corral and Isasi (2005) described the evolution of the concept for Latin America, whose private participation could be observed from the 19th century, through donations presented by the bourgeoisie for works of charity by the Catholic Church. Even within a context of informality, it can be said that the practice of social actions carried out by companies existed during that time.

After the Second World War, reflection on the theme became systemized in the academic, social, political and managerial arena, calling on the actors to be more active in terms of their participation in RSC discourse. After the decade of the 1980s, the discourse changed from an assistencialist vision towards a demand for the promotion of sustainable development.

Chrisman and Carroll (1984), in their study about the evolution of the concept of Corporate Responsibility, indicate the following perspectives: a traditional one, in which the prevalent concept of business responsibility emphasizes exclusively the economic consequences of their activity; a philanthropic view, that appears in the early twentieth century, as a way of supporting the government in their social actions; a contemporary view, which states that businesses cannot ignore social issues and also signs that the firm ought to be a socio-economic vision; and finally, the emerging perspective during the 1980s, whose assumptions pointed to the need of both social and economic objectives in company strategy.

Nevertheless, the authors analyzed perspectives of social responsibility under the American context and they used an historical and lineal way of discussing that ‘concept evolution’. We can say that there are three of these perspectives in Latin America, depending on various elements: strategy, sector, number of employees, leadership style, kind of product or service, long term vision, and so on. It is much more complex than one may think.

Presently, in spite of its dispersion and countless meanings, the concept is beginning to catch on, acquire an instrumental outline in the practices carried out by the companies. Vives (2006) points out that more support activities in Latin America are observed, probably because the public sector is deficient and unable to cover these social and environmental demands – such as education to less favoured groups. In this aspect the SAMB are more active in Latin America, through direct donations and more employee participation in social activities. The reasons behind these initiatives are different in the two regions: in Latin America, the ethical-religious and legal reasons are the principal motor of the companies, while Europe seeks to mainly improve its image and organizational efficiency through socially responsible actions.

Moreover, we can observe in RIRSE and VINCULAR's (2005) report that the CSR state within Latin America shows a great diversity even among the countries, oriented by its local characteristics: some countries are more advanced in development and diffusion of the theme, such as El Salvador and Guatemala, presenting a lack of coordination among the actors and a weak managerial action.

In conclusion, we can see how complex the configuration of corporate social responsibility is in Latin America, Europe, and everywhere else. There is no real truth about it; there is not only one statement about it. There is a great need for the contextualization of social responsibility discourse, in order to be consistent.

In Search of Conclusions

The main aim of this paper is to present and discuss corporate social responsibility in the Latin-American context, from a plural perspective of analysis.

As a methodological source we used secondary data, associated to the bibliographic systematization about the subject. Our purpose is not only to present social responsibility practices *per se*, but mainly we intended to analyze discourses and real motivations under social responsibility practices in the region.

First of all, we discussed the CSR concept and then presented its configuration in the developed countries and also in Latin America, highlighting the fundamental differences in their historic evolution and in present context

what, undoubtedly, influences CSR discourses and practices in each region. The way CSR is conceptualized and how it should be understood explains the differences observed between the developed and developing countries.

In this sense, it is possible to understand why corporate social responsibility is linked to philanthropic practices, especially in Latin America, and why it is not associated to a substantive rationality. In some cases we can observe CSR as part of an organizational strategy, as previously discussed. On doing this, there is a very close link between socially responsible practices to legal and instrumental responsibilities, in which it is more important to fulfill law determinations or reach economic results than the social and environmental preservation and sustainability. As a result, firms are mostly concerned about legitimating the capitalist system than committed to social, political and economic development. We can conclude that substantive rationality is very far from the entrepreneurial reality, especially in the Latin American context, where there are so many social and environmental demands to be satisfied and government just cannot do it.

Additionally, there are irresponsible practices in some organizations, which must be watched and penalized. Nevertheless, we can suppose that these kinds of problems are not on the political agenda, or the social one. There are rules, norms and laws that can regulate organizational action, but the civil society must be involved in order to make these regulated instruments be respected by the firms.

The argument presented by Vives (2006, p. 9) helps us to comprehend another point of view: 'When we talk about social responsibility, we can affirm that firms have to be responsible for society's problems? […] this applies to developing countries, which can be considered as firm responsibility'.

Moreover, there are arguments to sustain irresponsible practices, for instance, the fact of creating employment and the reduction of unemployment levels. In fact, some organizations maintain their social irresponsible practices – maybe the ones which are not so visible – and, through their 'social actions', justify them: they create the false impression of benefits, in the communities.

The civil society alone is still not connected to this discourse, and also does not participate in a deep discussion about the subject. The debate focuses on political and power dimensions, and the substantive rationality still does not matter for the SR movement. Maybe because there are so many social

and environmental gaps in Latin America – and they cannot be attended by the public sector, firms search to be proactive in these demands. Maybe because there is a strong need to improve productivity and competitiveness in businesses, as a result, companies are very concerned about linking their strategies to social actions, in search of a positive cost-benefit relationship. For example, companies seek to train their employees and, also, promote education in the community where they are installed. In this sense, they are 'preserving' potential human resource for their own.

So, we have to agree with the affirmation: a company's social responsibility will depend on its context. There is no exact answer and there is more than one answer for this question. Instead, we state that companies cannot run away from the consequences of their actions – in the long or short term, nor the results whether these be measured or not.

The importance of social responsibility in Latin America is embedded in cultural elements: their societies appreciate basic improvements in life conditions and they are not, necessarily the responsibility of a company – as health, education, basic infrastructures, for instance. Of course, companies must establish an evident 'link' between their activities and social actions and they have to be very careful about how their social actions are interpreted by the community. Dependency can be the 'other face' of social action and this is not social responsibility.

It is important to recognize that corporate social responsibility discourse can only contribute to society's growth in the following way: when society begins to ask for answers and for solutions to social exclusion and environmental degradation problems. Nevertheless, the collective conscience, human emancipation and the intrinsic value of social responsibility are not still institutionalized in Latin American context. There is a strong need for social control, legal mechanisms and a kind of oppression, in order for the social actors to be proactive in this process.

As mentioned before, the discourses that justify social responsible or irresponsible actions serve as bases for sustaining a capitalist system and an instrumental logic. If there is one thing that can be concluded, it can be said that social responsibility practices – or irresponsible ones – are dynamic reflections of how discourses are being constructed and re-constructed in the economic, political, cultural, social and historical perspectives of Latin America and, most probably, in developed countries. These practices and discourses cannot be

– and should not be – homogenized, once they depend on the scenario where the organizations are installed.

We are talking about a plural social responsibility, a complex one, which is embedded in multiple discourses and justifications in order to legitimize it. On doing so, there are no answers to the questions presented in the introduction. They must be constructing with the participation of all social actors, in which we should articulate interests, motivations, companies' characteristics and values and, of course, the conjunctures of the moment in which social responsibility will be analyzed.

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Corporate Governance and Corporate Social Responsibility Practices in Africa

Musa Obalola, Kamil Omoteso and Ismail Adelopo

Introduction

Corporate Governance (CG) and Corporate Social Responsibility (CSR) are concepts that have their roots in the Western economies where their practices have developed tremendously in the last two decades. During these periods the idea has been exported to other parts of the globe largely through the activities of Multinational Enterprises (MNEs). Globalisation and technological advancement especially in communication have enhanced the spread of these ideas to Australia, Asia and the Far East with different levels of success and peculiar difficulties. However, the same cannot be said of the economies of Africa. A number of reasons have been adduced for the slow embrace and development, both theoretically and in practical terms, of CG and CSR in Africa.

It has been argued that poor developmental infrastructures, underdeveloped money and capital markets, lack of guarantee of intellectual and property right, absence of impartial and independent judiciary, corruption and political instability have contributed to low foreign direct investments by Multinational Enterprises MNEs in these economies due to the high level of risk and uncertainty involved.

On the other hand, there are those with the belief that the concept of CG and CSR are intrinsically alien to Africa and have no bearing to these economies. They argued that differences in socio-cultural and political antecedents of the economies of Africa compared to the Western economies demand that the

concepts of CG and CSR be construed and interpreted with cognisance of these facts.

In this chapter, we mapped the historical developments of CG and CSR in the African contexts as a way of understanding the current trends in CG and CSR practices in African countries. Based on these, we were able to suggest the likely directions of these ideas within a foreseeable future. For this purpose, this chapter covers the leading economies in each of Africa's four regions. These are Nigeria (West), Egypt (North), South Africa (South) and Kenya (East).

Africa is the least developed continent in the world but has great potential for rapid growth. In Africa, there are substantial deposits of natural resources, huge potential skilled manpower, rich culture and a massive growing market for future global development. The World Development Indicator 2006 suggests that sub-Sahara African economies have consistently shown remarkable potential for growth and surpassed growth expectations with 20 of the region's 48 countries growing by more than 5 per cent in 2004. However, the continent faces significant challenges from conflict and political instability which continues to ravage it and stampedes economic recovery. Considerable investment is needed to provide necessary infrastructural facilities that will reduce transportation costs and provide sufficient sustainable power to stimulate growth. African countries require substantial amount of Foreign Direct Investment (FDI) to put them on a path of sustainable growth. However, foreign investors require some level of security for their investment and significant economic reforms. Along this line is the suggestion that concepts such as CG and CSR should be implemented in developing and emerging markets as a necessary first order condition for the inflow of the much needed FDI.

CG and CSR are two related and interwoven business concepts that are deeply embedded in business practices in the West and most developed economies. CG can be traced to the creation of the modern corporations in the 19th century, with the notion that businesses are totally free of their owners; have legal right, and power to hold properties, hire and fire employees and also sue and be sued (Reaz and Hossain, 2007). The idea of CG then was to put in place a proper system of managing these modern corporations in such a way that interest of their owners can be maximized and protected. CSR, which was also a baby of the 19th century holds the idea that whilst corporation have been given right to exist and have benefited from the society, must give something back to the society by a way of appreciation, which can lead to further benefits.

Although the idea of CSR largely started as a philanthropic gesture by a few wealthy businessmen, today it has embraced a lot of key issues on business society relationships. Sharma and Talwar (2005) argue that CSR provides a way for business to concern itself with social dimensions and pay some attention to its social impact. Frederick (1960) posits that CSR embraces the posture adopted by the society towards business in the use of economic and human resources, such that these resources are broadly employed to benefit the society and not just for the selfish interests of private persons and firms. Carroll (1979) defines CSR as encompassing the economic, legal, ethical and discretionary expectations that society has of organisations at a given point in time.

Two approaches to CG and CSR have been identified based on their orientations. These are the Continental European and Anglo-American approaches (Williams and Aguilera, 2006). The Continental European approach is believed to be stakeholder oriented (Taliento, 2007, Moerland, 1995). This paradigm may be found in some works as three different paradigms (see for example, Reaz and Hossain, 2007), but we have adopted a single paradigm approach because of the similarities shared by the three. In countries using this model, the financial market is scarcely developed, compared to countries using the Anglo-American model. Equity participation is widespread, cross and concentrated, with a high level of controls by financial institutions in general, and banks in particular.

The Anglo-American paradigm is generally considered to be market-based control where ownership, through the capital market, is dispersed. Managerial behaviours in countries using this paradigm are largely regulated by the changes in the capital market, where firms' performance are measured by their share prices. The primary objectives of these firms are therefore to maximize shareholders' wealth. The governance of such firms is usually by a single board of directors with internal and external representatives (Weimer and Pape, 1999). This composition allows for executive and non-executive directors, with the former responsible for the day to day running of the firm, and the latter saddled with the responsibility of supervising and advising the executive directors on issues relating to major policy issues that safeguard shareholders' interest (Lorsch and Maclver, 1989).

Both CG and CSR focus on the control of enterprises and the responsiveness of an organisation to its stakeholders and the environment in which it operates. CG and CSR affect the flow of funds from the surplus end of the global economic spectrum to the needing end of the spectrum. Investment decisions embody an assessment of the risk/reward profile and rational investment behaviour

dictates that risky investment should attract a greater return for the extra risk and uncertainty associated with them (Fama and Miller, 1972). An increase in return means an increase in agency cost in form of rising cost of borrowing and cost of financing for investments and operations (Jensen and Meckling, 1976). This has direct impact on performance and growth both at the micro or firm level and at a macro or country level.

There are studies that have found direct link between CG and firm performance (Gompers et al., 2003). Companies that are more open, less opaque, with more outside independent non-executive directors and less concentrated ownership structure have been documented to attract cheaper funds and hence perform better (Klock et al., 2005). Instrumental Stakeholder theorists suggest a positive relationship between socially responsible performance and corporate financial performance (Jones, 1995, Donaldson and Preston, 1995), has a potential to mitigate owners-management's conflict of interest (Hill and Jones, 1992, Jones, 1995) and enhances managers' ability to increase the efficiency of their organisation's adaptation to external demands (Orlizty et al., 2003). At a macro level, the degree of an economy's openness has been known to affect its political and economic stability (Bremmer, 2006). Openness at a macro-level will involve significant economic reforms in terms of liberalisation, exchange rate flexing, privatisation and improved judicial and human right records. These are the crucial ingredients for economic development.

CG and CSR are not totally new in Africa. The spread of globalisation, the effect of more liberalized technology, the free movement of goods and services around the globe and importantly the internet has meant that information spread faster than usual.

The practices of CG and CSR are not uniform across the countries in Africa. Obviously, this is due to both endogenous and exogenous factors. The state of economic development, political situation and historical antecedent of countries tied closely to their legal systems which also affect the level of openness in these economies. These peculiar situations and other factors are analysed below which suggest that the Western style of CG and CSR may not be suitable for the developing economies of Africa. Along this line, Boyacigiller and Adler (1991) have argued for the need to pay sufficient attention to the differences in cultural and economic system across countries when developing theories rather than assuming a universal applicability of theories. In the following sections, we provide an overview of CG and CSR in Africa, highlighting factors that affect the practices and adoption of CG and CSR and suggest that improvements in these factors will bring about a better appreciation of these concepts and

facilitate the flow of FDI into Africa. We also argued that the concept should be adopted in Africa with some necessary modification that takes cognisance of the cultural and developmental peculiarities of these countries. We analysed the state of play in Africa through a trajectory of four prominent economies in the continent viz; Nigeria, Egypt, South Africa and Kenya (until late 2007).

Current Trend in CG and CSR Practices in Africa

CSR practices in Africa is currently in its developmental stage due largely to the level of economic development, poor infrastructure facilities, weak legal and enforcement institutions. Practices and ideological basis of CSR in African countries are influenced by their historical antecedent of colonial imperialism which also determines, to a great extent, their legal system. Anglo-American model of the firm is often adopted by countries that were former British colonies while the countries colonized by France tend to adopt the socialist view of the firm.

Key drivers of CSR in the Western economies are quite different to what is obtainable in the developing economies though there seems to be no consensus about these drivers. Factors driving CSR in developing economies include the impact of the MNEs, culture, and drive for economic development, political factor and lastly ethical/religious factors. MNEs often adopt similar policies in their host countries as in their home countries partly because of pressure from their home countries to uphold acceptable corporate behaviours in their host countries and partly to signal philanthropic gestures. Host countries' level of stakeholders' activism may also stimulate or rather force MNEs to embark on philanthropic gesture of CSR. For example, in the Niger Delta area of Nigeria where most of the oil exploration takes place, the activities of MNEs have resulted in pollution of water and make the land uncultivable due to oil spillages effectively denying the local population their means of livelihood, fishing and farming. This partly gave rise to the host communities forming NGOs to articulate their concerns and has brought attention to their plight. In Kenya, MNEs have been documented to support health programmes in their host countries as a philanthropic gesture (Kivuitu et al., 2005). Arafat (2006) carried out a cross-country study on CSR in Middle Eastern and North African countries including Egypt and concluded that one of the major drivers of CSR is the activities of the MNEs. It may be misleading to suggest that MNEs embark on CSR only when pressured either from their home or host countries, some MNEs are genuinely interested in putting something back into the society where they have taken and some do it genuinely for philanthropic purposes.

Another key driver of CSR in African is culture and cultural practices. Boyacigiller and Adler (1991) have cautioned against 'discounting' the impact of culture in the development of theories or assuming a universal applicability of theories without giving enough thought to the vast cross national cultural dimension. However, a significant insight can be drawn from the works of Hofstede (1984, 1991) which can be further analysed using the framework suggested by Katz et al. (1999) to study the effect of culture on CSR. These works emphasized the role of cultural differences as key drivers of CSR. Hofstede identified five value orientated dimensions that distinguish societal culture viz; power distance, individualism versus collectivism, masculinity versus femininity, ways of handling uncertainty; long term orientation versus short term orientation in life, while Katz et al. analysed these dimensions on the CSR agenda in a society.

Stakeholder activism was mapped around five societal spheres namely: consumerism, environment, treatment of employees, government involvement in society and the role of business in the community. For example, 'Consumer activism' is expected to be higher in a society where power distance (the degree of equality or inequality between people in a society) is low, uncertainty avoidance (tolerance for uncertainty and ambiguity within a society) is low, individualism (the degree the society reinforces individual or collective achievements and interpersonal relationship) level is high and masculinity (the degree the society reinforces, or does not reinforce, the traditional masculine work role model of male achievement, control and power) is low.

On the other hand, environmental activism is likely to be high in a society where power distance is low, uncertainty avoidance is high, individualism is low, and masculinity level is low. Employee activism is more likely to occur in cultures exhibiting lower level of power distance, higher level of uncertainty avoidance, lower level of individualism and lower level of masculinity. Governmental activism is more likely to occur in cultures with lower level of power distance, lower level of individualism and lower level of masculinity and finally, Community activism is more likely to occur in cultures exhibiting lower level of power distance, lower level of uncertainty avoidance, lower level of individualism and lower level of masculinity. From these analyses, a lot of African countries would tend to have high power distance, high uncertainty avoidance, low individualism and high masculinity. Obviously, there would be overlaps in these characteristics and their implications may not be clear-cut but the model certainly provides a useful insight and a cultural dimension to the discussion on CSR

Factors Affecting the Adoption and Practices of CG and CSR in Africa

FINANCIAL DEVELOPMENT AND GROWTH

A number of studies have linked financial development and economic growth (Goldsmith, 1969; McKinnon, 1973; and Shaw, 1973). A strong financial system enhances efficient allocation of resources, reduces liquidity risk and facilitates effective management of risk by investors (Okealaham, 2004). An efficient money and capital market with adequate legal and infrastructural backing enhances market discipline and represent a mechanism for external control of enterprises which may constrain management excesses and reduce agency cost (Jensen and Meckling, 1976). An active financial system facilitates timely flow of information, reduces information asymmetry and enhances the enforcement of shareholders' rights (Jiraporn and Gleason, 2007).

Models of CG and CSR are conceived in Western economies with Agency and Stakeholder theories as the prime drivers. These models may be suitable to these economies because of the level of development in their financial markets. For instance there is the tacit and underlying assumption of an efficient market hypotheses and dispersed corporate ownership supported by an experienced and fair legal system. However, this is not the situation with the developing economies of Africa. Financial markets in Africa are grossly inadequate, immature and underdeveloped. As of 1980, there were only eight stock exchanges in the whole of Africa with the Johannesburg exchange in South Africa accounting for more than 80 per cent of total trading in these exchanges. In 1989, there were just five stock exchanges in Sub-Saharan Africa though the number increased to 16 by 2007 but this is still abysmally low. By 2002, there were just 20 stock exchanges in Africa at varying levels of development. In terms of market capitalisation, an IMF survey reported a rise in market capitalisation from $113 billion in 1992 to $245 billion in 2002. This reported growth (which is about 27 per cent of these countries' GDP) is still low compared to the average capitalisation in most emerging economies. African stock markets are generally small with few listed companies and low market liquidity (Yartey and Adjasi, 2007). For instance, in Nigeria, a World Bank-funded study found that only 13.3 per cent of enterprises are listed on the Nigerian Stock Exchange (Oyejide and Soyibo, 2001).

Despite the modest increase in the number of functioning stock exchanges in Africa, available market infrastructures are still poor and inadequate and market regulations are still weak and premature. These features of the African

financial market have greatly hampered the speed and quality of development. Closely related to this is the ownership structure of companies in these countries.

OWNERSHIP STRUCTURE AND PRIVATISATION

Dispersed corporate ownership structure necessitated the separation of ownership from the management (Fama and Jensen, 1983) with such separation comes the problem of information asymmetry and the attendant agency cost. A veritable proposition to constraint management from excessive perquisite is to have an active market for corporate control. This is partly ensured through active and proactive institutional investors who are able to intervene and align the conflicting interests of stock owners and management (Black and Coffee, 1994). Concentrated ownership structures have been documented to be less transparent and accountable and compromise minority shareholders' right (Chen et al., 2003).

Evidence from studies in transitional and emerging economies showed that state ownership of companies is characterized with inefficiency, insider dealing and poor accountability (Oyejide and Soyibo, 2001). Privatisation and programme of reforms aimed at divesting government ownership have been suggested, with mixed results recorded (Kornai, 2000; Black et al., 2000).

In Africa, the majority of companies are small and family-owned businesses. Stock ownership are concentrated, insider control and familial. For instance, the top five companies in Kenya represent over half of the total market capitalisation and all have multinational as the controlling shareholder (Nganga et al., 2003). The consequence of such ownership structure is the emergence of dominant, very powerful corporate oligarchs who can override corporate control and enjoy excessive perquisite. Shareholders and essentially minority shareholders are not protected. State owned corporation have similar structure with board appointments based on political association and cronyism. The roles of institutional ownership are still relatively limited in these economies (Okealhalam, 2004).

Closely related to corporate ownership in Africa are the issues of privatisation and economic reforms. Proponents of economic transformations are divided on the potency or otherwise of privatisation. The shock therapist school believe that government should divest and allow the market to appropriately allocate resources. Rather than the state owning enterprises, government should be concerned about providing an enabling environment through infrastructures

and legislation. The gradualist school suggested that economic transformation require a step-wise process (Gregory and Stuart, 2001).

Developing economies should not attempt to do everything all at once, instead, 'sequencing' should be adopted. Experience of privatisation in Africa is very similar to those recorded in transitional and emerging economies of Eastern Europe where privatisation has not resulted in the desired dispersed ownership (Crotty and Jobome, 2004). Inequitable distribution of resources has meant that former government enterprises are sold to few individuals or corporations at a grossly undervalued amount, the process of the sales are not transparent and fair. These gave rise largely to concentrated ownership and insider controlled invisible organisations. In order to give visibility to the privatisation exercise there is the need for greater transparency in the process of sale, these enterprises should be appropriately valued and the process needs to be fair and above board. These would require the right statutory and legal institutions that can enforce fair competition and are capable of protecting shareholders' rights.

Ownership structures, to a large extent, affect the board composition and structure. Studies have found relationship between board size and firm performance (Yermack 1996; John and Senbet, 1998). Members of the board are supposed to bring on to the board wide range of real experience to sharpen the strategic focus of an enterprise. The more diverse the board composition, all things being equal, the better the profile of expertise and knowledge that a firm should benefit from. Board sizes of listed companies in Africa range from an average of four in South Africa to 12 in Namibia and Botswana. Table 5.1 shows the average board size for some African countries.

Table 5.1 Average board sizes of some African countries (adapted from Okeahalam, 2004)

Country	Average Board Size
Ghana	7
Cote d'Ivoire	8
Nigeria	10
Kenya	8
Zimbabwe	9
Zambia	8
Mauritius	10
South Africa	4
Namibia	12
Botswana	12

LEGAL DEVELOPMENT AND GOVERNANCE

The importance of a strong legal system in enhancing corporate governance and in facilitating economic growth cannot be overstressed. La Porta et al. (1998), La Porta et al. (2002) and Roe (1991) show a significant relationship between legal development, firm performance and CG. Improvement in legal practices and reform would enhance contractual integrity, spur the inflow of financial capital as well as aid financial market development. Claessen and Laeven (2003) indicated that better property right lead to higher growth through improved asset allocation. A robust and reliable legal system provides necessary framework for the enforcement of property right and regulation of the financial system. Protection of shareholders' right and especially minority shareholders is enhanced. Strong legal system also facilitates the developments of bankruptcy legislation, provides a framework for competition policy, development of strong accounting and auditing regulations and overall enhances an active market for corporate control. Developing economies need to signal transparency, judicial probity and fairness to potential investors in order to attract the much needed FDI.

A firm level cross-country survey of 14 emerging markets including South Africa focusing on the level of governance showed that firm level governance is lower in countries with a weak legal system (Klapper and Love, 2002). Furthermore, a comparative evaluation of governance in a number of African countries including Nigeria, Kenya, South Africa and Zimbabwe revealed that in terms of shareholders' right protection South Africa is ranked top with a five point score compared to four point score by Nigeria, Kenya and Zimbabwe, while other African countries score an average of three points. Reports on creditors' right protection around the world showed that African countries scored four points, which is higher than the global average of 3.11. However, African countries human right and rule of law records are unimpressive. They all scored below the average for countries with English legal origin. Nigeria has the lowest at 2.73, Zimbabwe 3.63, South Africa 4.42 and Kenya 5.42 compare to the average of 6.46 for other English speaking countries (La porta et al., 1998).

African countries' weak legal institution may not be unconnected with the political situation and corruption. Loayza and Soares (2001) indicated that potentially a negative relationship exists between corruption and democratisation in a country. Countries that have a stable political climate tend to be able to put in place a fair judicial system which in turn curbs the level of corruption (Loayza et al., 2001). A good number of African countries

are experiencing political instability, military rule and corruption is endemic. There is sharp incongruence between military rule and rule of law. Experience in Nigerian pre-1999 and the post-democratisation period confirmed that during military regime, rule of law and, indeed, the judicial system were put in abeyance, governance was by military decree and the judiciary had no independence. These were disincentive to both domestic and foreign investors who rightly see investment in such an environment as too risky. The existing property and ownership right cannot be guaranteed in such an unpredictable political atmosphere. However, with democracy and strong independent judiciary, confidence was gradually being restored in the economy. Integration in the financial sector especially the banking and insurance sub-sectors have facilitated the flow of funds into the economy. Kenya (until late 2007) and Egypt have also witnessed relative political stability. Reforms in the financial markets and judiciary have contributed to significant increase in flow of foreign direct investments.

Having presented a general picture of CG and CSR practices in Africa, a deeper analysis of the leading economies in each of the four regions would be necessary to further assess the level of the entrenchment of these concepts in the continent. Towards this end, the following sections discuss these concepts in the context of Nigeria, Egypt, South Africa and Kenya.

CG and CSR in Nigeria

Based on the UN 2007 figure, Nigeria remains the most populated country in Africa with 148 million people. The country is highly heterogeneous with respect to culture, language and religion. The mainstay of the economy is petroleum and cocoa and has a GNI per capita of $560 (World Bank, 2006). The political system of the country has been stable since 1999 when the military handed over power to a democratically elected government. This stability has boosted the economy through effective fiscal and monetary policies which continue to generate growing FDI.

CORPORATE GOVERNANCE

The governance system in Nigeria is not clear cut, but can be arguably said to share traits of all the models. Current trends however seem to suggest that it is positively skewed towards the Anglo-American model, though in a somewhat less developed state. The liberalisation of the economy (the

jettisoning of interventionist development agenda), through privatisation and enactment of various foreign investment-friendly legislations is suggestive of this position. The tendency to drift towards the Anglo-American model has also been explained on the basis that Nigeria, like other developing Anglophone countries, has her company law modelled towards that of Britain (her colonial master). The country was neck deep in debt to international financial institutions (IMF, World Bank, Paris Club etc.), who have directly or indirectly stipulated the kind of economic reforms that must be undertaken to either get additional loan (Reed, 2002), have debt rescheduling, cancellation or forgiveness. The introduction of the structural adjustment programme (SAP) in 1986 is illustrative to this effect. The SAP was aimed at promoting economic efficiency and private sector development, through the downsizing of the public sector, and the improvement in the management of publicly owned assets (Abegunrin, 2003).

By liberalizing the economy, it was anticipated that there will be inflow of FDI, with such investors having power of majority shareholding in companies invested in, having a joint venture with domestic firms, and entitled to repatriate their profits without necessarily resulting to capital flight.

Doubts have however been raised on the suitability of the Anglo-American paradigm for developing economies which includes Nigeria. In ownership structure where majority holding largely belongs to families, agency problems may arise between these majority shareholders and minority shareholders (La Porta et al., 1999) in the case of wholly owned indigenous companies, while in the case of jointly owned companies (foreign and indigenous), foreign shareholders may not necessarily concern themselves with the interests of indigenous shareholders (Reed, 2002). These cases have been demonstrated to exist in the Nigerian governance system (Yakasai, 2001). Despite the enactment of Company and Allied Matters Act (CAMA) to protect shareholders and ensure shareholder democracy, individual shareholders are only able to exert any measure of control based on the size of their holding, with the minority shareholders losing out in the control race. This obviously calls to question, the widely held view that shareholders influence board composition and channel direction for business corporations.

The other hypothesis that the Nigerian governance system shares the traits of other models, in this case, the Continental European model can be seen in the composition of some private and publicly quoted companies. Ownerships in the Nigerian public limited firms for instance are not diffused, but rather

concentrated (Ahunwan, 2002), a reminiscence of Continental European model, but without cross holding and strong equity participation by banks. The cultural colourisation of the model is also lacking in the Nigerian case, as there is no trust relationship between the board of directors (management) and the equity holders (owners). In this regards, Yakasai (2001) argues that the Nigerian culture and history seem to influence the mind and behaviours of management, which impact negatively on the corporate governance practice. Also, despite the privatisation exercise, large holdings by government in some of the parastatals are still prevalent, with attendant interference in the board composition and management of such corporations, similar to the French system.

Even though the Nigerian capital market is one of the few vibrant ones in Africa, albeit the reforms in the banking and insurance industries, which call for a larger capital base, it is still highly illiquid and underdeveloped compared to the developed economies where the Anglo-American model has been successful. In this wise, one can arguably posit that the Nigerian governance system is still largely insider controlled. It is therefore the case that the Anglo-American model, which Nigeria appears to have shown affinity for, be supplemented with ingredients from other systems to ensure compatibility with the country's developmental goals (Reed, 2002).

CORPORATE SOCIAL RESPONSIBILITY

It has already been established above that the Nigerian legal system is fashioned towards that of the British legal system, particularly the Company law, and one would have expected Nigerian firms to show responsive steps towards stakeholder supremacy, as is evident of recent company law reforms in Britain. The opposite however appears to be the case. Strong emphasis is still largely on shareholder's wealth maximisation (Amaechi et al., 2006). This current position may be explained in view of the corporate governance structure, which has been shown to be Anglo-American friendly. Arguing in support of this position, Amaechi et al. expressed that while Nigerian company law is modelled after the UK law, its interpretation and application are more contractarian in nature, a reminiscence of the US system. Exceptions to this are the oil companies operating in the country, who are from countries with diverse governance systems. This largely informs their liberal views towards shareholders' value maximisation and CSR. This argument derives strong support from Taliento's (2007) work who posits that corporate governance mirrors social responsibility practice. The empirical results from Amaechi et

al., demonstrates that CSR is largely perceived as philanthropy, a phenomenon they attribute to the socio-economic condition of the Nigerian society. They apparently document differences in the perceptions and practices of indigenous firms and the multinational firms. Whereas, the MNEs see CSR as a strategic response and appear to have well developed programmes in this regards, the indigenous firms see social responsibility as philanthropic and altruistic.

Prior to the coming of the Western idea of social responsibility, it has been argued that some form of its practice do exist in Africa (Phillips, 2006, 23). This view equated the collective communal problem-solving and the extended family system to social responsibility, though in an unformalized form. While such practices are common in Africa, it is very difficult to equate such acts to CSR. This line of thought was also expressed by Steiner and Steiner (2000), where the authors argued that there is a lack of indigenous sense of corporate responsibility in developing countries.

Limbs and Fort (2000) had earlier posited that CSR agenda in Nigeria is a reflection of the firm's ownership structure, where firms are owned and governed by men who are both family and business heads, faced with the need to balance their interests and concerns in these two roles. These dual roles in addition to the extended family structure of the eldest or head of the family caring for the younger ones and the less privileged has been held to form the bedrock of CSR practices in Nigeria (Anyansi-Archibong, 1988; Amaechi et al., 2006). The strong influence of religion on firms' practices of CSR in Nigeria has also been identified. Embedded in CSR practices in Nigeria is the religious notion of gift and sacrifice, apparently brought to limelight by the two dominant religions – Islam and Christianity (Amaechi et al., 2006).

CG and CSR in Egypt

According to the UN 2007 figure, Egypt is thesecond most populous country in Africa with 78 million people. The IMF has rated the country as one of the top countries in the world undertaking economic reforms and it is expected that it will overtake South Africa as the highest earner of FDI in Africa in 2007; it earned $6 billion in FDI in 2006. The Egyptian stock market is one of the oldest in the world established in 1818 and 1903 respectively. This is because it is one exchange but trades on two floors, the Cairo and Alexandra Stock Exchanges (CASE). In 1992, there were just 656 companies listed on the exchanges. This rose to 1151 in 2002 and the market capitalisation rose from 8 per cent of GDP in

1992 to 32 per cent of GDP in 2002. While the French civil laws have significant influence on the Egyptian legal systems, relevant capital market laws are influenced greatly by the Anglo-American legal system. In terms of regulatory framework, the market is regulated by the Capital Market Authority (CMA).

CG IN EGYPT

CG in Egypt compares well with other countries in Africa. The concept is relatively new and a lot of effort is being done to improve the country's performance in respect of governance. Like many emerging economies, ownership is concentrated and in most cases insider-led and familial. Shareholders activism is still evolving and CG legislations are relatively new though significant steps are being taken to bring CG in Egypt to an international standard. In a study sponsored by The Centre for International Private Enterprise which was conducted by the Egyptian Centre for Economic Studies, the country's performance was benchmarked with the OCED five principle of CG issued in 1999 viz: 1) shareholders right, 2) equitable treatment of shareholders, 3) stakeholders role in CG, 4) disclosure and transparency, and 5) responsibilities of the board of directors. The summary report suggested that Egypt is doing relatively well but needs to do a lot more to develop CG in the county especially in the area of legal institution and protection of minority shareholders' right. The assessment and areas of recent improvements are highlighted below.

Shareholders' right

According to the OECD principles, this includes the right to own and transfer shares, right to vote at the annual general meeting, right to participate in the selection of the board, right to dividend and the right to actively participate in the general assembly. CG in Egypt experiences its most significant growth between 2001 and 2003. The study observed recent developments which have bolstered the performance of Egypt in CG globally such as the possibility of shareholders to vote by ordinary mail or electronic mail at the annual general meeting, the development of registration rules to conform to the international principles on CG, the provision of safe methods of registration, settlements and profit distributions, the establishment of the Settlement Guarantee Fund and Dispute Resolutions Centre.

Equitable treatment of shareholders

This refers to equal treatment of all shareholders in all categories. It includes the defence of their right, the right to vote in general meeting on fundamental decisions, the right to be protected against suspicious merger and acquisition and from insider trading as well as the right to be informed of all transactions involving the board member or executive manager. Between 2001 and 2003, the following improvements have been observed in terms of equitable treatment of shareholders: the Capital Market Authority (CMA) now have the right to suspend the decision of the General Assembly (Annual general meeting) that are biased to a specific category of shareholders, registered owners of equity are now allowed to vote on behalf of the beneficiary owner either totally or severally, new disclosure rules have now been issued that allow for strict supervision of insider trading and the organisation of acquisition operations and purchase offers and allowing class action lawsuits.

Disclosure and transparency

This refers to disclosure of important corporate information, the role of the auditor and related party disclosure as well as disclosure relating to the board members and executives. Recent developments include the disclosure requirements of both financial and non-financial statements and their electronic dissemination, draft laws to facilitate the practice of accounting and auditing professions in the county and the requirement to appoint a person responsible for the shareholders' affairs.

Role of stakeholders in CG

This implies the respect of their legal rights and compensating them for any breach of these rights. It covers a mechanism for the supervision of management and means of enhancing their participation in this process. It is now possible for employees to form a workers-shareholders' association.

Responsibilities of the board

This includes the board structure, its legal duties, the process of board members' selection, its main function and its supervisory role of the executive management. Recent developments in this area include the requirement for the board of directors to be composed of both executive and independent or non-executive directors; the board is also required to establish an audit committee

composed solely of non-executive directors; companies are now required to disclose the ownership structure, the principal shareholders and the report of the board of directors.

Furthermore in 2004, Fawzy also did a study comparing CG performance in Egypt with selected MENA and Emerging markets using the OCED 1999 principle modified in 2004. Overall, CG performance in Egypt was rated 1.6 out of 3 compared to Poland with an overall score of 2 out of 3 and Greece with an overall 2.5 out of 3.

CSR IN EGYPT

CSR in Egypt is still very much in its formative stage. According to a cross-country study involving 13 countries across four continents, CSR in Egypt was profiled to be in its emergent stage and understood mainly as a philanthropic phenomenon due to a strong cultural and religious practice, especially Islam, which encourages giving and community cohesion. (Mohn and Eisemblatter, 2007) There are no significant public policies on CSR but there are some soft laws which endorse the OCED guidelines and ISO standards and which encourage state and private companies to implement good corporate governance practice, consumer protection agenda and environmental protection policies.

CSR is very much in the cultural, religious and national psyche of the country and it is in consonance with the traditional values of the society. This makes it a very important tool in the stride towards market reforms and economic transformation that has dominated the Egyptian economic discourse in recent times. In terms of public policy maturity, CSR in Egypt is in its first generation moving towards the second generation. This implies that CSR has 'not yet taken hold in any public sector agencies; discussions around the concept are still at the conceptual levels and attempts to promote it are hindered by a number of factors such as the existence of high bureaucratic barriers and lack of law enforcement'. CSR is not seen as top strategic issue and current efforts are disjointed and uncoordinated. Communication of CSR is also still very low and unregulated.

The following recommendation has been made to move CSR forward in Egypt: Firstly, that there is the need for the development of a coherent and modern CSR understanding and strategy based on philanthropic and religious tradition. Secondly, the implementation of CSR initiatives should stress voluntary initiatives and incentives rather than being based on mandatory

obligations. Thirdly, that the civil society should be more actively involved in the development of a broad CSR strategic objectives and in the sensitisation of the society and lastly the creation of greater cross-sectoral CSR dialogue between state business and civil society

CG and CSR in South Africa

The country rose to prominence soon after a forty-six year white minority rule (apartheid) in 1994. The democratisation success paved the way for the return of MNEs who were pressured to either withdraw or divest from the country, based on the Sullivan principle during the apartheid era while additional new ones entered the South African market. Indigenous businesses were also able to spread their activities beyond Africa and other countries also lifted trade embargos earlier imposed on the country. The combined effect of these post-apartheid developments has made South Africa the biggest economy in Africa. However, in spite of this economic boom, most of South Africa's forty-eight million people still live below the poverty line. As a result, the government is still battling with unemployment, crime, HIV/AIDS on the one hand and, on the other, redressing the socio-economic predicament the apartheid brought upon the black population though social transformation and wealth redistribution.

CG IN SOUTH AFRICA

As in most Western economies, the South African Company Act of 1973 allows for companies to either be limited by shares (in the form of private or public) or guarantee (public). A large proportion of South African businesses are family-owned.

According to Rossouw et al. (2002), in order to protect the public and other stakeholders, the government exercises control over companies through the Reserve Bank, the Registrar of Banks, the Financial Services Board and the Registrar of Companies.

South Africa's corporate structures are similar to those of Western countries (West, 2006). It is not surprising therefore that most of the issues raised in the King report of 2002 were similar to those contained in the UK's CG reports and guidelines. Nevertheless, State intervention in the labour and capital markets makes South Africa's corporate environment unique in Africa. This is

legitimized through the Employment Equity Act of 1998 and the Broad-based Black Economic Empowerment Act of 2003.

The following words of West (2006) aptly describe the situation in South Africa vis-à-vis economic development and corporate governance: 'At the southern tip of the poorest continent, still dealing with vestiges of apartheid and colonialism, and yet at the same time maintaining a 'first-world' financial infrastructure and efficient capital market, any developments in corporate governance are bound to reflect competing economic and social interests'.

Although CG has been a major issue in South Africa for quite a long time, the King Report of 1994 rekindled stakeholders' interests in CG through its inclusive approach (Rossouw et al., 2002). The report also emphasized the concepts of ethics and environmental management. The 2002 revision to the report focused on social and ethical accounting; auditing and reporting; control and risk management; safety, health and environmental issues; transformation and black economic empowerment; compliance and enforcement. It also moved the South African CG a bit closer to the Anglo-American model that is underpinned by discipline, transparency, independence, accountability, fairness and social responsibility, in order to sustain the current foreign capital flows in the economy as evidenced in the exponential growth in trans-national entrepreneurship. However, these underpinning principles are being entrenched without compromising African values such as spiritual collectiveness, consensus, humility and morality on the one hand and the socio-economic necessities of post-apartheid on the other.

The revised King report has been criticized for recommending a voluntary reporting of most social, environmental and sustainability issues by corporate entities (Barrier, 2003). Furthermore, West questioned the real participation of stakeholders in corporate activities since the release of the report as shareholders still dominate the scene. Also, the African values advocated in the last part of the revised report were considered completely over-shadowed by the Anglo-American frames that took precedence in the report. Besides, although it can be argued that the concept of African values could be ambiguous because of the multi-tribal and multilingual nature of South Africa, the values being advocated seem to be shared by both the dominant and minority tribes in South Africa.

It could be argued that the idea of a globalized world, where Western cultures and values permeate and influence other countries, could make it extremely difficult to entrench and sustain African values. Furthermore, the

need to attract continuous and sustained foreign investment requires that South Africa's emphasis on African values ought to be toned down, 'particularly the more radical elements – radical communitarianism and the precedence of communal/ancestral property rights.' (West, 2006: 445).

The obvious crack within the South African ruling party, the African National Congress, over the succession bid of Jacob Zuma and his eventual emergence as the party's leader is generating some concerns that some of the socio-economic policies (including CGs) of the incumbent government might not be followed through. It is also not yet clear how Jacob Zuma would reflect his strong belief in African values on his socio-economic policies and how a man who was sacked as the country's vice president over allegations of rape and corruption would prove his sceptics wrong.

CSR IN SOUTH AFRICA

Visser (2005) mapped the evolutionary trend of CSR among large companies in South Africa within the frames of legislative reform (ANC's Reconstruction and Development Programme and Bill of Rights); globalisation (activities of MNEs, NGOs and labour movements); stakeholder activism (stakeholder groups) and codification (ISO 14001 and the King code).

Prior to the final exit of the apartheid era, a trend towards free market solutions to social problems and more voluntary CSR programmes by companies was observed, South African companies were beginning to 'assign a more strategic role to CSR programmes and their formulation' (Brice and Wegner, 1989: 169).

In furtherance of the invaluable roles played by the business sector through the Consultative Business Movement in bringing an end to apartheid and the country's transition to democracy (Fourie and Eloff, 2005), corporate social investment (CSI) is gaining prominence. In recent years, there has been an increase in the use of CSI policies among South African companies to build their brand image as a competitive tool (Irwin, 2003). Consumers' awareness and sensitivity to companies' social roles grew dramatically after the apartheid era as it did not only become fashionable but competitively strategic for companies to show 'a deep interest in the process of social transformation and wealth redistribution in the country' (Irwin, 2003: 303). Similarly, Visser (2005) argued that although the Bill of Rights of the 1996 Constitution which encodes policy issues such as poverty alleviation, environment, health, safety and work

empowerment, drove CSR into action, the business case remains the dominant catalyst.

Rambharos (2005) put forward the argument that the magnitude of HIV/AIDS epidemic in South Africa makes CSR imperative for business organisations' sustainability. Most organisations now have programmes and human resources policies put in place to support their workers as it is only a healthy workforce that will guarantee a healthy business.

As a result of the wide gap created by successive apartheid governments' policies between the rich and the poor, the enormous amounts spent on CSI by corporate entities are yet to have any meaningful impact on the latter's well-being in terms of economic empowerment.

CG and CSR in Kenya

The restoration of multi-party politics in the 1990s paved the way for Mwai Kibaki's opposition party, National Rainbow Coalition (NRC) to mount pressure on the incumbent ruling party, Kenya African National Union (KANU). Kibaki's key campaign points of Kibaki centred on anti-corruption and economic rejuvenation. His efforts finally led to his emergence as the new face of Kenya through his landslide victory in the 2002 general election. It was a turning point in the political history of Kenya as it marked the end of KANU's almost 40-year rule.

Kenya's economy has been on the path of recovery since 2003, as tourism remains one of the major economic strengths due to the country's abundant wildlife. Other sources include horticulture, tea, coffee and petroleum products. With a GNI per capita of US $540 and an economic growth of 6.1 per cent (World Bank, 2006), Kenya soon became the strongest economy on the East coast of Africa.

Kibaki's government introduced some significant economic reforms with a view to mobilizing domestic savings and boost FDI. These include the privatisation of state enterprises through the Nairobi Stock Exchange and allowing foreign investors to own shares in the listed companies. Barako et al.'s (2006) study indicated that factors such as a firm's corporate governance attributes (particularly the presence of audit committee), ownership structure and company characteristics, do influence the extent of voluntary disclosure

among Kenyan companies. Also, Muthuri (2007) advocated purposive corporate action in order to promote collaborative initiatives that could tackle social problems in deprived Kenyan communities.

Horticultural Ethical Business Initiative (HEBI), a multi-stakeholder body established in 1999 to ensure social accountability in Kenya's flourishing cut-flower industry, developed necessary standards for social accountability and set up a voluntary private initiative to oversee its implementation (Dolan and Opondo, 2005). However, the state's ability to enforce labour and environmental legislation is still considered weak.

Despite the above progress made through the new political dispensation, Kibaki's government has been widely criticized for widespread corruption which he pledged to tackle. Critics believe that this endemic canker, corruption, affects the country's development as evidenced in high level of unemployment, crime and poverty. Also, the corruption allegation and its attendant costs gave the opposition party, the Orange Democratic Movement (ODM) led by Raila Odinga, to make waves in the 2007 general election, winning a majority seat in the parliament and accusing Kibaki's NRC of rigging the presidential post. With the recent 'resolution' of the political impasse between NRC and ODM, the coast should be clear to move the country forward and stem the tide of corruption. This is expected to create an enabling environment for good CG and CSR practices.

Conclusion

In this chapter, we have projected the lenses of CG and CSR across the most prominent economies in Africa. We suggested that the models of CG and CSR are important in the context of African and developing economies generally, this is because economic growth requires substantial inflow of FDI. As these economies make efforts towards growth and sustainable development, it is becoming increasingly important that they signal a transparent and egalitarian corporate behaviour both at firm and country levels.

Implementation of western style models of CG and CSR in Africa have been hampered by factors such as underdeveloped financial markets, poor development infrastructure, weak legal and judicial system, political instability and cultural differences. This is why it has been argued that models of CG and CSR need to be modified in the context of the uniqueness of the African

economies. While certain elements from the Anglo-American models such as, active market control may be suitable, some elements of the Continental European approach such as significant equity holding by financial institutions may also suit the developmental needs of these countries. A hybrid approach that effectively integrates the merits of the western style models with the pragmatic developmental needs of the continent is strongly advocated. This will involve considerable efforts from indigenous business professional, policy makers, and academics to undertake cutting edge research in an effort to provide a suitable framework for the contextualisation of CG and CSR in Africa. The importance of the role of international organisations such as the World Bank, the International Monetary Fund, African Development Bank, the African Union and The New Partnership for Africa's Development (NEPAD) cannot be overemphasized. These bodies should encourage national governments and, where appropriate, corporations that uphold and are receptive to good governance practices. They should give substantial support for research and scholarly efforts that would be beneficial to the developmental objectives of these countries which will in turn stimulate good CG and CSR practices.

The supportive roles from international institutions as advocated above can only be feasible in a stable political atmosphere. At the moment, there is relative political stability in most African countries. *Coup d'état* is fast becoming unfashionable as the African Union (AU) no longer accepts military leaders in its midst. However, the current trend of new and emerging leaders in some African countries falling out with their predecessors may lead to vendetta, vengeance and vindictiveness. These are often expressed in terms of reversing economic policies and reform agenda of their predecessors thereby discouraging FDI and stemming the tide of CG and CSR development in the continent. Examples of these include the case of Umoru Yar'Adua and his predecessor, Obasanjo in Nigeria; Jacob Zuma and Thabo Mbeki in South Africa; and the 'marriage of inconvenience' between Mwai Kibaki and Raila Odinga in Kenya.

Finally, CG and CSR in Africa deserve more intellectual attention. More empirical study should be conducted to establish the role of institutional investors in governance in Africa, shareholders activism, determinants of governance disclosures, and the practicality of a convergence of CG and CSR practices in Africa.

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PART 2
Local Perspectives

In this second part of the book we move to a more local and comparative analysis as we seek to explore differences within and between countries and types of business. In the main much of the very extensive body of analysis that has been done elsewhere has focused upon large corporations (mainly international) and a European or North American context. There has been within the discourse implicit assumptions that the findings and theorisation are equally applicable to other parts of the world and to smaller companies. There has also been an imperialistic assumption that the rest of the world, the so called developing countries, aspires to emulate Europe and North America and therefore that this single analysis is sufficient. This approach is of course hegemonic and is reminiscent of the approach taken to the harmonisation of accounting standards which Aras and Crowther (2008a) argue is inappropriate in the fields of corporate governance and corporate social responsibility. The argument in this part therefore rejects this approach and the various authors opt for a different and more refined form of analysis.

In the first contribution to this part therefore Ertuna and Ertuna investigate developing countries and particularly the evolution of corporate governance in such countries in order to evaluate their potential contribution. They start by stating that corporate governance concepts and principles originated mainly from developed countries and expanded to developing countries through the forces of globalisation. They argue however that the models developed in these countries cannot address the unique problems of developing countries since they do not either understand or accommodate to their underlying institutional context. They then go on to propose what they call a convergence-in-diversity approach, where convergences on common principles are achieved through cross-fertilisation between developed and developing country models and diversity is maintained through unique, context-specific governance mechanisms.

In the following chapter Raimbaev investigates Uzbekistan, which is one of the newly independent states in Central Asia making its way towards a market economy. It has a strong commitment to its own Uzbek culture and the development of the Small Medium Enterprise (SME) sector was chosen by the state as one of the preferred tools for improving social welfare. These SMEs account for nearly 80 per cent of companies and over 60 per cent of employment in Uzbekistan. In this chapter he investigates the development of the ideas and concepts of CSR in the very different context of a country which is changing from a highly controlled and centrally planned economy to one based upon the operation of free market forces. In doing so he highlights the opportunities and threats which exist and which can provide lessons in other parts of the world.

Sehirli, in the subsequent chapter, changes our focus to that of family owned firms. She chooses to concentrate on a comparison between Italy and Turkey, which she describes as two civil law countries that have family controlled businesses with concentrated ownership and weak minority shareowner protection and can be contrasted with common law countries with dispersed ownership and strong shareholder protection such as the UK and the USA. Her analysis shows that the extent of the adoption of Corporate Governance (CG) and Corporate Social Responsibility (CSR) policies by the companies differs according to their own understanding unless those policies are compulsory. Her conclusion from this analysis is that the adoption of the CG Codes of Italy and Turkey by family firms offer lessons for other countries where civil law based family firms dominate.

In the final chapter in this section Charbaji considers the deficiencies in the corporate governance system in Lebanon, seeking for what she describes as the missing ingredient. The findings of her research show that the majority of the managers in the Lebanon are highly educated and believe in separating management from ownership. More importantly they also belong to the current information age and understand the importance of implementing eCRM and DSS systems in advancing corporate governance in Lebanon. Nevertheless, cultural influences interfere and cause inadequacies due to the hierarchical nature of family authority which overrides any introduced procedures.

In this section we have taken a different level of analysis which has shown similar features. These are the dominance of forces for globalisation which create a tendency for homogeneity and harmonisation. In opposition to this is the strength of cultural influences which tend to favour a traditional and individual approach to governance and social responsibility issues. These two

forces seem to exist in a constant state of tension and this is something very often ignored by the discourse, although it is dealt with extensively by the various contributors in Aras and Crowther (2008b). At this point therefore we need to seek some theoretical understandings and this is the subject matter of the final part of the book.

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6

Evolution of Corporate Governance and Potential Contribution of Developing Countries

Özer Ertuna and Bengi Ertuna

Introduction

This paper aims to analyze the current state and the evolution of corporate governance principles, concepts and practice in a way to provide a basis for discussion on its future directions and the potential contribution of developing countries. Corporate governance concepts and principles originated mainly from developed countries and expanded to developing countries through the forces of globalization. Although corporate governance models lie in a continuum between shareholder oriented and stakeholder oriented models, the dominant model, which has been expanded to the developing countries, includes most of the principles and mechanisms of the shareholder model. However, the model cannot address the unique problems of developing countries since it does not comply with their underlying institutional context. We propose a convergence-in-diversity approach, where convergences on common principles are achieved through cross-fertilization between developed and developing country models and diversity is maintained through unique, context-specific governance mechanisms. Search for models that fit to their unique problems and contextual characteristic, both developed and developing countries, can provide for the diversity, which is necessary for the evolution of the corporate governance system. Furthermore, cross-fertilization between developed and developing country models can facilitate development of models that can address the challenging, global problems and fulfill societal aspirations.

Corporate governance is a relatively recent concept, but which is currently in a state of development. Corporate governance systems are complex, evolving and dynamic. The topic has been approached from multiple disciplines and has included several different definitions. Differences in definitions mainly originate from the differences in cultural contexts, intellectual backgrounds, interests and worldviews of scholars investigating the issue (Gillan, 2006). Finance-oriented scholars have adopted a narrow definition of corporate governance. In their influential review of corporate governance, Shleifer and Vishny (1997) define corporate governance narrowly as 'the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment'. Broader approaches define corporate governance as the 'system of laws, rules and factors that control operations in a company' (Gillan and Starks, 1998) or as 'the relationship among various participants in determining the direction and performance of the corporations' (Monks and Minow, 1995). OECD definition of corporate governance is comprehensive, including dimensions of both narrow and broad perspectives.[1]

In spite of the diversity in the definition of the corporate governance, at its present stage of development the corporate governance concept is the product of the western capitalist system, based on its definition of the 'corporation'. Therefore, the current dynamics of corporate governance is very much under the influence of changes in the role and the structure of corporations and constrained by the options of the capitalist system.

The aim of this paper is to analyze the current state and the evolution of the corporate governance concept and practice, identify its current modes of dissemination and discuss the country or culture dependence of successful implementations. The paper also attempts to provide a discussion on the dimensions of future developments and the potential role of the developing countries in these developments.

1 OECD (1999). Definition: Corporate governance is the system by which business corporations are directed and controlled. The corporate governance structure specifies the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set, and the means of attaining those objectives and monitoring performance.

THE CAPITALIST SYSTEM AND THE 'CORPORATION'

Capitalism as an economic system evolved over the last three centuries. But, it has gained its widespread acceptance since the Second World War, following which, two dominant systems emerged that were both capitalist, private in the West and state in the East. In other words, of the two dominant forms, one was based on private capital ownership, while the other was based on state capital ownership. That is, both systems were seeking to serve the interests of capital, one that of the private owners, the other the interest of the state, as if the workers were just a resource to serve capital (Vanek, 2006). Private capitalism flourished in the West and state capitalism in the East. The fall of the state capitalism around the 1990s was interpreted as the victory of private capitalism and private capitalism combined with the market mechanism became the dominant system to serve human beings in all parts of the world. Soon capitalism acquired new means to develop itself under the Globalization movement, which obtained momentum after the signing of the GATT (General Agreement on Tariffs and Trade) and establishment of the WTO (World Trade Organization). In the capitalist system, corporations are the economic agents to conduct the production activities. As the capitalism evolved into new forms under the forces of globalization, the nature and the role of corporations also changed together with the nature of the problems posed by globalization.

THE NARROW AND BROAD DEFINITIONS OF CORPORATE GOVERNANCE: SHAREHOLDERS V STAKEHOLDERS

Broadly speaking, corporations are social mechanisms designed to reach the aspirations of the societies. How these corporations are directed and controlled, in other words, how corporate governance is defined is important since it shapes our societies. What will be produced and consumed in the society and in the meanwhile, whose interests will be served, are largely determined by how corporations are governed. The narrow definition focuses on the interests of shareholders who provide the capital, while the broad definition takes into account the interests of various stakeholders of the corporation, such as employees, customers, suppliers and the society. Narrow and broad definitions relate to the two traditional models of corporate governance at the two ends of a continuum; namely shareholder-oriented and stakeholder-oriented models.

In the shareholder-oriented model of corporate governance, the aim of the corporation is profit maximization or maximization of shareholder wealth and the main criterion of performance is the market value. The model is based mainly

on agency theory and transaction cost theory. The corporation is characterized by separation of ownership and control, where the corporation is owned by shareholders, but controlled by the managers. That is, managers (agents) run the company on behalf of shareholders (principals). Here it is assumed that there is a potential conflict between the interests of the agents and the principals.[2] Managers are assumed to pursue their self-interest at the expense of the shareholders. Thus, corporate governance involves mechanisms to monitor and control managers so that they act in the interests of the shareholders, rather than their own self-interest.

However, the assumed conflict of interest may be applicable only to a limited case of ownership types. This type of conflict of interest may arise when the shareholders are disperse and outside the company with no direct access to the management of the corporation. In the presence of this type of conflict of interests, governance mechanisms are developed to align the interests of managers with the shareholders. In line with the objective of value maximization for the shareholders, basing the compensation of managers on the profit of the company or the market value of shares is a proposed mechanism of aligning interests. This mechanism may ensure that the company is governed with the aim of maximization of profit or shareholder wealth, however it may also cause the corporation to focus on short-term financial gain and loose its long-term vision. Although the mechanism seems to align the interests of managers (agents) and the shareholders (principals), its focus on market value may actually conflict with long-term shareholder interests. This market based governance system is not an internal but an *external* system for the corporations. For the success of this type of corporate governance non-misleading presentation of accounting information is important. Transparency and disclosure becomes another mechanism of corporate governance in the shareholder-oriented model.

External, market based governance mechanisms are more relevant in developed countries where ownership is disperse and the capital markets, as well as external audit functions, are well developed. While the dispersed ownership type is the prevailing type in some of the developed countries, developing countries are characterized by concentrated ownership structure. In developing countries, the relevant conflict of interest is not between the managers and the shareholders but between the controlling shareholders and the minority shareholders. In most of the developing countries, there are few number of controlling shareholders which are inside, the company therefore

2 Capitalism assumes that each player seeks his own interest rather than serving a common interest.

have direct access to management. It can be generalized that, in developing countries, the controlling shareholders manage the company themselves, they are either managers or have very close control of the managers. Consequently, market based governance mechanisms that assume dispersed ownership structure is largely ineffective for directing and controlling the companies in developing countries. Moreover, the focus of the shareholder-oriented model remains largely inadequate to address the global issues influencing both developed and developing countries.

In the stakeholder-oriented model of corporate governance, the aim of the corporation is to create wealth and value for all of its stakeholders. The company has obligations not only to the shareholders, but to all stakeholders including the society at large. The ownership of the corporation is characterized by the presence of a small number of controlling shareholders, such as banks, industrial corporations (Jeffers, 2005). Long-term relations exist between the controlling owners and the company. Corporate governance mechanisms are exercised by various stakeholders having an interest in the company. Main corporate governance mechanisms are *internal* to the corporation, in a way to align stakeholders' interest in wealth creation as a whole.

Context Dependence of Corporate Governance Models

These two models briefly explained above relate to different legal origins and financial systems. While shareholder-oriented model is identified with the common law origin and capital market dominated financial systems, stakeholder oriented model is associated with the civil law origin and bank dominated financial systems. Between the two models, there exist a variety of models depending on the relevant contextual characteristics. While neither model is ideal, both has its strengths in different contexts. Corporate governance systems of different countries exhibit a great variety in different countries as a response to the differences in their historical, social, political and economic characteristics. Although globalization has created some common issues and challenges; regions and countries face a unique set of challenges and are equipped with different contextual qualifications. Broadly classified, developed and developing countries have different sets of issues to be resolved together with a common but changing global agenda.

Corporate governance systems should be able to attend to these challenges in a way to fulfill the aspirations of societies. A good corporate governance is a

system that develops mechanisms to direct and control the corporations in a way to fulfill these changing aspirations through attending to the challenges. In his analysis of corporate governance systems of five countries,[3] Charkham (1994) develops a framework of the characteristics of a good corporate governance system. Accordingly, the main strength of a good governance system lies in its ability 'to give power to those best able to use it and remove it if they use it poorly or evilly'. Accordingly, corporate governance system should be able to develop checks and balances on the exercise of this power and its peaceful transfer, in a way to make sure that the corporations consistently achieve economic and social ends. He suggests dynamism and accountability as the criteria for assessing its economic performance.

DIVERSITY AND CONVERGENCE WITHIN DEVELOPED COUNTRY CONTEXT

It is important to note that the progress in corporate governance concept and models is mostly developed country-based. However, the concept and models exhibit very important differences within developed countries, as well. The German two-tier management and Japanese type of management set prominent examples for the differences within developed country practices. Vanek (2006), who has pioneering studies on economic democracy, notes that, 'The two perhaps most successful western economies, those of Germany and Japan, performed exceedingly well while they practiced some degree of worker participation, in Germany through the system of co-determination, and in Japan through a "family-like" position of the worker in the enterprise'. In most of the developed countries, especially in the UK and US, corporations have a single board system with no mandatory labor representation. On the other hand, in Germany companies have a dual board system, including a managing board and a supervisory board, where labor and banks are represented on the supervisory board. German two-tier board system takes its roots from the national historical and institutional developments of the 19th century. While Germany sets a good example of the influence of historical and institutional factors on the diversity observed within developing countries, recent changes in its governance structure also point to the forces of interaction and convergence in government models. Due to the dynamic nature of corporate governance needs, Germany has made some amendments[4] on its Corporate Governance Code on 14 June 2007. The foreword of amended code draws attention to the

3 Germany, Japan, France, USA and UK.

4 We recommend reading the current version of the German Corporate Governance Code (Government Commission, 2007).

convergence of the dual-board and the single-board systems due to the intensive interaction of the Management Board and the Supervisory Board in the dual-board system. Furthermore, the possibility of adopting the single-board system is given to the companies in Germany through the European Company (SE) statute. On the other hand, the European Union has also accepted the dual-board system. Thus, corporate governance models are country specific but evolve by incorporating elements from each other.

Consequently, differing economic and social goals in different societies and at different times call for the presence of a variety of corporate governance models, which are also able to evolve over time depending on the aspirations of the societies. Convergence to a static model is not in line with the rapid rate of transformation that the world is going through and the severity of the global problems to be addressed. The system should be dynamic, be able to evolve to facilitate progress and deal with the common pressing problems by identifying common elements that underlie good governance. To handle economic and social issues that are specific to different parts of the world, variety in corporate governance is needed. This variation in governance models is also suggested to provide possibility for evolution of the common elements that underlie good governance.

In the following sections of the paper we will analyze in detail the evolution of the corporate governance concepts to have a better understanding of its dynamics before discussing the directions for future development and the potential contribution of the developing countries.

Mainstream Corporate Governance Literature: Shareholder Oriented

The first scholarly books with the title of 'corporate governance' started to appear in the early 1990s and increasing academic interest followed from that period onwards. Subsequently, there has been a flood of academic studies together with a diverse body of studies from various institutions such as institutional investors, rating agencies and international organizations. While the topic has become a fad, theoretical and empirical research has mainly focused on UK and USA, taking into consideration the relevant contextual characteristics of these countries and implicitly assuming dispersed ownership structure and market capitalism. This was mainly under the influence of the development of the theory of the firm, which was led by US scholars in a period

of 'ideological contest between capitalism and communism' (Turnbull, 1997). With the presumed victory of market capitalism, US form of corporation has gained acceptance. Consequently, shareholder-oriented model of corporate governance has become the dominant model in the extant literature.

The shareholder-oriented model has developed in countries characterized with strong legal protection of shareholders. In these countries, companies have dispersed ownership structures, raise financing majorly from the market and are subject to the discipline of the market. Bank financing and other stakeholders are relatively less significant. Within this context, ownership and management is separate and the major conflict within the company is between the shareholders and managers. Therefore, monitoring of managers so that they act in the interests of shareholders becomes the central issue, this is performed internally by the board and externally by the market discipline as it was explained above. Thus, independent directors, board committees dominated by outsiders, link between management compensation and firm value, independent audits and transparency and disclosure have become the major mechanisms of corporate governance in the shareholder-oriented model. These mechanisms form the backbone of the good governance principles suggested to companies worldwide. Furthermore, global corporate governance literature, which is dominated by US scholars, largely ignores the importance of cultural, economic and institutional factors and predicts convergence to US shareholder-oriented model (Branson, 2001).

DISSEMINATION OF THE SHAREHOLDER-ORIENTED MODEL

Globalization has contributed to the spread of this dominant shareholder-oriented model to companies worldwide, without much consideration of the relevance of the assumptions of the model in different contexts. Countries and companies have become increasingly dependent on the global capital and especially developing countries have realized the need to improve their quality of governance, discipline managers and increase transparency in order to attract this global capital (Friedman, 2000).

Along this line, there has been a proliferation of corporate governance codes.[5] Good corporate governance principles have been developed and suggested to companies worldwide, focusing majorly on the shareholder-oriented model. Upon the declaration, during the G7 Summit in 1997, that corporate

5 See an extensive list of 70 country or region codes on the European Corporate Governance website http://www.ecgi.org/codes/all_codes.php.

governance would be one of the pillars of the economic architecture of the 21st century; the OECD has drafted its Corporate Governance Principles in 1999. These OECD Principles that were subsequently amended in 2004, have become the benchmark for good governance for developing as well as for developed countries (Mallin, 2004). Around the same time, IMF and Worldbank have also supported developing countries to prepare their corporate governance codes in line with the OECD Principles. Many companies have developed or revised their codes during the early 2000s. Acknowledging the presence of alternative models of corporate governance, OECD Principles aim to identify 'common elements that underlie good governance' (OECD, 2004), however the emphasis is still on shareholder-value model. OECD states 'corporations should be run first and foremost in the interests of the shareholders' (OECD, 1999).

Pressure from global institutional investors have also helped the adoption of the dominant model and related principles worldwide. Global institutional investors have developed their own codes[6] and held them as guidelines in forming their investment strategies. As competition for global capital increased, adopting good governance principles has become necessary for companies to attract and retain investment capital.

The motivation behind advocating these principles is that good governance is assumed to provide increased access to capital, lower the cost of capital and thus increase the value of companies. However, the results of empirical studies are largely conflicting in nature with respect to the link between governance and firm value mostly because of the irrelevance of the assumptions of dominant shareholder-oriented model in different contexts. There is no clear relationship between differences in corporate governance and firm performance across countries (Thomsen and Pedersen, 1996). However, this link between corporate governance and performance is used in order to facilitate the spread of the model

LIMITATIONS OF THE SHAREHOLDER-ORIENTED MODEL

One of the most prominent limitations of the shareholder model lies in its objective function of shareholder wealth maximization. Under this objective function, the responsibility of the corporation is solely to its shareholders.

6 Outstanding examples are codes of TIAA-CREF (Teachers Insurance and Annuity Association – College Retirement Equities Fund) and Hermes Fund. TIAA (2007) Policy Statement on Corporate Governance, http://www.tiaa-cref.org/pubs/pdf/governance_policy.pdf; Hermes Pensions Management Limited (2006) Hermes Principles http://www.hermes.co.uk/pdf/corporate_governance/Hermes_Principles.pdf.

In the corporation where shareholders contribute financial capital and employees contribute human capital, objective function of this model favors the shareholders and aims to maximize the wealth of this group. It is implicitly assumed that increasing the profit or value of the corporation requires lowering costs, including the labor costs. The underlying assumption is that since shareholders are entitled to residual cash flows, they assume all the risks of the business, thus deserve favorable treatment. This assumption ignores the risks assumed by the laborers. Ghoshal (2005) criticizes the mainstream theory and its assumptions and claims that the assumption of the theory is responsible for its failure. He states that through these invalid assumptions 'elegant mathematics of principal-agent models are applied to the enormously complex economic, social and moral issues related to governance of giant public corporations that have enormous influence on the lives of thousands – often millions of people'.

A related limitation arises from the fact that the shareholder-oriented model have not proven to be adequate in effectively directing and controlling the corporation. Effectiveness of the model has started to be questioned after a series of corporate failures starting with Enron in 2001. Enron symbolized US corporations and the ideal application of the shareholder-oriented model of corporate governance. In their article, Deakin and Konzelman (2004) argue that the reason of the corporate failures lies not in the inadequate application of the shareholder-oriented model but in weaknesses of the shareholder-oriented model itself. They hold 'laser focus' on shareholder value, which reflected into the business plan and accounting policy, to be responsible for the failure. Moreover, suggested governance mechanisms of the model have also been ineffective. Corporate governance reforms following the corporate failures have tried to strengthen the existing mechanisms of the model. But, a study of governance reforms reveals that before their bankruptcy corporate governance attributes of the major corporate failures in US would have satisfied the requirements of the new rules (Petra, 2006). These observations supported the proposition that shareholder oriented model neither leads to sustainability of the corporation nor increases the welfare of the stakeholders, including the shareholders.

Ignorance of contextual factors is another important limitation of the shareholder-oriented model. Differences in historical, cultural and institutional factors are largely ignored in this model. Branson (2001) attributes this ignorance largely to 'insularity and cultural insensitivity' of the US corporate governance scholars, that dominate the literature. In their influential book titled '*The Myth of the Global Corporation*', Doremus et al. (1998) argue for the

importance of national factors in shaping the firm-level corporate governance structures and long term financing patterns. They suggest that institutions and ideologies that shape throughout the unique history of a nation are the basic factors influencing the firm level governance structures. The resulting corporate governance structures define the competitive advantages of the companies in that given context. Shareholder oriented model has limited application in different contexts than the one in which it has developed. It has developed 'in cultures committed to competition with strong antitrust laws and large scale publicly traded firms without related party transactions' (Turnbull, 1997). Therefore, the model is less applicable in alternative settings that strongly relate to the developing country settings.

Furthermore, shareholder-oriented model, which focuses solely on maximizing the value of the company, has also been insufficient to address the current urgent issues of the world, such as environmental degradation, unacceptable distribution of income and poverty. Furthermore, it remains to be an inadequate model for the governance of global multinational companies (MNCs), which have moved outside the realm of the control of the national governments. Issues such as worker exploitation, child labor, human rights, and plantation production were not effectively addressed using the shareholder-oriented model. In fact, shareholder oriented model has contributed to most of the problems of globalization as companies tried to maximize profits using the tools of economic liberalization. With the objective of shareholder maximization, companies focus on maximizing their short term profits and environmental protection and social measures are treated as costs to be minimized while the costs to the society do not accrue to the corporations. Thus, corporations contribute to most of the environmental degradation since the cost of this degradation is a cost on society but not a cost item for these corporations. These limitations of the shareholder model, together with the increased awareness on the global economic problems, contributed to the recognition of the stakeholder-oriented model in corporate governance literature.

EMERGENCE OF STAKEHOLDER-ORIENTED MODEL

While the shareholder-oriented model, based on the US form of corporation, has contributed to the innovation and economic growth, it has not been able to resolve the current problems of globalization. The limitations of the shareholder-oriented model coupled with pressing problems of globalization have lead to the incorporation of other stakeholders' interests into the US corporate governance literature. In her review of US corporate governance research from

the perspective of financial economists, Denis (2001) reports a disagreement in literature with respect to the objective function of the firm following the dramatic changes in the nature of the corporation in the last twenty-five years. Besides maximization of firm value for the shareholders, attending to other stakeholders, especially attracting and retaining human capital, have become critical concerns for companies. Along with employees, other stakeholders' interests, including the general society, have started entering into the objective function of the corporations. This has been an important development in corporate governance. However, the stakeholder-oriented model of corporate governance is not considered to be without limitations.

Stakeholder-oriented model of corporate governance is claimed to lack academic rigor. Although it has a conceptual appeal, it is criticized for failing to specify the ways to resolve trade-offs among competing interests of various stakeholders. Both profit and value maximizations are easily defined objective functions. But, it is not possible to reduce these competing interests of various stakeholders to a simple objective function. Jensen (2002) claims that stakeholder theory may reduce managerial accountability and make purposeful decisions impossible due to the presence of multiple objectives. Additionally, adopting a stakeholder-oriented perspective requires a change in foundational moral principles rather than mere change of objective function. Philips (2003) proposes the principle of 'fairness' in the management of stakeholder interests. There is also an increased public pressure in favor of 'fair wage', 'fair price', thus 'fair trade'. However, adopting the principle of fairness has its own challenges, since fairness itself has different meanings and respect in different cultures. In spite of the difficulties, alternative principles and objective functions have started appearing in corporate governance literature. While developing countries are adopting the elements of corporate governance systems from developed countries, developed countries are also incorporating principles from eastern philosophies into their corporate governance systems. Empirical studies on companies worldwide aim to document the existing state of corporate governance models and their determinants.

RECENT EMPIRICAL STUDIES

Empirical studies on corporate governance in different parts of the world include both comparative studies using a large sample of companies worldwide and case studies of corporate governance in a specific country. Case studies include developed countries such as Japan, Germany, Italy, France as well as developing ones like Russia, Slovenia, Turkey, Korea, and Brazil. One of the

deficiencies of most of the empirical studies is that they still utilize the main assumptions and investigate the dominant mechanisms of the shareholder-oriented model. They usually reach bold conclusions with little analysis and citation and involve implications along the lines suggested by the shareholder models (Branson, 2001).

In these comparative studies, corporate governance systems are usually assessed using scales, which are based on the international codes. In multi-country studies, the most frequently used corporate governance indices are CLSA (Credit Lyonnais Securities Asia) and S&P indices. Using these indices to assess the corporate governance structures of companies in different contexts has serious limitations, therefore in case studies context specific indices are usually developed by researchers (Black et.al., 2006). Furthermore, only a few large, publicly listed companies from a large number of countries are included in the samples of the comparative studies and small and privately held companies are mostly unrepresented. However, most of the economic activities, especially in the developing countries, originate from non-listed, privately held companies. The sample characteristics of the multi-country studies cause the distorted and inadequate representation of companies from developing countries.

In spite of their limitations, comparative multi-country studies[7] generate important insight into the corporate governance models and their determinants. Conflicts in some of the findings mainly arise from their methodological problems and irrelevance of some their assumptions in different contexts. Overall, these studies reveal the wide variation in firm-level governance and provide evidence for the country-specific factors in explaining most of the variation in corporate governance. In other words, strongest determinant of variation seems to be the country-specific characteristics rather than company-specific characteristics.

The findings seem to support the logical chain suggested by Doremus et.al. (1998) that firm level structures of corporate governance are determined by domestic institutions and ideologies, which are the product of unique national histories. Similar logical chain is proposed by La Porta et.al (2000) in which historical and political forces shape the laws which in turn shape the corporate governance and financial systems in different countries. This logical chain is defining how well investors are protected in a given context. Thus, legal origin is suggested to determine investor protection at the country level. 'Good' investor protection is found to correlate with larger securities markets and less

7 Klapper and Love (2004), Durnev and Kim (2005), Khanna et.al. (2006), Doidge et.al. (2007).

concentrated ownership structures, while ‘poor’ investor protection is found to correlate with concentrated ownership structures (La Porta et.al, 2000). Developing countries are typically characterized by concentrated ownership structures. In concentrated ownership structures, the controlling shareholders are mostly families or state (Claessens et.al, 2000). In fact, the dominant governance system in the world is not the Anglo-American shareholder model but the family controlled model (Morck and Steier, 2005). This finding supports the irrelevance of the corporate governance mechanisms derived from the shareholder-oriented model for most of the other countries, especially for the developing countries.

Our state of knowledge on developing country corporate governance models is very tentative and incomplete, but there is some empirical evidence on certain dimensions. Group affiliation is one of those dimensions. In his review of empirical studies on the role of business groups in developing countries, Khanna (2000) identifies a generally positive effect of group affiliation of the performance of companies. There also seems to be increasing evidence on the presence of a potential for minority expropriation in pyramidal ownership structures. While impacts of certain corporate governance models are more understood, the mechanisms that lead to the observed impacts remain unclear and poorly investigated. Recent empirical studies provide a general evidence for the importance of contextual factors in shaping the ownership structures and corporate governance systems. In other words, cultural, historical, political factors largely shape the institutional and corporate governance structures. Consequently, companies in different countries have different sets of corporate governance characteristics and related problems, which necessitate different mechanisms of directing and controlling.

Developing countries have very different historical, cultural and institutional characteristics than the developed countries. The ownership and management structures, management styles, core values of managers, environmental and institutional settings are all very different. These differences present three important opportunities: First, these developing countries should be in search of the appropriate corporate governance systems that best suit them in order to strengthen the foundations of their economies. This is an opportunity that will provide the dynamism for the evolution of corporate governance. Second, these differences may present opportunities for the companies in developing countries to gain competitive advantages in competing with the developed country companies. The third opportunity is a universal opportunity: Cross fertilization between the corporate governance systems developed in the

developed and developing countries may help to create better corporations to serve international community. In spite of these opportunities, forces of globalization may operate in a way to decrease the importance of contextual factors.

Convergence in Corporate Governance Models

Vast body of literature deals with the impact of globalization on the corporate governance systems. While some predict convergence to the US shareholder-oriented model, others argue against such convergence and expect a convergence to some hybrid model between shareholder and stakeholder-oriented models.[8]

Arguments against convergence to the shareholder-oriented model also stress the importance of contextual factors. Guillen (2000) groups arguments against convergence as legal, institutional and political reasons against convergence. Legal arguments emphasize that laws and regulations develop in a path dependent manner and thus are resistant to change. Institutional arguments state that institutional structures offer companies and countries different competitive advantages on which they reside. Countries might be addressing governance issues through different institutional arrangements. Political arguments suggest that domestic politics influence how globalization and external trends interact with governance structures. While benefits from adopting a common governance practice might be apparent, countries might refuse to change their style politically. There are also strong cultural barriers in implementing corporate governance standards developed in different contexts. For example, corporate governance standards that have developed in highly individualistic cultures cannot be used to direct and control the companies in conformist and collectivist cultures. All these arguments support the notion of 'sticky governance' based on the observation that companies can change their governance slowly in response to economic factors (Black, et.al, 2006).

Empirical studies fail to provide clear evidence on convergence in corporate governance practices. Distinguishing between *'de jure'* and 'de facto' convergence clarifies the existence of conflicting findings. Using a large sample

8 Influence of globalization on the business system is outlined in four scenarios in Lane (2000): 1. convergence toward the Anglo-American neo-liberal market system 2. greater specialization in domestic model in line with institutional characteristics 3. incremental adaptation of the domestic business system in a path dependent manner 4. evolution of a hybrid system in a path deviant manner.

of companies from 49 developed and developing countries, Khanna et.al (2006) report a strong evidence for *de jure* convergence. This convergence in rules and regulations is found to be driven not by US corporate governance, but by economic linkages. Corporate governance of economically interlinked countries is documented to display *de jure* convergence. However, they find no evidence for de facto convergence and conclude that although common corporate standards adopted, they are not actually implemented. Difficulties in implementation are also documented by opinion surveys. A survey of executive opinions in Germany reveals a wide variety of opinions on the reform of the German system along the lines of OECD principles, together with an overall demand for flexibility in designing company specific governance mechanisms and incentives (Peck and Ruigrok, 2000).

Currently, country-specific governance models seem to prevail, there seems to be a limited convergence in standards due to the pressures from globalization. But this increasing similarity in standards is not reflected to company practices. In fact, countries and companies are benefiting from their divergence and developing their competitive advantages according to their distinctive corporate governance systems. However, a consensus on common principles seems to be necessary considering the common global problems and unique needs of the developing countries. The variation in corporate governance models is also a precondition for the dynamism and development of the common principles of good governance. Thus, a convergence on common principles and a divergence in governance mechanisms may be proposed.

At this point, it is important to clarify the meaning of convergence. Convergence may be understood as adopting corporate governance models from the developed countries. In fact, globalization does attempt to provide grounds for such adoptions. As it is explained above, the empirical studies have not found wide scale 'successful' adoptions. In fact, an approach of picking up the best governance mechanisms from a multiple developed country systems has proved to be inadequate in Slovenia, which adopted its governance systems from UK, Germany and US (Garrod, 2000). Thus, it can be argued that successful adoptions may not be what we actually need. We may need a different type of convergence: A cross-fertilization between corporate governance practices of countries of different cultures; or a cross-fertilization between corporate governance practices of developed and developing countries. Defining convergence as adoption of the best practices from the divergent systems through cross-fertilization, corporate governance practices may evolve to serve the aspirations of mankind. In such a convergence, we may argue that a

convergence in common principles of corporate governance will also preserve diversity in corporate governance mechanisms to suit the different cultural and contextual characteristics of the nations. It could be argued that one of the common principles may be the need of diversity. Through such a conversion, we may be able to direct and control the corporations in a way to achieve the aspirations of the societies. This convergence-in-diversity perspective can also provide opportunities for developing countries both to contribute to the common principles in a way to offer solutions to common global problems and to adopt principles to spur their economic development and growth.

FUTURE AHEAD AND THE POTENTIAL FOR DEVELOPING COUNTRY CONTRIBUTIONS

Great developments have been witnessed in corporate governance in recent years, but great challenges still remain. It is encouraging to observe accelerated improvements in many factors influencing the developments in corporate governance over the recent decades. The most important one is the aspirations of the society. Severe global problems, such as environmental degradation, unequal income distribution, poverty, have restructured societal aspirations. At no time in history, the global society has been aware its aspirations that much and at no time in history, the global society had the means to realize its aspirations.

Corporate governance may be a means to manage the affairs of a corporation to meet the aspiration of the society. Society wants the corporations to be managed to serve all concerned. Society wants the companies managed in such a way that due respect will be paid to nature. Society does not want exploitation of any member of the related interest groups. In the future, companies will face more and more pressure to reshape their management to meet these demands. These demands have both universal and country specific dimensions. These demands with multiple dimensions will require different solutions in different countries, in different cultural and institutional contexts. Each country, developing or developed, must create solutions for their specific case and try to benefit from the solutions developed by other countries.

Corporate governance concepts have initially started with the objective of serving the capital owners. Developed countries have important problems in meeting this objective because of their dispersed ownership structure, characterized by the separation of ownership and control. Developed countries also possess some institutions to attack the problem. Developed capital markets

and external audits provide some tools to design a corporate governance system. On the other hand, developing countries do not suffer the same problem. Managing owners are in position to direct and control the corporations. Even at that stage, developing countries face other problems arising from their institutional and cultural characteristics. Managing group of companies and related transactions, attending to the problems of the controlling family, managing succession and family fragmentation are among the governance problems of the developing countries. Furthermore, organizing economic activity in a way to generate economic growth, innovation and employment are some of the challenges of developing countries. Most of the Eastern companies have a unique management practice for employee and customer relations, which fits best with the value systems in their societies. Examples of guiding employee relations with parental motives through creating a family atmosphere in the workplace and building relations with customers on the principle of 'service'[9] indicate the importance of cultural values in shaping management practices. In fact, some of the corporate governance practices by Eastern companies seem to be difficult to comprehend in other cultures.

Some of the developed countries have taken labor into account in their corporate governance models, as a result of their historical and institutional developments. Dual-board system provides solution for the representation of labor in the governance process. Two-tier, dual-board implementations are gaining wider acceptance in developed countries, as importance of human capital increases. Although dual-board system is one of the mechanisms for attending to an important stakeholders' interests, the institutional requirements of the dual-board system may not be present in developing countries. Developing countries might utilize other mechanisms that substitute the dual-board system. An example for a model that is used in some of the Eastern countries is the family type governance. It is common in many developing countries for workers to see their owner-manager as a father, who usually treats their employees as sons and daughters.

This type of corporate governance practices are very common in traditional sections of Turkey. These companies are homes for employees, owner-managers care for the health of the employees' families and feel responsible for the education and wedding of the children of the employees. Utilizing stronger family relations in the workplace might be an alternative mechanism for attending to the stakeholders' interests.

9 In Turkey a proverb goes 'Serving people is serving God'.

Although both developing and developed countries seem to agree on the common principle of enlarging the objective function in a way to include other stakeholders, the mechanisms that they use largely differ. At the current state of development, there seems to be a general consensus on the principle that companies should be directed and controlled to serve the benefits of all stakeholders. But, no corporate governance model has yet developed to achieve this end. Designing a satisfactory corporate governance model to balance the interests of all stakeholders seems to be a difficult task. The accomplishment of this task may require the development of a new concept, such as the concept of 'economic democracy'. Development of such a concept is not easy. In search of such a new concept, both developed and developing countries have to revitalize and cross-fertilize their human-based, rather than money-based value systems

Whatever the definition attributed to 'economic democracy', corporations will have to define corporate governance systems to serve the benefits of all stakeholders. The most difficult part of serving the stakeholders and preserving the environment is assigning weights to different dimensions of interest. Vanek (2000) claims that economic democracy requires participation of every one according to their intensity and quality of involvement, which are qualitatively distinct, and cannot be quantitatively compared to each other. Vanek gives some examples for different kinds of quality of involvement:

1. intellectual involvement;
2. indirect involvement;
3. direct involvement;
4. vital involvement;
5. parental involvement;
6. spiritual involvement; and
7. loving involvement.

We summarize the dimensions provided by Vanek, only to illustrate the complexity in the development of corporate governance models that will facilitate 'economic democracy'. However, both developed and developing countries will have to endeavour to meet societal aspirations of global

sustainability. Companies in developed countries face increasing societal pressure for sustainability. If the developing countries are successful in developing creative models, cross fertilizations with developed country models may help to produce corporate governance systems that will serve humanity. Currently there are some signs to be optimistic in this regard.

There are various emerging examples of developing country influence on corporate governance practices. Recently an Eastern concept of management, 'karma capitalism' is attracting increased attention in management circles in the US, where the approach to corporate governance is mainly shareholder focused. Applying the principles of *Bhagavad-Gita* to management and governance, Indian theorists and American management consultants have been developing concepts for American corporate managers. One of the concepts is the principle that 'executives should be motivated by a broader purpose than money'. Another one is the principle that 'companies should take a more holistic approach to business, one that takes into account the needs of shareholders, employees, customers, society, and the environment' (Business Week, 2006). Prahalad, a consultant and University of Michigan professor calls it 'inclusive capitalism'. 'It's the idea that corporations can simultaneously create value and social justice.' (*Business Week*, 2006).

Cross-fertilization of principles of the developed and developing countries may provide an opportunity for the design of corporate governance models that are able to serve the interests of all the stakeholders. For addressing global problems, convergence in principles might be facilitated by integration of the developed and developing country values. At the same time, presence of diversity in developed and developing country models may help in the evolution of corporate governance in facing the new challenges. Different countries with different cultures and regional cultures within countries provide rich examples of corporate governance concept and models. Corporate governance models of these countries and regions need to be researched and studied for better fertilization of corporate governance practices in order to serve better the aspirations of nations and humanity at large.

Conclusions

Corporate governance and its mechanisms evolved in the developed countries in a way to meet the demands of the shareholders in the earlier stages and the stakeholders in the later stages of its development. The evolution

responded to the problems to be addressed, which were dependent on relevant contextual characteristics. The models developed for corporate governance aimed to resolve the agency problems of the dispersed ownership structure. In this ownership structure, a conflict of interests between the shareholders and managers was present due to the separation of ownership and control. Corporate governance models defined ways of monitoring the managers so that they act in the interests of shareholders. Monitoring of managers is performed internally by the board and externally through the discipline of the market. Thus, independent directors, board committees dominated by outsiders, link between management compensation and firm value, independent audits and transparency and disclosure have become the major mechanisms of corporate governance in the shareholder-oriented model. Within developed countries, variety also existed depending on contextual characteristics. Other stakeholders, such as employees and banks, were represented in the advisory board in the two tier board systems. Developments in corporate governance have been context dependent.

In the process of globalization, developed countries tried to expand their corporate governance practices to developing countries. Developing countries and companies in those countries, which were in need of capital for economic growth, were ready to adopt these corporate governance models of developed countries. However, adopting governance standards and mechanisms from other settings have mostly proved to be ineffective in addressing the governance issues of developing countries. Empirical studies show that these adoptions were *de jure* adoption rather then de facto.

'Good' corporate governance implementations very much depend on the problems they address, institutional settings that provide tools for solutions and the cultural settings. That is, good governance implementations cannot be copied from other nations and communities. This means, developed country practices should not be imposed on developing countries. Developing countries must be in search of models that solve their problems and suit their contextual characteristics. This will provide opportunities to developing countries to design systems to provide them with competitive advantages and to contribute to the evolution of corporate government practices. We argue that although corporate governance principles cannot be copied, they yield themselves to cross-fertilization. Both the developed and developing countries are faced with severe global problems such as environmental degradation, income inequality and poverty. Corporate governance mechanisms of the developed countries have not been effective in addressing these challenging global problems. In

fact, developing countries with diverse cultural context, have a great potential to contribute to global evolution of corporate governance implementations, in a way to fulfill societal aspirations.

The future of corporate governance may lead to 'economic-democracy'. It is quite possible that search for better governance in developing and developed countries, through a process of cross-fertilization, may lead to a better corporate governance model that enables economic democracy. In such an economic democracy, all stakeholders may contribute to decision and control mechanisms of companies according to their intensity and quality of involvement, in a way to direct and control the corporations for the common good of the society.

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7

Corporate Social Responsibility among SMEs in Uzbekistan

Azim Raimbaev

Introduction

Uzbekistan is one of the newly independent states in Central Asia making its way towards a market economy. It has a strong commitment to the Uzbek culture, which has evolved over the centuries. Developing the Small and Medium Enterprise (SME) sector was chosen by the state as one of the preferred tools for improving social welfare. The SMEs account for nearly 80 per cent of companies and over 60 per cent of employment in Uzbekistan. This chapter focuses on the Corporate Social Responsibility (CSR) activities of the Uzbek SMEs. It observes the internal and external motives for their CSR. CSR among the Uzbek SMEs can be considered of a philanthropic nature and does less based on the 'business case'. The main internal motive for Uzbek SMEs is to comply with the community and religious norms. Externally, the state is actively initiating social and environmental programs, which normally involve a contribution from businesses. These programs are usually implemented through the local communities (*mahallas*). With current stable economic growth, businesses have an opportunity to devise long term plans and the CSR can be seen by them as a means of sustainability. Also, there is a growing pressure on export oriented SMEs from international markets, which demand the exporting companies to be responsive to the society needs.

Uzbekistan has the largest population among the countries in Central Asia, which amounted to 25.5 million in 2003. 77.2 per cent of the population are Uzbeks, and the rest are Russians, Tajiks, Kazakhs and Tatars. Uzbekistan is one of the largest cotton producers in the world (Country Profile, 2008)

Over 67 per cent of its Gross Domestic Product (GDP) is made up by the non-state sector and the share of small and medium enterprises (SMEs) in the GDP is equal to 38 per cent. Expenditures on social protection constitute the largest part of the public budget and equal 11 per cent of the national income. The SMEs account for nearly 80 per cent of all companies and 66 per cent of the employed in the country (Uzbekistan Economy, 2005).

Clearly, SMEs are very important for the Uzbek economy and its social well-being. However, private entrepreneurship is a new concept in this former planned economy. Before the break-up of the Soviet regime, entrepreneurial activity had been punished under Soviet law. The state, while being the only regulating body, could not effectively manage the economic system. The companies tried to reduce their production plans and increase the resources received from the state, while officials (e.g. ministries, Gosplan) did the opposite. The ethical issues in such an environment had a 'highly personalized' form (Avtonomov, 2006). Uzbekistan was the cotton producing centre of the Soviet Union and therefore specialized in the agricultural sector. People involved in the cotton production worked collectively within the so called 'kolkhoz' – regional administrative units. Kolkhozes were under pressure to fulfil the plan imposed by the central government. If the 'kolkhoz' failed to reap the planned volume of cotton production, its chairman would be prosecuted.

The plan was the highest priority. The state implemented even those production processes which were harmful to health. People had no 'say' in decisions which would directly affect their well-being. The Soviet regime neglected issues related to environmental protection for the sake of the plan. One example is the Aral Sea. It is located in Central Asia and shared by Kazakhstan, Kyrgystan, Tajikistan, Turkmenistan and Uzbekistan. The Aral Sea used to be the fourth largest inland water basin until the Soviet economy started to divert the waters of its main river sources – Amudarya and Syrdarya – to cotton fields in Uzbekistan. This was part of the 'Aral Sea Plan', which entailed doubling the irrigation area between 1960 and 1990 (Aslov 2003, see Aral Sea). By now the Aral Sea has lost half of its surface area and three-quarters of its water resources, its salinity tripled – all outcomes of the 'cotton monoculture' imposed by the former planned economy (Aral Sea).

There are many arguments claiming that the main aim of the SMEs is to survive in a competitive environment, rather than spending time and resources on addressing business ethics. This seems to be especially true in developing countries. However, case studies of SMEs, like the Grameen Bank, which has

managed not only to survive, but also to achieve significant results in the global arena, suggest that firms can be financially successful and, at the same time, remain ethical (Enderle, 2004). Since Uzbekistan gained independence from the Soviet Union, state property has been gradually privatized. Some of the state assets were turned into new private SMEs. Given the challenges of the transition period, owners of SMEs would prioritize profit maximization, and business ethics would not be the first item on their agenda.

Factors which motivate SMEs to adopt the ethical norms can be divided into internal and external. Research by Brown and King (1982) implies that, in terms of the internal factors, SMEs, for example, in the US, place the highest importance on pressure from the community, while the threat of punishment from the government has a little influence on their decisions. These SMEs identify competition as the most important external factor. Following Brown and King, it would be interesting to see which internal and external factors which are currently motivating SMEs in Uzbekistan to carry out CSR.

Internal Factors

For Uzbek SMEs, decisions on CSR largely depend on the personality of the owner. This coincides with the attitude of Asian businesses in other countries towards business norms. For example, in the Asian small enterprises located in the UK the philanthropic motive of the owner is the main driving force behind CSR. They run CSR activities informally and on an ad hoc basis (Worthington, Ram and Jones, 2006). It is argued that the owners of the Asian SMEs put the highest priority on religious principles.

In the context of the Uzbek SMEs, the pressure from the community is one of the most important internal drivers. Traditionally, Uzbeks prefer to live in extended families, show respect to the elderly and obey local ethical rules. However, depending on the region and individual character of entrepreneurs, the commitment to the religious norms may be greater than the sense of obligation towards traditional values. These two self imposed codes of conduct have many overlaps between them, because historically the Islamic norms have had a significant influence on the lifestyles of the local communities (mahallas).[1]

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1 Based on the results of interviews with the SME owners from the different regions of Uzbekistan. The interviews were run in November of 2006 within the CSR-SME joint project of Westminster International University in Tashkent with the Chamber of Commerce.

Graafland, Ven and Stoffele (2003) find that for small firms, unlike for large companies, informal rules are very important. It is often a business owner who communicates norms and values to the employees. While this is also the case for the Uzbek entrepreneurs, the SME owners in Uzbekistan themselves try to follow the informal rules set by the mahallas.

Mahallas are administrative units, which are comprised of around 2,000 people. There are about 10,000 mahallas all over the country. The mahalla has its own tradition and customs which people and businesses in that community follow. For example, if someone is running a wedding ceremony, people in the mahalla come to help with its arrangements. The same is true in the case of other social events. The mahalla chairman, elected by the majority of voters, calls people and businesses in the neighbourhood to make donations to the needy and sometimes to construct schools or kindergartens.

External Factors

Uzbekistan is famous for its practice of turning the informal social unit – mahallas – into a formal one and using it for the better allocation of budget and non-budget funds to the socially vulnerable people. This transformation was done through passing the Mahalla Law.[2] The Law aimed to 'formalize' informal norms and regulations (i.e. tradition, customs) and is a legal foundation for the Mahalla Fund. The Fund unites all mahallas in the country and serves as their coordinating body. Mahallas participate in the allocation of state transfers to the needy, organize various social events and interact with the local entrepreneurs in addressing social and environmental issues.

However, the influence of mahallas on entrepreneurs is no longer limited to supervising the voluntary initiatives of the latter. Mahallas collaborate with various authorities and follow action plans devised by the Mahalla Fund. The action plan normally anticipates the active involvement of businesses operating in the neighbourhood and therefore serves as one of the external factors for CSR.

The government of Uzbekistan chose a gradual approach in the transition to a market economy with a strong emphasis on social protection. At times when newly privatized companies were struggling with financial and administrative difficulties they were not supposed to engage in CSR because it

2 See the Decree of the President of Uzbekistan (1992) on the setting up of the Mahalla Fund.

was not seen as a profit generating activity. Therefore, state intervention seems to have been necessary. To make companies more socially responsible, the government of Uzbekistan has passed laws on consumer and environmental protection and implemented standards for the imported goods and licences for alcohol retailers. These measures are seen as the external factors which make companies in Uzbekistan, including SMEs, pay attention to the needs of society. A similar move can be observed even in countries with high income levels. For example, the development of CSR in the US is mainly due to public regulation. Institutions such as the Occupational Safety and Health Administration, Equal Opportunity Commission and others set up the standards which regulate CSR. In contrast, the CSR is Latin America is much weaker than in the US as a result of weak government regulation. The other difference is that consumers in Latin America do not put pressure on companies like their counterparts do in the US. However, CSR currently in the US seems to be limited to charity giving, while the reality demands companies to focus on the sustainability issues (Jones, no date). Another example of state intervention, which helped the development of the CSR, is the Danish practice. Companies in Denmark have been encouraged by the government to recruit the disabled, immigrants and refugees. This helped to reduce the unemployment rate and save public funds, which would otherwise be spent on sustaining refugees and migrant workers (Buhmann 2006, p.192).

It has become a good tradition in Uzbekistan to assign a certain title for each year in order to provide a focus for current social policy. For example, 2006 was announced to be the Year of Charity and Medical Workers, 2007 the Year of Social Protection and 2008 the Year of Youth. The government allocates a greater share of state funds and runs public programs to provide additional support to that area of social policy. Enterprises at all levels, including SMEs, are encouraged (e.g. through tax reductions) to take active part in these programs.

In 2005, the state passed the Decree on Social Protection And Support For The Utility Companies.[3] Under this regulation, households and businesses are required to install resource efficient technologies in an attempt to reduce energy tariffs. This is important for environmental protection, because until recently people and small businesses had paid a fixed amount for the unlimited use of water and gas. To facilitate the process, households are given the opportunity to pay the cost of the gas and water meters over a period of three to four years.

3 See the Decree of the President (2005), on Measures for the Social Protection of the Population and Support for the Utility Companies. September 2005, Uzbekistan.

It follows that, in Uzbekistan, the state actively promotes CSR related activities. However, some case studies suggest that in order to have a strong CSR, its principles should be initiated by businesses themselves. For example, the Caux principles[4] developed by company executives in Japan, Europe and the US, serve as a foundation of CSR in these countries. These principles are proposed by businesses and not by officials or other institutions (Kakabadse and Rozuel, 2006). Similarly, to promote CSR among Uzbek SMEs, they should be unified under a common initiative for achieving sustainable growth. There does exist the Uzbek Chamber of Commerce, which oversees most of companies in Uzbekistan. It is currently organizing an annual 'The Best Entrepreneur' competition for businesses, including SMEs. Amongst other criteria, preference is given to those entrepreneurs who have demonstrated a strong commitment to the support of the needy and development of the local community. Nevertheless, these CSR related activities in Uzbek SMEs are not yet seen as having financial pay-offs.

Challenges

Capaldi (2005) divides the types of company responsibilities into three major categories: keeping business from illegal activities, increasing profits and supplementary activities (e.g. participation in the environmental campaigns, promotion of the good image, etc.). Supplementary activities may specifically include: marketing campaigns demonstrating good relations with reputable institutions; recruitment through running sponsored events which would attract competent employees and retain existing ones; participating in the community activities; and limiting international initiatives to those countries where the rule of law is respected (Capaldi, 2005, p. 414). Due to the lack of voluntary initiatives from businesses, it seems that CSR at present in Uzbekistan falls into the first category. The third category is not popular among the Uzbek SMEs because entrepreneurs are not very aware about the potential benefits of the CSR. There are many business training courses in the country, but they limit themselves to the classical rules of running the firm. This is also true for other countries in transition. The Soviet educational system was focused mainly on scientific and technological disciplines. After the break up of the Soviet Union, there has been a huge demand for business training courses. Although, the number of these courses is now increasing, their syllabuses don't address

4 'Caux principles are based on two main ideas: first, living and working together for the common good (*kyosei*); second, valuing each human person as an end and not as a means (human dignity)'(Kakabadse and Rozuel, 2006, p.79).

issues related to ethics, environmental protection and other types of social responsibility (Harrisons and Lewelyng, 2004).

One of the most important sustainability issues is consumer loyalty. Salmones, Crespo and Bosque (2005) find the indirect impact of social responsibility on consumer loyalty in Spain. However, unlike in the developed nations, the consumer loyalty in the former planned economies is driven by the price versus quality trade-off. Business ethics have not yet gained popularity among consumers in Uzbekistan as a benchmark in their purchasing decisions. Therefore, at the moment the Uzbek SMEs are not under pressure from consumers to promote CSR.

The other factor holding back the development of CSR is supposed to be the fear of bureaucracy. However, Castka, P. et al. (2004) find that this is not a problem given that the pay-offs are significant. Because in the Uzbek SMEs CSR is limited to philanthropic activities, these SMEs are not facing the bureaucracy problem yet. At the same time, some entrepreneurs deliberately refuse to publicize their 'good deeds' in order to comply with religious norms. These norms discourage the disclosure of donations (i.e. charity should not be made for the sake of publicity). If, in the future, CSR comes to be perceived by the Uzbek SMEs as a tool for attaining long term sustainability, its scope will increase (e.g. marketing campaigns) and this may involve some level of bureaucracy. Nevertheless, following Castka, P. et al. (2004), if the entrepreneurs are confident about the pay-offs of the CSR, the paper work will not discourage them significantly.

There are some signs indicating that the issue of sustainability is becoming important for businesses in Uzbekistan. Economic growth is nearly 7 per cent, price changes are predictable and state owned assets are gradually privatized (Uzbekistan Economy, 2005). Taxes are reviewed year-on-year basis in order to make the business environment more favourable. Uzbekistan is among the top reformers, like Croatia and Kenya (Doing Business 2008 Uzbekistan, p. 5). This, in turn, contributes to the current level of competition among SMEs, which will need to search for new business solutions. This may lead to greater consideration of the 'business case' for CSR.

One of the priority directions of the Uzbek government's economics policy is promoting exports. The government has passed a number of Decrees, which grant various incentives for exporters. The most popular incentive is the exemption from taxes. However, the share of SMEs engaged in exports is

only 6 per cent (Uzbekistan Economy, 2005). Currently international markets are setting new social and environmental standards, to which SMEs, who are exporters from developing countries 'do not know how to respond' (Luken and Stares, 2005). The same is true for the SMEs in Uzbekistan, who are carrying out foreign trade activities. This problem might be one of the reasons for the low share of SMEs in overall exports. The growing pressure from consumers abroad will make businesses all over the world review their development plans and focus on CSR activities. This also will help Uzbek SMEs exporting abroad to further consider the business case for CSR.

Summary

SMEs in Uzbekistan do not yet consider the CSR to have a significant effect on profit. Similar to other Asian societies, the most important internal motive amongst Uzbek SMEs is compliance with the local community code and in some cases, religious norms.

CSR among the Uzbek SMEs in Uzbekistan is limited to philanthropic activities and mainly initiated by state programs. It normally takes the form of charity to the needy, sponsoring social events and participation in collective campaigns to clean up the environment. The transition programs of the state focus on a strong social protection policy. The government has passed many Decrees, which serve as external motives for local businesses to engage in CSR. These Decrees regulate the matters related to consumer protection, environment and other social policy issues. Each year the government determines a priority direction of social policy and allocates state budget funds to finance related activities. Local communities (mahallas) take an active part in promoting the state programs among the local SMEs.

The Uzbek economy is now setting itself on a path of stable development, which creates a chance for businesses to devise long term plans. This change, together with growing pressure from international markets, may encourage firms in Uzbekistan to interpret CSR as a tool for achieving long term sustainability.

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8

Corporate Governance in Family Firms: A Comparison between Italy and Turkey

Kubra Sehirli

Introduction

Italy and Turkey are two civil law countries that have family controlled businesses with concentrated ownership and weak minority shareowner protection in contrast to common law countries with dispersed ownership and strong shareholder protection such as UK and US. The aim of this chapter is to contribute to the literature on Corporate Governance (CG) in family firms by studying Italy and Turkey.[1]

The application of the CG codes of Italy and Turkey are analysed by chosing one company from each country – Italmobiliare from Italy and Sabanci from Turkey. The results of this analysis are: first, both of these firms recruited independent and non-executive board members, increased disclosure and transparency and created board committees similar to the world's largest publicly owned companies. However, the extent of the adoption of CG and Corporate Social Responsibility (CSR) policies by the companies differs according to their own understanding unless the policies are compulsory. Second, both Turkey and Italy seem to follow the trends throughout the world, especially those of the US and EU, while reflecting their own specialties and national regulatory framework in the corporate governance principles they adopt. Therefore, the

1 This chapter is based on my dissertation with the same title at Birmingham Business School in 2007. I am grateful to my supervisor Prof. Dr Christine Mallin for her beneficial comments on my dissertation.

adoption of the CG Codes of Italy and Turkey by family firms offer lessons for other countries where civil law based family firms dominate.

Family firms are common throughout the world. The ownership structure of companies in different countries was analysed by La Porta et al. (1999) and it was found that family owned companies are common and important in most countries. Continental European companies are primarily owned and managed by families (Faccio and Lang, 2002). In a family business group, with a pyramidal ownership structure, 'the family achieves control by a chain of ownership relations: the family directly controls a firm, which in turn controls another firm, which might itself control another firm, and so forth' (Almeida and Wolfenzon, 2006). The ownership is highly concentrated in Italy and the common way of holding control is pyramidal ownership, which is almost absent in countries with dispersed ownership structures such as the UK and US (Enriques and Volpin, 2007). The situation in Turkey is similar to that in Italy.

Corporate Governance have mainly focused on companies with highly dispersed ownership structures. Ward (2005) stated that the fundamental difference between family-controlled firms and widely-held listed ones is the discrete nature of the ownership (Ward, 2005). In other words, the unique nature of family businesses, which distinguishes them from the other companies, is the involvement of families into management (Chua et al., 1999).

In this chapter, Italy and Turkey are chosen as two civil law countries that have family businesses with concentrated ownership. Family groups are dominant and important both in Italy and Turkey. Therefore, the governance structures and the performances of the family owned companies in these countries are effective in the growth of capital markets. The organizational bodies and stock exchanges pay attention to corporate governance applications and issue CG codes parallel to OECD Code of 2004. Both countries have been making important new regulations in accordance with the changes in the world. Italy has improved more in making CG Codes mandatory than Turkey.

The method consisted of a detailed analysis of two case studies comparing the application in the CG codes in Italy and Turkey to one company from each country – Italmobiliare SpA (Italmobiliare) from Italy and Haci Omer Sabanci Holding AS (Sabanci) from Turkey. Italmobiliare from Italy and Sabanci from Turkey may be regarded as representative of the main characteristics of their countries.

The structures and processes of corporate governance in Sabanci and Italmobiliare are not as clear as they often are assumed to be in non-family big publicly listed corporations. This results from cross-holdings and pyramid ownership structures and is in accord with the opinion of Melin and Nordqvist (2000). However, Sabanci developed a mechanism of control in terms of governance practices and disclosure that resembled the Anglo-Saxon governance regime as the world's largest transnational firms mentioned by Markarian et al. (2007), than do the mechanisms of Italmobiliare. The main similarities and differences of two companies are discussed below.

The Structure of The Board of Directors

Sabanci has the separation of the roles of the CEO and Chairman and Audit Committee structure. Italmobiliare follows the traditional Italian system in line with Corporate Governance Code of Italy such as the Lead Independent Director and the Board of Statutory Auditors.

This difference results from the differences in the codes of Turkey and Italy. Similar to the US and UK systems, the CG Principles of Turkey advises that the Chairman and CEO are not the same person and the majority of the board consists of non-executive members. In Italy, the advice is to avoid fusion of the roles of Chairman and CEO but there is flexibility regarding a lead independent director. When the Chairman and CEO are the same person or the Chairman is from the controlling issuer, the Board designates a lead independent director. In this system, the lead independent director is a control mechanism of the governance in corporate governance terms. This is considered beneficial for a family business management system. The same structure may be added to Turkish Corporate Governance Principles for companies that have the Chairman and CEO as the same person.

The Board Committees and The Audit Structure

The appointment of Internal Auditors is defined in the by-laws of Sabanci. The Internal auditors of Sabanci are two independent members. They audit the income statement and the balance sheet according to the Tax Law and the Commercial Law of Turkey and report to the shareholders' meeting. Although under the Code of Italy (2006) an internal audit function is created and may be entrusted to independent professionals, the structure and responsibility of

the Board of Statutory Auditors in Italy is in a way an improved form of the Internal Auditor in Turkey. The Board of Statutory Auditors of Italmobiliare has three members. Under the legislation, the Chairman of the Board of Statutory Auditors is appointed by the shareholders' meeting from the auditors elected by minority shareholders but none of the current Statutory Auditors of Italmobiliare represent the minority shareholders.

The board committees are organized according to needs of the companies themselves. Both of the companies, in line with their country codes have executive committees to support the Board of Directors.

In Italy, the Internal Control Committee examines the reports prepared by the Controller and the independent auditors to check the adequacy of the internal control system, and it reports on its activities and the adequacy of the internal control system to the Board of Directors. The Board of Directors is in the center of internal control system. The Internal Control Committee, which acts as a consultant, carries out the preparatory activity.

In contrast to the structure in Italy, the Audit Committee, which is mandatory in Turkey, is the sole responsible body for the audit and control processes. The Audit Committee is responsible to take the necessary measures to ensure both external and internal auditing processes are carried out transparently and adequately. In other words, both the internal control process and the external audit structure are under the control of the Audit Committee (Principles of Turkey, 2005).

When the Chairman and CEO are the same person, an additional audit structure may be useful for the good governance of family-owned companies. In that case, a distribution of powers and responsibilities may be necessary.

Disclosure

The consolidated financial statements and notes of Sabanci for 2006 are in conformity with the IFRS and have been prepared in accordance with CMB regulations. They have also been audited by an independent auditor in accordance with IAS and accordingly disclosed to the public (Annual Report of Sabanci, 2006). Similarly, the financial statements of 2006 of Italmobiliare have been prepared in compliance with IFRS. They are also audited by an external audit firm in accordance with IAS and disclosed to the public (Annual Report of Italmobiliare, 2006).

Sabanci has a well-organized website both in English and Turkish which gives detailed information about the Company. In the Turkish version of the website there is also the company by-laws. The relevant people who can have insider knowledge are listed by name in the Annual Report 2006.

A similar structure can be seen in Italmobiliare, which has a well-organized website both in English and Italian giving detailed information about the company. The Investment Relations site includes Annual Reports since 1998, Half Year Reports since 1999 and Quarterly Reports since 2000. In the English version of the website there is the company by-laws. Relevant people to disclose information when carried out transactions on their own behalf on Italmobiliare shares under the Internal Dealing Code are defined.

Disclosure is a mandatory application of corporate governance both in Turkey and Italy. Thus, with the compulsory regulations in the disclosure area, transparency and accountability have increased significantly in both of the companies. This brings an improvement in terms of corporate governance. This is consistent with the study of IFC and Lex Mundi (2006) that Turkey and Italy have increased disclosure requirements.

Corporate Social Responsibility

Both Italmobiliare and Sabanci give priority to CSR, they both have Foundations and a Code of Business Ethics. In addition, Sabanci has an Ethics Board reporting directly to the Chairperson of the Holding Company, while Sabanci has the Human Resource Committee.

Family Business and Corporate Governance

The ownership structures in different countries were analyzed by La Porta et al. (1999) who found that family ownership is common in most countries. In addition, most of the Continental European companies are owned and managed by family groups (Faccio and Lang, 2002).

Chua et al. (1999) defines family firms as follows: ‘the family business is a business governed and/or managed with the intention to shape and pursue the vision of the business held by a dominant coalition controlled by members of the same family or a small number of families in a manner that is potentially sustainable across generations of the family or families.’

The main differences between family and non-family firms are on the basis of family ownership, family management, and trans-generational sustainability (Chua et al., 1999; Chrisman et al., 2002). Family owned businesses are differentiated in ownership structure, leadership and evolutionary dynamics (Habbershon et al., 2001; Schulze et al., 2001; Melin and Nordqvist, 2000). In a family firm the main shareholder, who is the family, is the main decision maker (Daily and Dollinger, 1992; Melin and Nordqvist, 2000). Cadbury (2000) sees clear identity and long-term perspective as strengths of family firms (Cadbury, 2000, p. 6), whereas Stark and Falk (1998), Kang (2000), Van den Berghe and Carchon (2003), Tokarczyk et al. (2007) states that altruistic behavior and trust may provide additional advantages such as minimization of information asymmetries among family members, collective ownership of family members who are working in the firm, commitment to the long-term performance and strategy of the firm (Stark and Falk 1998; Kang 2000; Van den Berghe and Carchon, 2003; Tokarczyk et al., 2007). Moreover, 'family businesses with high levels of family capital possibly do hold a sustained competitive advantage over family businesses with low levels of family capital and/or non-family businesses' (Hoffman et al., 2006).

On average, family-controlled businesses are managed better than publicly-owned ones. Besides, the control by family protects shareholders' interests against managerial abuses (Enriques and Volpin, 2007). On the other hand, family firms are known for their higher costs and inefficiencies. Conflicts of interests between family members in different roles may create a situation that can threaten efficient collaboration and information exchange. Family members may be concentrated on achieving their own goals, rather than the well-being of the family as a whole (Van den Berghe and Carchon, 2003). In addition, family and business matters may be confused. Family interests may be favoured over the firm's interests due to family loyalty (Randoy et al., 2003; Schulze et al., 2003; Spanos, et al., 2006). Naturally, Cadbury (2000) argues that family hierarchy makes it difficult to apply competence-based assessment practices (Cadbury, 2000, p. 14). Family companies create internal labour markets favouring family members, but the publicly owned companies have more competence-based recruitment. This may cause a decrease in the quality of executives and other managers, which may cause significant monitoring costs in the long run (Van den Berghe and Carchon, 2003).

'The distinct purpose of governance for the family business, and the source of its unique competitive advantage, is to assure united and committed family ownership.' (Ward, 2005). Various studies stated that the agency costs are

minimized when the management and the shareholder family are the same person or from the same family (Jensen and Meckling, 1976; Fama and Jensen, 1983; Randoy et al., 2003; Schulze et al., 2003; Spanos, et al., 2006). However, the agency costs can still exist in a concentrated ownership structure as in a diluted ownership structure. In this case, the conflict of interests is between the controlling shareholder and the minority shareholder. This may happen if the controlling shareholder abuses the use of his power against minority shareholders' rights. (Moressi, 2005).

The family and the firm are the two parts of family firms. As businesses have grown, external financing has become essential. This need brings another part to the family firm, the non-family owner. In consequence of this, family, company and non-family owners become three indispensable and interconnected social parts in a family-owned business strategy (Tagiuri and Davis, 1996; Stattford et al., 1999; Davis, 2001; Van den Berghe and Carchon, 2003, Spanos, et al., 2006). Van den Berghe and Carchon, (2003) argue that the family may benefit from effective family governance whereas the business may benefit from corporate governance. In other words, corporate governance should be the main focus but family governance should not be neglected. The entrance of non-family shareholders may have a disciplining effect on family members in family firms in an intense competitive environment (Van den Berghe and Carchon, 2003). CG in family firms helps the owner to realize his vision, goals and objectives (Melin and Nordqvist, 2000).

Many countries recognize that non-family owners or investors will only be attracted if their rights are strongly protected both in the legal framework of the country and also in the corporate governance applications of the company in which they invest (Mallin, 2004). The importance of professional board members, establishment of independent committees, hiring professional directors and securing efficient succession in family firms have been considered in the literature (Jonovic, 1989; Huse, 1990; Leach, 1991; Schwartz and Barnes, 1991). Melin and Nordqvist (2000) focused on both the contextual and the processual elements, and the structures and processes of CG in family firms in order to understand the strategic development of them (Melin and Nordqvist, 2000).

Corporate Governance in the US and Europe

Continental Europe is based on a civil law system with concentrated ownership structures whereas the UK and US are based on common law with dispersed ownership structures (La Porta et al., 1998). The Sarbanes-Oxley Act of 2002 has made the US CG system mandatory in terms of director responsibilities. UK and Continental European systems are based on 'comply or explain', which is a voluntary system (Mallin, 2004). In insider systems shareholders have long-term relationships with the companies, in outsider systems, like those of the US, large firms are owned by mostly institutional investors who have little interest in the management of the firms. In contrast to outsider systems, insider systems have low stock market capitalization and a strong system of employment protection. (Almond et al., 2003).

In the study of the World Bank, IFC and Lex Mundi (2006), the strength of the investor protection index (IPI) was determined for January 2005 data of 156 countries.[2] (World Bank, IFC and Lex Mundi, 2006).

The results of this survey are given in Table 8.1. Turkey and Italy had similar IPI ratings 5.0 and 4.7 respectively. There were fifty one countries with a score below 4.7 and 70 countries with a score below 5.0. UK and US had similar scores, which were completely different from Italy and Turkey. Turkey and Italy had increased disclosure requirements, but director liability and the effectiveness of investor protections against self-dealing were still weak (World Bank, IFC and Lex Mundi, 2006).

Table 8.1 World Bank, IFC and Lex Mundi Survey

	DI	DLI	SSI	IPI
Turkey	8	3	4	5.0
Italy	7	2	5	4.7
US	7	9	9	8.3
UK	10	7	7	8.0

Source: IFC and Lex Mundi (2006).

2 The indicators distinguish three dimensions of investor protection: transparency of transactions (extent of disclosure index), liability for self-dealing (extent of director liability index) and shareholders' ability to sue officers and directors for misconduct (ease of shareholder suits index). IPI was measured as the average of the extent of disclosure index (DI), the extent of director liability index (DLI) and the ease of shareholder suits index (SSI). The IPI range was between 0 and 10, with higher values indicating better investor protection (World Bank, IFC and Lex Mundi, 2006).

Corporate Governance Framework of Italy

Italy is one of the countries that have insider-dominated corporate governance systems (La Porta et al., 1999) and company structure is based on civil law with family business domination. 'In contrast to other main European corporate governance systems (and US), neither banks (as in Germany) not institutional investors (as in UK) have a direct influence on the corporate governance system' (Melis, 1999 cited from Melis, 2006a, p. 58). The Italian corporate sector is based on family-controlled firms, either small or large, even when publicly quoted (OECD, 2005). In Italy, 'voice rather than exit of the important shareholders' is main characteristic of the governance system. Powerful families, financial holding companies and cross shareholdings are common. The voting agreements and the hierarchical groups are instruments for concentrating voting power without concentrating ownership (Melis, 1998; OECD, 2003, p. 19). The largest stakeholders in the companies are other non-financial or holding companies. There is a large amount of cross-shareholding. Contrary to other European countries, bank and institutional investor activism is minimal and there is a limitation on the amount held by financial institutions (Mallin, 2004; Gleason et al., 2007). The financial authority of Italy CONSOB reported that for year 2005 'on the average, major shareholder of a company still owns approximately 33 per cent of the total share capital' (Melis, 2006b, p. 46). The pyramidal ownerships or the pyramidal groups are common ways of holding control in the companies of Italy as in other Continental European countries (Enriques and Volpin, 2007).

Italy's stock market is around 65 per cent of GDP, where approximately 30 per cent of this amount is held by the state. The market for corporate control is limited; acquisitions and hostile takeovers are infrequent (Gleason et al., 2007). As stated by La Porta et al. (1998), Italy was one of the lowest ranked industrialized countries in terms of minority protection. The corporate governance system is composed of weak managers, strong blockholders and unprotected minority shareholders (Melis, 2000).

The Corporate Governance is based on the 'comply or explain' formula in Italy. Corporate governance in Italy has been regulated primarily by the Draghi Law 1998, and then by the Preda Code (1999, updated in 2002), followed by the Company Law 2004, and recently by the Savings Law (2006) and the Corporate Governance Code (2006) of Borsa Italiana.

The Draghi Law mainly focused on the regulation of financial markets and corporate governance of listed companies in order to strengthen protection of investors and major shareholders (Melis, 2006b, p. 53).

The Company Act 2004 allows companies to choose one of the three board types. The first one is the traditional Italian board structure with a board of directors and a board of statutory auditors, appointed by shareholders. The second resembles the German two-tier board structure with a supervisory council and a management committee. The structure differs from the German type in two areas. Labour representation on the board and the management committee in an executive role are not mandatory. The third is like the British unitary board structure composed of independent non-executive directors with an audit committee appointed by board of directors (Melis, 2006a, p. 57; Melis, 2006b, p. 62–3). These new rules have shifted the balance towards mandatory rules instead of default rules (Vitali, 2006).

The law for the protection of savings (Savings Law) of 2006 made significant changes in many areas. For example, at least one of the board members must be elected from the list of the minority shareholders. The chairman of the board of auditors is to be appointed in the shareholders' meeting from the auditors elected by the minority shareholders. The independency requirements are strengthened (Freshfields Bruckhaus Deringer, 2006).

The Preda Code's main deviations from Anglo-Saxon norms relate to the composition and workings of the board (board structure, audit and internal control) (Plender, 2004). As announced by Borsa Italiana 2006, the new Voluntary Code of Conduct (Corporate Governance Code of 2006) replaces the Preda Code and its entirety by the end of the financial year begun in 2006. The content is similar to Preda Code, but the structure is different. It has three sections, which are general principles, application criteria and comments. Borsa Italiana disclosed the main new features in 2006 to the public in detail, including: The introduction of recommendations of limits to the number of roles held by each director and annual self-assessment by the board; the improved definition of the role of non-executive directors, the introduction of the so called 'lead independent director', in case of fusion of roles of Chairman and CEO, the restatement and specification of the transparency principle in the appointment procedure, with examples of possible duties of the Nominating Committee, the definition of the structure and purposes of remuneration, providing a distinction between executive and non-executive directors, the specification of duties of the Remuneration Committee, the improved definition of roles and

relations between various persons/bodies involved in defining, monitoring and updating the system (specifically relations between the Board of Auditors and the Internal Control Committee), the promotion of initiatives aimed at facilitating shareholder's awareness of company information and favoring their participation in shareholders' meetings and the exercise of their rights. As a result it is possible to say 'recent legislation and self-regulatory measures are steps in the right direction, pushing corporate Italy closer to international standards of governance.' (Limbach, 2006).

Corporate Social Responsibility in Italy

Corporate Social Responsibility (CSR) culture and adoption in Italy has increased in the last decade especially with the adoption of Sodalitas[3] in 1995 in line with the CSR movement of the 1990s. (Canarutto and Nidasio, 2004, p. 280). More than two hundred bodies (companies, not-for-profit organizations, etc.) organize social or environmental reports, almost twenty companies (i.e. banks, manufacturing and telecom companies) publish sustainability/social-environmental reports parallel to the triple-bottom-line approach (Canarutto and Nidasio, 2004, p. 285).

Traditionally, with the effective role of the Catholic Church, which states that work has a social side not only to the family but also to the public good, Italian firms had social responsibility activities before these developments. However, as cited from Italia Lavaro and Censis (2003), it is the idea that 'profit cannot be achieved without paying attention to social results' which has been the driving force for Italian companies to improve CSR activities (Canarutto and Nidasio, 2004, p. 286).

Corporate Governance Framework of Turkey

Turkey is one of the countries which has insider-dominated corporate governance systems (Yurtoglu, 2003), and the company structure is based on civil law with family business domination. Family-owned firms have expanded and diversified, and holding companies have been established in the 1980s and 1990s (Ararat et al., 2006a, p. 270). The Turkish corporate sector is based on family-controlled financial-industrial company groups with a concentrated ownership. Pyramidal structures are common and there is a high

3 Italian representative of CSR Europe.

degree of cross shareholding within some company groups. The controlling shareholders are often effective in the daily management and strategic direction of companies even if publicly held (OECD, 2006, p. 9). Families own 80 per cent of the companies, directly or indirectly. Families keep the majority control. The control is mainly held through pyramidal or complex ownership structures and by using dual-class shares (Yurtoglu, 2003).

Istanbul Stock Exchange (ISE) had 625 companies in December 2005. Market capitalization was approximately 28 per cent of estimated GDP (OECD, 2006, p. 22). According to the data of ISE (2001), holding companies are the most common direct shareholders who have largest stake in 121 companies. On average they own 47 per cent of the outstanding shares. Besides, non-financial companies have the largest stake in 57 companies whereas financial companies have the largest stake in 39 companies. Families are the largest direct shareholders of 54 companies and they own on average almost 35 per cent of the shares. Overall, 64 per cent of the total equity belongs to the five largest shareholders (Yurtoglu, 2003).

Turkey regulates the corporate governance framework through the Turkish Commercial Code (1956), the Capital Market Law (1981, amended 1999) and the Regulations of Law, and Corporate Governance Principles (2003, amended 2005) based on the Turkish Commercial Code. A Draft of a new Turkish Commercial Code (TCC, 2005) includes some major corporate governance rules that will result in them being compulsory for all companies.

According to the Turkish Commercial Code the board of directors can be elected from among the shareholders. The board members are appointed and dismissed by the shareholders at the shareholders' meetings. Under the laws listed companies are not obliged to elect executive officers or senior managers. Turkish legislation does not contain the CEO concept. Internal auditors are compulsory with TCC and there are independence criteria for them (TCC, 1956).

The Capital Market Board (CMB) set the regulations on a disclosure-based approach. After the 2001 economic crisis in Turkey, and in parallel with the banking sector reforms of the Banking Regulation and Supervision Agency, the Capital Markets Board of Turkey issued the Corporate Governance Principles of Turkey (Code, Principles). The Turkish Corporate Governance Code is based on the OECD Principles of 2004 and is mainly focused on the structure of the board of directors, to tighten audit functions, to improve transparency and to

protect minority shareholders. The code contains four sections. The first section is about the rights of shareholders and their equal treatment, the second section discusses transparency and disclosure issues including financial statements and reports, the third section is concerned with the stakeholder groups including, shareholders, creditors, customers, suppliers, non-governmental organizations and workers. The last section is about duties, obligations and structure of the board of directors.

A draft of New Turkish Company Law 2005 includes the major corporate governance principles, which are applicable to all of the companies both publicly or privately owned (OECD, 2006). Some of the most significant reforms are about financial reporting, transparency, board responsibilities, requirements for company groups and cross-shareholdings. The new TCC will include more regulation to prohibit the parent company from abusing its power to control the subsidiary and to increase transparency. Cross-shareholdings will continue to be permitted but with restrictions (New Draft TCC, 2005; OECD, 2006).

Corporate Social Responsibility in Turkey

Highly concentrated family ownership is not being helpful to emphasize shareholder value in Turkey. Turkish Businessmen and Industrialists Association (TUSIAD) stated their mission to establish the social role of Turkish private sector rather than increasing shareholder value in terms of CSR. Parallel to this, the corporate philanthropy is strong. Most companies give a percentage of their net profits to their family foundations. Their by-laws have provisions on the subject (Ararat, 2004, p. 249). This application is parallel to the traditional philanthropy understanding of Turkish society. In Islamic tradition, philanthropy is made for God's sake, not for any other personal benefit. The Foundation is the generally accepted form of making continuous philanthropic activities. So, it is welcomed by the whole society and the shareholders do not generally resist to the foundations of their companies. Besides, tax reductions are allowed to foundations. However, Ascigil (2004) in her unpublished survey stated that the managers of the firms do not give priority to ethical considerations if they will have negative effect on the economic performance of their companies. In the same survey it is also mentioned that CSR is more like a public relations matter by giving priority to customers and quality of the product rather than a strategic concept for the firms (Ascigil, 2004, p. 253).

Major Characteristics of Corporate Governance Framework of Turkey and Italy

Table 8.2 summarizes the major characteristics of the Corporate Governance framework of the two countries. Turkey and Italy have similar corporate governance environments and ownership patterns. In terms of disclosure and CSR they have close similarities. The major differences are in the board and the audit structures.

Table 8.2 Corporate Governance Framework of Turkey and Italy

TURKEY	ITALY
Corporate governance environment is insider-nominated.	Corporate governance environment is insider-nominated.
Ownership Patterns Ownership pattern may be classified as block share ownership pattern, often in the form of family-controlled, financial-industrial company groups.	Ownership Patterns Ownership pattern may be classified as block share ownership pattern, often in the form of family-controlled, financial-industrial company groups.
Board Structures Board of Directors: • aims to raise the company's market value to the maximum extent possible • ensures that shareholders acquire long-term and stable income • maintains balance between shareholder interest and growth prospect of company. The traditional single-tier oversight structure is used. Board members are classified as executive, non-executive and independent. Specialist sub-committees such as audit, corporate governance and remuneration are created. The chairman of each sub-committee should be elected from independent board members. It is maintained that the Chairman and CEO are not the same person and majority of the board consist of non-executive members.	**Board Structures** Board of Directors pursues the priority of creating value for the shareholders in the medium-long term. Companies are free to choose between single-tier, two-tier board structure, or the Italian traditional board structure with board of directors and board of statutory auditors. Board members are classified as executive, non-executive and independent. Specialist sub-committees such as internal control, nomination and remuneration, executive are created. These sub-committees are either required or recommended to include board members who meet independence criteria. The advice is to avoid fusion of roles of the Chairman and CEO. However, when the Chairman and CEO are the same person or the chairman is by the controlling issuer, the Board designates a lead independent director.

Table 8.2 *Continued*

Internal Auditors An Internal Auditor structure is mandatory in Turkey. At most five (but at least one) individual is selected from shareholders or independent professionals. They audit the income statement and the balance sheet according to the Commercial Law of Turkey and report to the audit committee and shareholders' meeting. They have the responsibility to check and observe the acts and decisions of the Board of Directors in terms of compliance with laws and correct administration. Any shareholder has the right to ask the internal auditors to look into doubtful matters and the internal auditors solve the problems.	**Board of Statutory Auditors** A Board of Auditor structure is mandatory in Italy. The Board of Statutory Auditors has the responsibility to check and observe the acts and decisions of the Board of Directors in terms of compliance with laws and correct administration. They report the consolidated financial statements, which are audited by an independent external audit firm in terms of their compliance with current laws and in conformity with the IFRS. Minority shareholders appoint at least one statutory auditor. The Chairman of the Board of Statutory Auditors is appointed by the shareholders' meeting from the auditors who are elected by minority shareholders.
Audit Committee – Internal Control System Establishing an audit committee, appointing an external auditor firm and reporting on internal controls are compulsory. The audit committee has responsibility for establishing procedures about accounting practices, internal control systems, external auditing, and monitoring their compliance with legislation, company by-laws, regulations and rules. The committee reports to the board and includes their reports in annual reports. The audit committee takes the necessary measures to ensure both internal and external auditing is carried out adequately and transparently.	**Internal Control Committee – Internal Control System** The Board of Directors is in the center of the internal control mechanism. The Internal Control Committee carries out the preparatory activity. The role is separate from the role of the Board of Auditors, which performs mainly ex-post control function. There is flexibility to give some of the duties of to the Board of Statutory Auditors to Internal Control Committee about external audit process. The Internal Control Committee is established to define the procedures of internal control system. The chairman of the Board of Auditors participates in the work of internal control. An executive director supervises the functionality of internal control system. The internal audit function is created by and may be entrusted to independent professionals. These people may be responsible for internal control.
Functions of External Audit The External Audit firm and the auditors must be independent. They are subject to regular rotation. Audit and consultancy services should be clearly separated. These are compulsory. The Audit committees are to oversee the selection of the external auditor, negotiation of the audit engagement and to conduct the external audit.	**Functions of External Audit** The External Audit firm and the auditors must be independent. The External auditing firm is appointed by shareholders' meeting. The positive opinion of the board of statutory auditors is required. They are subject to regular rotation. These are compulsory.

Table 8.2 *Concluded*

Disclosure and Shareholder Rights The disclosure of significant information about company, market abuse and insider trading are regulated by CMB and ISE. So, these are mandatory for listed-companies. Since 2005, listed companies have been required to publish audited financial statements prepared in accordance with the CMB's IFRS-based standards. It is acceptable for these to be published according to International Financial Reporting Standards (IFRS). Annual reports, semi-annual reports, quarterly periodical financial statements and audit reports are prepared. They are announced on websites. Listed-companies are encouraged to: facilitate investors' equal, timely and cost-effective access to information about the company through various media, including company websites; conduct shareholder meetings in a way that encourages all shareholders to participate actively; recognize stakeholders' rights established by law or through mutual agreements. Listed companies are required to publish an annual Corporate Governance Compliance Report and are recommended to disclose information about stakeholder policies and employees' rights. There should be two executives responsible for public disclosure and personnel employed for a shareholder relations department. In addition, the department should consist of authorized staff as a head, and an adequate number of personnel.	**Disclosure and Shareholder Rights** CONSOB and BI regulate disclosure of significant information about company, market abuse and insider dealing. These are mandatory for listed-companies. It is obligatory for companies whose shares are traded on regulated markets to prepare their financial statements in conformity with the international accounting standards as from financial year 2006. Annual reports, semi-annual reports, quarterly periodical financial statements and audit reports are prepared. They are announced on websites. Listed companies are encouraged to use best efforts for ensuring that shareholders' access to information is timely and easy, so as to allow them to exercise their rights; for reducing restrictions and fulfillments which will make it difficult to participate in shareholder meetings and exercise voting rights. Listed companies are required to publish an annual Corporate Governance Report available to shareholders before the general meeting; this is to be sent to Stock Exchange to be disclosed to the public on a web page. A person is to be identified as responsible for handling relations with shareholders.
CSR Philanthropy is traditionally supported.	**CSR** Philanthropy is traditionally supported.

Corporate Governance in the World's Largest Transnational Firms

Corporate governance becomes more important for the firms in countries with insufficient shareholder protection and poor judicial efficiency. Alternatively, when the firms are well governed there will be less need for the legal system in solving the governance-conflicts. Although the firm level corporate governance does not compensate for a strong and good legal infrastructure, companies can individually improve their investor protection and minority shareholder rights to a certain degree at the firm level (Klapper and Love, 2002).

Markarian et al. (2007) analyzed the world's largest transnational firms' disclosure and governance practices in 75 Anglo-Saxon and non-Anglo-Saxon firms in two time periods, 1995 and 2002. The results indicated that non-Anglo-Saxon firms have developed an independent mechanism of control in terms

of governance practices similar to the Anglo-Saxon governance regime but Anglo-Saxon firms had smaller boards with a larger percentage of independent directors and non-executive directors than non-Anglo-Saxon firms. CEO and Chairman separation was higher in Anglo-Saxon firms. A comparison of the two time periods showed that governance practices have moved towards a more independent mechanism of control and more disclosure across both Anglo-Saxon and non-Anglo-Saxon firms (Markarian et al., 2007). Besides the differences in CG systems of Anglo-Saxon and non-Anglo-Saxon firms there are differences in CG practices of family and non-family firms. As Melin and Nordqvist, (2000) claimed, 'the structures and processes of corporate governance are not at all as clear-cut as they often are assumed to be in non-family firms, such as big publicly listed corporations' (Melin and Nordqvist, 2000).

Methodology

This is a study of Sabanci from Turkey and Italmobiliare from Italy analysing their corporate governance under the Corporate Governance Codes of the two countries with a 'two-case' case study (Yin, 2003, p. 53) method made with secondary data.

Two companies have been compared to each other, so it is a comparative two-case case study. Sabanci and Italmobiliare are chosen because they represent the characteristics of their markets and countries, they have a direct influence on the economies of their countries, and they are competitive in the international arena. The disclosed data are under the control of CONSOB and CMB, which are the regulatory bodies of their countries. Besides, it is possible to find rich information about them on their websites.

Corporate Governance in ItalmobilIARE SpA

HISTORY AND PROFILE

Italcementi SpA created Italmobiliare SpA (Italmobiliare) in 1946 to diversify the company activities and Italmobiliare became Italcementi's controlling shareholder in 1979. It is a financial holding company listed on the Milan Stock Exchange (Annual Report, 2006; Italmobiliare Website).

Two main branches of Italcementi – Società Bergamasca per la fabbricazione del cemento e della calce idraulica of Giuseppe Piccinelli (1864) and Ditta Fratelli Pesenti fu Antonio (1878) merged in 1906. The establishment of the first firm (1864) is only three years younger than unified Italy. After this merger, the Pesenti family started to manage the firm (Zamagni, 2004). In 1925, Italcementi was quoted the Milan Stock Exchange under the name of 'Società Bergamasca per la Fabbricazione del Cemento e della Calce Idraulica' and has been operating under the name of Italcementi SpA since 1927 (Annual Report, 2006; Italmobiliare Website).

Italcementi has expanded internationally without giving up its local and family roots. The stock exchange quotation protected it from potential instabilities. The importance of the group structure is understood well in order to increase synergy in the company. The necessary conditions have been set up to reach internationalization. The predominance of engineers in the leading managerial positions and the life commitment with the company of the top managers has been the major characteristics of the Italcementi (and later on Italmobiliare) (Zamagni, 2004). The companies controlled by Italmobiliare SpA are involved in a range of activities in the industrial, financial and banking sectors both in Italy and the global arena. (Annual Report, 2006; Italmobiliare Website).

CORPORATE GOVERNANCE APPLICATIONS

The corporate governance system of the company is adopted by Voluntary Code of Conduct, by-laws, Code of Ethics, Treatment of Confidential Information, Internal Dealing Code of Conduct, Procedural Code for Transactions with Related Parties, Insider Register Procedure, Organization, Management and Control Model (Annual Report, 2006; Italmobiliare Website).

Ownership and control

The Pesenti Family holds a relative majority of the ordinary shares of Italmobiliare SpA through Efiparind BV, which is an unlisted holding company of the family. The shareholding structure is given in Table 8.3.

The Company share-capital is 100,166,937 Euros, consisting of 38,525,745 shares with a nominal value of 2.60 Euros each, of which 22,182,583 are ordinary shares and 16,343,162 are savings shares. The importance of this is that Italmobiliare represents the characteristics of Italian companies, which have concentrated family ownership and crossholding (Annual Report, 2006; Italmobiliare Website).

THE BOARD STRUCTURE

The Board of Directors

The company by-laws states that the Board of Directors is composed of a minimum of five and a maximum of fifteen directors. The Board of Directors of Italmobiliare is selected for a three-year period and has ten members (Annual Report, 2006; Italmobiliare Website).

There has been a role change between the committee members depending on the Lead Independent Director and Executive Director responsible for supervising the internal control system. The Board of Directors includes eight non-executive directors. Two of these are independent. The Executive Committee is composed of four members. The resolutions of the Executive Committee are reported to the Board (Interim Report, 2007; Italmobiliare Website).

Table 8.3 Ownership Structure

Shareholder	Share (%)
Efiparind BV	
Serfis SpA	10.319
Mediabanca SpA	9.498
Italmobiliare SpA (own stock)	3.948
Hermes Focus Asset Management Europe Ltd.	2.837

Source: Annual Report, 2006.

Table 8.4 The Board of Directors

Name	Position
Giampiero Pesenti 1–2	Chairman – Chief Executive Officer – CEO
Italo Lucchini 1–3	Deputy Chairman
Pier Giorgio Barlassina	Director
Mauro Bini 4–5–6–7	Independent Director
Giorgio Bonomi 4	Director
Gabriele Galateri di Genola	Director
Luca Minoli 3	Director
Giorgio Perolari 1–3–5	Independent Director
Carlo Pesenti 1	Chief Operating Officer – COO
Livio Strazzera	Director
Graziano Molinari 8	Secretary to the Board

Source: Interim Report, 2007.

The Pesenti Family has control power over the subsidiaries by appointing Giampiero Pesenti and Carlo Pesenti as the director, the auditor and the Chief Executive Officer.

The Committees of The Board of Directors

The Italmobiliare SpA has a Remuneration Committee and an Internal Control Committee from among its members. The *Remuneration Committee* has three non-executive members, of whom one is an independent director. The *Internal Control Committee* has three non-executives, two of whom are independent. (Annual Report, 2006; Italmobiliare Website).

THE AUDIT STRUCTURE

The by-laws states that one Acting Auditor and one Substitute Auditor are appointed by minority shareholders. The Chairman of the Board of Statutory Auditors has to be appointed by the Shareholders' Meeting from the auditors elected by minority shareholders. However, none of the current Statutory Auditors represent the minority shareholders (Annual Report, 2006; Italmobiliare Website).

The Board of Statutory Auditors

The Board of Statutory Auditors reports the consolidated financial statements in terms of their compliance with current laws and in conformity with the IFRS (Annual Report, 2006; Italmobiliare Website). Under the CGC (2006), it is possible that some duties such as assessing the results set out in the report and any letter of recommendations presented by external audit firms, and monitoring the effectiveness of the auditing process could be assigned to the Internal Control Committee rather than to the Board of Statutory Auditors. However, Italmobiliare keeps these duties at the Board of Statutory Auditors (Annual Report, 2006; Italmobiliare Website).

DISCLOSURE OF INFORMATION

Italmobiliare has a well-organized website both in English and Italian which gives detailed information about the company. The Investment Relations site includes Annual Reports since 1998, Half Year Reports since 1999, Quarterly Reports since 2000. Annual Reports have corporate governance parts (Annual Report, 2006; Italmobiliare Website).

Italmobiliare defines the Relevant Persons who carry out transactions on their own behalf on Italmobiliare shares as the Board of Directors, the Board of Statutory Auditors and the Chief Operating Officer and anyone who holds an interest of at least 10 per cent in the voting capital of Italmobiliare SpA, and any other party who controls Italmobiliare SpA (Annual Report, 2006; Italmobiliare Website).

The financial statements of the company, and the 2005 comparatives, have been prepared in compliance with the IAS/IFRS and disclosed to the public (Annual Report, 2006; Italmobiliare Website).

CORPORATE SOCIAL RESPONSIBILITY

In line with the CSR activities in Italy, Italcementi and Italmobiliare established Fondazione Italcementi Cav. Lav. Carlo Pesenti (Pesenti Foundation) to support education and scientific research in June 2004. Pesenti Foundation's special emphasis is laid on 'the sustainable economic and social development of enterprises consistent with an efficient and effective use of available resources, and the ethical, social and cultural growth of the communities involved'. In addition, the Pesenti Foundation contributes humanitarian projects especially for natural disasters. Moreover, The Code of Ethics of Italmobiliare (1993, amended 2001) are announced (Annual Report, 2006; Italmobiliare Website).

Corporate Governance in Haci Omer Sabanci Holding AS

HISTORY AND PROFILE

Haci Omer Sabanci started working life in 1925 in the cotton trade business, which is only two years later than the foundation of the Republic of Turkey. In 1932 he became a shareholder in a cotton ginning plant called Circir Plant. After he passed away in 1966, Sabanci brothers founded Haci Omer Sabanci Holding AS in 1967. The second child of the Family, Sakip Sabanci attended as the Chairman and CEO of the Board of Directors until he passed away in 2004. Until 1980s Sabanci Holding had the success of being one of Turkey's leading industrial and financial conglomerates (Annual Report, 2006; Sabanci Website).

After 1980s, in parallel with the liberalization process of Turkey, internationalization process started by mergers and partnerships with

multinational companies. Since 1997 it has been quoted to ISE, which was established in 1986. Since 2004, Guler Sabanci who is the third generation of family to have been the Chairman and Managing Director of the company. Sabanci has been successful in expanding internationally by holding its local and family roots at the same time. They seek the improvement of society and show sensitivity to the traditions and culture of the country (Annual Report, 2006; Sabanci Website).

Haci Omer Sabanci Holding AS (Sabanci) is the parent company of the Sabanci Group which is composed of seventy companies, many of which are recognized market leaders in their sectors which are financial services, tire, and tire reinforcement materials, automotive, food, retailing, chemicals, cement, textile, energy, paper and packaging materials, information technology, tourism and international trading. Furthermore, Sabanci Holding has controlling interests in twelve companies listed on the Istanbul Stock Exchange (Annual Report, 2006; Sabanci Website).

CORPORATE GOVERNANCE APPLICATIONS

The corporate governance system of the company is adopted by Corporate Governance Principles, by-laws, Code of Business Ethics, Risk Management and Strategy, Internal Control Mechanism, Human Resource System, CSR Policy and Principles (Annual Report, 2006; Sabanci Website).

Ownership and control

Sabanci Holding's authorized and issued capital consists of 180,000,000,000 (2005:180,000,000,000) shares of YKr 1 each. Sabanci Holding's authorized and paid-in share capital and shareholding structure at 31 December 2006 were as follows:

Table 8.5 Ownership Structure

Shareholder	Share (%)
Sabanci family members	58.36
Public Quotation	25.21
Sakıp Sabanci Holding AS	14.81
Sabanci University	1.62
Share Capital	100.00

Source: Annual Report, 2006.

Sabanci family keeps direct ownership interest in and indirect control over each of the Sabanci Group companies through Sabanci Holding (Annual Report, 2006; Sabanci Website).

THE BOARD STRUCTURE

The Board of Directors

The company by-laws provides for the company to be governed by a Board of Directors composed of a minimum of seven and a maximum of fifteen directors. A Board of Directors is selected for the three-year period and has nine members (Annual Report, 2006; Sabanci Website).

As of 31 December 2006, the Board of Directors of Sabanci is made up as follows (Table 8.6).

There is separation of Chairperson and CEO. Chairperson and managing director, Guler Sabanci, is a family member. CEO Ahmet Cemal DORDUNCU is a professional. At the same time two independent and non-executive member and five non-executive member from family. (Annual Report, 2006; Sabanci Website).

Table 8.6 The Board of Directors

Name	Position
Guler SABANCI*	Chairperson and Managing Director
Sevket SABANCI	Vice Chairman (non-executive)
Erol SABANCI**	Vice Chairman (non-executive)
Omer SABANCI	Member (non-executive)
Sevil Sabanci SABANCI***	Member (non-executive)
Serra SABANCI	Member (non-executive)
Hasan GULESCI	Independent member (non-executive)
Nafiz Can PAKER	Independent member (non-executive)
Ahmet Cemal DORDUNCU	Member and CEO

* Human Resources Committee member
** Finance Committee member
*** Audit Committee member

Source: Annual Report, 2006.

The Committees of the Board of Directors

Sabanci has executive committees assisting and reporting to the Board of Directors. These are Finance Committee, Audit Committee and Human Resources Committee. There is no corporate governance committee, because the board of directors directs corporate governance regulations and practices. Each board member can be appointed at most to one committee depending on their work experience (Annual Report, 2006; Sabanci Website).

THE AUDIT STRUCTURE

The Internal Auditors

Appointment of the Internal Auditors is defined in by-laws of company. Internal auditors of Sabanci are two independent members. They audit income statement and balance sheet according to the Tax Law and the Commercial Law of Turkey and report to the shareholders meeting (Annual Report, 2006; Sabanci Website).

The Audit Committee, Risk Management and Internal Control Mechanism, External Audit

The Risk Management Department has conducted appraisal and analysis studies in 2006 with the aim of providing maximum value to the shareholders. In addition, the Audit Committee with two members supports the internal control mechanism. External Auditor is reporting to the Audit Committee (Annual Report, 2006; Sabanci Website).

DISCLOSURE OF INFORMATION

The consolidated financial statements and notes of Sabanci for 2006 are in conformity with IFRS and have been prepared in accordance with CMB regulations. They are also audited by an independent auditor in accordance with IAS and accordingly disclosed to the public (Annual Report, 2006; Sabanci Website).

Sabanci has a well-organized website, both in English and Turkish, which gives detailed information about the Company as a whole. In the Turkish version of the website there are company by-laws. The 2006 Annual Report has corporate governance and corporate responsibility parts. The relevant people

who can have insider knowledge are listed by name in Annual Report 2006 (Annual Report, 2006; Sabanci Website).

CORPORATE SOCIAL RESPONSIBILITY

CSR Policy of Sabanci Group is to manage the economic, social and environmental impact of their actions with responsibility and to place priority on the development of society. The Code of Business Ethics of Sabanci Group Companies (SA-Ethics) program was put into practice. The Ethics Board reports directly to the Chairperson of the Holding Company. In addition, Human Resource Committee is organized with the aim of recruiting highest talent workforce. The major CSR activity of Sabanci is coordinated under Haci Omer Sabanci Vakfi (Vaksa). Sabanci brothers founded Vaksa in 1974. Vaksa is one of the largest family funded charity foundations in Turkey. The resources are provided by donations from family members, companies within the Sabanci Group and from revenue generated by its own assets. Vaksa has been contributed with developing many schools, student residences, healthcare units, cultural centers, libraries, sports and social facilities in different parts of Turkey. Vaksa is one of the major contributors of United Nations Joint Program on 'Promoting and Protecting Women and Girls' Human Rights' (Annual Report, 2006; Sabanci Website).

Discussion

Family owned businesses are the most common and dominant company structure both in Italy and Turkey. Their importance in the economies of these countries has been increasing because non-family owners or investors will only be attracted if their rights are strongly protected both in the legal framework of the country and also in the corporate governance applications of the company in which they invest (Mallin, 2004). As a result of this, the organizational bodies and stock exchanges pay attention to corporate governance applications and issue CG codes parallel to OECD Code of 2004. Both countries have been making important new regulations in accordance with the changes in the world. Italy has improved in making more CG Codes mandatory than Turkey.

The structures and processes of corporate governance in Sabanci and Italmobiliare are not as clear as they often are assumed to be in non-family big publicly listed corporations. This results from cross-holdings and pyramid ownership structures and is in accord with the opinion of Melin and

Nordqvist (2000). However, Sabanci developed a mechanism of control in terms of governance practices and disclosure that resembled the Anglo-Saxon governance regime as the world's largest transnational firms mentioned by Markarian et al. (2007), than do the mechanisms of Italmobiliare. For example, Sabanci has the separation of the roles of the CEO and Chairman and Audit Committee structure. Italmobiliare follows the traditional Italian system in line with Corporate Governance Code of Italy such as the Lead Independent Director and the Board of Statutory Auditors. The main similarities and differences of two companies are discussed below.

THE STRUCTURE OF THE BOARD OF DIRECTORS

In Sabanci, there is a separation of the Chairman and CEO. The Chairman and managing director, Guler Sabanci, is a family member. The CEO, Ahmet Cemal DORDUNCU, is a professional. At the same time, there are two independent and non-executive members and five non-executive members from the family. In contrast, Italmobiliare does not separate the Chairman and CEO. Giampiero Pesenti who is a family member has the powers and responsibilities of both the Chairman and the CEO. There is the Lead Independent Director and Executive Director responsible for supervising the internal control system, who is Mauro Bini, an independent professional. There are eight non-executive directors and two of them are independent. The Executive Committee is composed of four members.

This difference results from the differences in the codes of Turkey and Italy. Similar to the US and UK systems, the CG Principles of Turkey advises that the Chairman and CEO are not the same person and the majority of the board consists of non-executive members. In Italy, the advice is to avoid fusion of the roles of Chairman and CEO but there is flexibility regarding a lead independent director. When the Chairman and CEO are the same person or the Chairman is from the controlling issuer, the Board designates a lead independent director. In this system, the lead independent director is a control mechanism of the governance in corporate governance terms. This is considered beneficial for a family business management system. The same structure may be added to Turkish Corporate Governance Principles for companies that have the Chairman and CEO as the same person.

THE BOARD COMMITTEES AND THE AUDIT STRUCTURE

The appointment of Internal Auditors is defined in the by-laws of Sabanci. The Internal auditors of Sabanci are two independent members. They audit the income statement and the balance sheet according to the Tax Law and the Commercial Law of Turkey and report to the shareholders' meeting. Although under the Code of Italy (2006) an internal audit function is created and may be entrusted to independent professionals, the structure and responsibility of the Board of Statutory Auditors in Italy is in a way an improved form of the Internal Auditor in Turkey. The Board of Statutory Auditors of Italmobiliare has three members. One of them is called the Chairman, besides there are three substitute auditors. This board reports the consolidated financial statements in terms of their compliance with current laws and in conformity with IFRS. The by-laws provide for the presentation of lists to ensure the appointment of one Acting Auditor and one Substitute Auditor by minority shareholders. Under the legislation, the Chairman of the Board of Statutory Auditors is appointed by the shareholders' meeting from the auditors elected by minority shareholders but none of the current Statutory Auditors of Italmobiliare represent the minority shareholders.

The board committees are organized according to needs of the companies themselves. Both of the companies, in line with their country codes have executive committees to support the Board of Directors.

In Italy, the Internal Control Committee examines the reports prepared by the Controller and the independent auditors to check the adequacy of the internal control system, and it reports on its activities and the adequacy of the internal control system to the Board of Directors. The Board of Directors is in the center of the internal control system. The Internal Control Committee, which acts as a consultant, carries out the preparatory activity. This role is separate from the role of the Board of Statutory Auditors, which performs mainly ex-post control functions (CGC of Italy, 2006). However, there is flexibility in delegating some of the responsibilities of the Board of Statutory Auditors about the auditing process to the Internal Control Committee (Code of Italy, 2006). However, Italmobiliare keeps the duties at the Board of Statutory Auditors.

In contrast to the structure in Italy, the Audit Committee, which is mandatory in Turkey, is the sole responsible body for the audit and control processes. The Audit Committee is responsible to take the necessary measures to ensure both external and internal auditing processes are carried out transparently and

adequately. In other words, both the internal control process and the external audit structure are under the control of the Audit Committee (Principles of Turkey, 2005). Audit Committee in Sabanci functions in conformity with the duties stated in CG Principles of 2005.

When the Chairman and CEO are the same person, an additional audit structure may be useful for the good governance of family-owned companies. In that case, a distribution of powers and responsibilities may be necessary. In Italy, the Internal Control Committee and the Board of Statutory Auditors can control each other's responsibility and power areas. The same structure could be organized in Turkey so that in the listed companies of Turkey who do not separate the CEO and Chairman duties, the Audit Committee may act as does the Internal Control Committee in Italy. However, this is a complex structure to apply. When there is separation of the Chairman and CEO, the structure currently used in Turkey seems to be more functional.

DISCLOSURE

The consolidated financial statements and notes of Sabanci for 2006 are in conformity with the IFRS and have been prepared in accordance with CMB regulations. They have also been audited by an independent auditor in accordance with IAS and accordingly disclosed to the public (Annual Report of Sabanci, 2006). Similarly, the financial statements of 2006 of Italmobiliare have been prepared in compliance with IFRS. They are also audited by an external audit firm in accordance with IAS and disclosed to the public (Annual Report of Italmobiliare, 2006).

Sabanci has a well-organized website both in English and Turkish which gives detailed information about the Company. In the Turkish version of the website there is also the company by-laws. The relevant people who can have insider knowledge are listed by name in the Annual Report 2006.

A similar structure can be seen in Italmobiliare,which has a well-organized website both in English and Italian which gives detailed information about the company. The Investment Relations site includes Annual Reports since 1998, Half Year Reports since 1999, Quarterly Reports since 2000. In the English version of the website there is the company by-laws. Relevant people to disclose information when carried out transactions on their own behalf on Italmobiliare shares under the Internal Dealing Code are defined.

Disclosure is a mandatory application of corporate governance both in Turkey and Italy. Thus, with the compulsory regulations in the disclosure area, transparency and accountability have increased significantly in both of the companies. This brings an improvement in terms of corporate governance. This is consistent with the study of IFC and Lex Mundi (2006) that Turkey and Italy have increased disclosure requirements.

CORPORATE SOCIAL RESPONSIBILITY

Both Italmobiliare and Sabanci give priority to CSR. They both have Foundations and a Code of Business Ethics. In addition, Sabanci has an Ethics Board reporting directly to the Chairperson of the Holding Company. Also, Sabanci has the Human Resource Committee. For the holding organizations a human resource committee may be useful in terms of employee-employer relations. Moreover, Sabanci has adopted CSR Policy and the Principles and announced this on the company website.

Conclusion

The governance system of family-owned companies has unique characteristics. The purpose of my study was to analyze the CG characteristics and applications in large listed family-owned companies in Turkey and Italy, by employing one sample company from each, respectively Sabanci and Italmobiliare. The main conclusion is that these two companies, which carry the specific characteristics of listed family-owned firms, are on the way to applying the CG Codes of their own countries. These firms follow the framework defined by the national law and regulations and comply voluntarily with CG standards depending on their own needs.

Both of these firms recruited independent and non-executive board members, increased disclosure and transparency, created board committees and CSR applications. In Sabanci, there is a separation of the Chairman and CEO. In contrast, Italmobiliare does not separate the Chairman and CEO. Giampiero Pesenti who is a family member has the powers and responsibilities of both the Chairman and the CEO. There is the Lead Independent Director and Executive Director responsible for supervising the internal control system, who is Mauro Bini, an independent professional. In Italy, when the Chairman and CEO are the same person or the Chairman is from the controlling issuer, the Board designates a lead independent director. In this system, the lead independent

director is a control mechanism of the governance in corporate governance terms. This is considered beneficial for a family business management system. The same structure may be added to Turkish Corporate Governance Principles for companies that have the Chairman and CEO as the same person.

The internal control and audit structures have different applications in both of the companies parallel to their country's laws and CG standards. The appointment of Internal Auditors is defined in the by-laws of Sabanci. The Internal auditors of Sabanci are two independent members. They audit the income statement and the balance sheet according to the Tax Law and the Commercial Law of Turkey and report to the shareholders' meeting. Although under the Code of Italy (2006) an internal audit function is created and may be entrusted to independent professionals, the structure and responsibility of the Board of Statutory Auditors in Italy is in a way an improved form of the Internal Auditor in Turkey. The Board of Statutory Auditors of Italmobiliare has three members.

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Disclosure is a mandatory application of corporate governance both in Turkey and Italy. Thus, with the compulsory regulations in the disclosure area, transparency and accountability have increased significantly in both of the companies. This brings an improvement in terms of corporate governance. This is consistent with the study of IFC and Lex Mundi (2006) that Turkey and Italy have increased disclosure requirements.

Both Italmobiliare and Sabanci give priority to CSR. They both have Foundations and a Code of Business Ethics. CG is seen as necessary to compete in the global business environment by both of the companies. Although the sample firms have good governance practices, there is still a way to go.

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9

The Missing Ingredient to an Effective Corporate Governance System in Lebanon

Suzanne Charbaji

Introduction

The purpose of the present study is to extend our understanding of the awareness of corporate governance in Lebanon. Only 60 valid self-administered questionnaires were returned from managers working for different organizations were used as the population for this study. More than 75 per cent of the sample disagree or strongly disagree that 'Corporate Governance basically means that while involving you and your brother/sister in management the final decision-maker is your father (mother)'. The findings of this study shows that the majority of the managers in the sample are highly educated and they believe in separating management from ownership and in having control over management. More important they do belong to the current information age and they understand the importance of implementing eCRM and DSS systems in advancing corporate governance in Lebanon. A cross validation of the findings across different industries and different sectors becomes imperative before we can generalize the findings to all managers in Lebanon.

After its independence from France in 1943, Lebanon became the financial center for Arab countries and it became known as 'the Switzerland of the Middle East' (Khouri, 2007) until its disastrous 1975–1990 civil war. The civil war resulted in a heavy loss – both human and material (Thornton, 2008). Currently, Lebanon similar to all other Arab countries, is recognized by having Small and Medium Enterprise, the main industries are food processing; jewellery; cement; textiles; mineral and chemical products; wood and furniture

products; oil refining; and metal fabricating (The World Factbook, 2008). The family business in Lebanon is defenseless because various Lebanese media love crisis and all TV channels have been spreading the word that a potential armed conflict is going to break-out one day. The researcher in this study truly believes that somebody, some day; may create a misinformation, that may have a half truth in it, in order to create panic and make money out of his/her propaganda. People all over the world had similar unethical cases throughout history. As an example, we heard of companies that created computer virus and at the same time created the remedy 'anti-virus software'. We have also heard on the news that companies are preparing to produce vaccines for bird flue and, we wonder how much business ethics is there? Besides, the US Department of State, recognizes that 'Unauthorized copying of imported books, videotapes, cassettes, and computer software is common in Lebanon'. (Heritage, 2004). Lebanese business is a family business made of small and medium enterprises (SME). As to be expected, 'Family involvement in a firm has an impact on many aspects of organizational behaviour' (Cromile and O'Sullivan, 1999, p. 77). This leads to a lot of job complexities including role ambiguity, role conflict, stress and dissatisfaction which in turn leads to employee turnover. Goffee, notes that the term 'family' is itself sufficient 'to distinguish the use of more traditional/particularistic, face-to-face forms of authority – paternalistic from more rational/universalistic and impersonal modes' (Goffee, 1996, p. 40). Morris et al., argue that 'family firms violate a tent of contemporary models of organizations, namely, the separation of ownership from management' (Morris et al.,1996, p. 68). When it comes to technology, it becomes evident that a serious digital divide exists between Lebanon and the developed world (Abouchedid and Eid, 2004). Internet users in Lebanon is just 2.8 per cent of the Internet users in the Middle East and Lebanon is ranked 8th among 15 Middle Eastern countries (InternetWorld Stats, 2008).

Significance of the Study

Since the 1980s, business ethics have attracted increasing research attention due to various scandals related to companies which were symbols of success until recently (e.g. Arthur Andersen, Enron and WorldCom) and became images of greed and unethical behavior. Corporate governance in many western organizations is deeply grounded in agency theory (Jensen and Meckling, 1976) thereby focusing primarily on maximizing shareholder values, and in the process leaves managers with limited discretion to serve other stakeholders (Freeman, 1984). In contrast, there is mounting pressure on executives to adhere

to strict code of ethics (Dolan and Cannings, 1995). Moreover, ethical issues are increasingly starting to be recognized as important aspects of different business sectors in our country (Halawi and Karkoulian, 2006: Zgheib, 2005). Within this framework, business schools which are considered a basic source of providing leaders, managers and entrepreneurs, seem to be blamed for much of the unethical behavior in business (Pizzolatto and Bevill, 1996).

Granted, there have been many studies done on SME in general, however, there was no attempt to study how can technology advance corporate governance in developing countries such as Lebanon. The researcher in this study believes that implementation of advanced systems such as eCRM and/or DSS is the missing ingredient to an effective corporate governance system in Lebanon. A study, such as the one conducted here, is recommended by experts in this area. In their critique of Small and Medium Enterprise business research, Morris and colleagues note 'the prevalence of inadequate research designs and major limitations in terms of statistical analysis and results' (Morris et al., 1996). In fact 'The relationship between people and their work has long attracted psychologists and other behavioral scientists' (Wiley, 1995, p. 263) but investigating the relation between corporate governance and technology in developing countries has always been insufficient.

Purpose of the Study

This study aims at addressing the subject of the attitude towards using technology in advancing corporate governance in Lebanon. The purpose of the present study is: First, to extend our understanding of the awareness of corporate governance in Lebanon. Second, to contribute to a rather under-investigated field area, and raise issues for further research in Lebanon. This study is descriptive and explanatory.

Literature Review

INVESTIGATING THE AWARENESS OF BUSINESS ETHICS

The word 'ethics' is derived from the Greek word *ethos* meaning from the notion of character and deep values which determine the identity and goodness or badness of an individual or group (Rion, 1990). Ethics has been defined as 'the study of standards of conduct and moral judgement' and as 'reflection on the

moral significance of human action' (Gandz and Hayes, 1988). It refers to 'rules and principles that define right and wrong conduct and managers make their decisions based on ethical principles.' (Zgheib, 2005). Professional ethics can be defined as the rules or standards governing the conduct of a profession while work ethics are considered as 'a construct compose of two distinct parts: attitudes or values and the behaviors that outwardly reflects these attitudes or values' (McCortney and Engels, 2003). Normally, the work ethic is studied as a cultural model principally affected by formative socialization experiences during childhood and adolescence by internalizing them through experiencing and observing the attitudes and actions of family and colleagues at work (Brown, 2000, Hill and Petty, 1995). The ethical values that regulate the economic activity which came to be known as Business Ethics is a relatively recent effort, and the role of ethics in business activity has been debated overtime (Mohammad et al., 2003). Based on review of literature it is found that the assessment of individual ethical behavior continues to be very important in business practice. (Zgheib, 2005). A recent report by the World Bank has advanced some upsetting numbers on the extent of bribery and corruption in the world. It estimates that on annual basis some US$1,000 billion (a trillion dollars!) is exchanged in bribes, or $2.7 billion per day is paid in bribes in both developing and rich countries! In this context, Lebanon ranks 78th out of 133 countries surveyed, an unenviable ranking! Similarly, the recent World Bank report on Governance in the MENA countries reveals that Lebanon falls below the average for the MENA countries as well as the Upper Middle Income Countries on indices of public accountability, quality of administration and the overall quality of governance! (Nasser Saidi, 2004). Problems such as virus's appearance, computer fraud, and illegal software copying are now commonly mentioned by the paper press. Ethical problems are growing fast in schools, colleges and higher education institutions (Halawi and Karkoulian, 2006). Many researchers reveal that undergraduate students hold the same ethical attitudes as graduate students or employed individuals. Accordingly, business schools which are considered a basic source of providing leaders, managers and entrepreneurs, seem to be blamed for much of the unethical behavior in business (Pizzolatto and Bevill, 1996).

STUDIES THAT INVESTIGATED BUSINESS STUDENTS' ETHICAL BELIEFS

A large number of studies were conducted to investigate business students' ethical beliefs. They tested how future business people may react to ethical business dilemmas. Few studies of business students were conducted in an attempt to explore empirically some of their respective values as a key

to predict their future behavior in an actual work setting. The studies have also compared perceptions in ethical beliefs to the differences in educational background, educational level, and work experience. Many of these studies have found that 'judgment related to ethical issues (issues that refer to the grey area between what is right or wrong) is a subject of multiple forces, e.g. demographic, environmental, situational factors and personal traits' (Holian, 2002). Concerning the influence of the demographic factors, elements such as: gender, ethnicity, occupational experience and ideology, religion, socioeconomic status, social milieu, geographic region were more examined. (Ford and Richardson 1994).

STUDIES CONDUCTED ABOUT BUSINESS ETHICS IN LEBANON

According to a recent report on Global Corruption from Transparency International, Lebanon ranks 78th out of 133 countries surveyed; an unenviable ranking! (Nasser Saidi, 2004). A lot of events were mentioned in the media that revealed violation of ethics have occurred such as news of bribery, corruption and malpractices (Zgheib, 2005). Ethical problems are growing fast in schools, colleges and higher education institutions (Halawi and Karkoulian, 2006). Some studies investigated the quality of business services offered to customers by Lebanese institutions (Jamali et al., 2006) and others investigated business students' perceptions of ethical beliefs and their attitude towards an ethical practices code and ethical values in Lebanon. (Halawi and Karkoulian, 2006, Zgheib, 2005). This shows the imperative need to further investigate business ethics and the role that technology can take in advancing corporate governance in Lebanon.

Procedures and Methodology

POPULATION OF THE STUDY

Managers working for different organizations were used as the population for this study.

INSTRUMENTATION

Through a review of literature, informal discussion with university colleagues, and this researcher's personal experience, this researcher constructed an instrument that was distributed to managers in different sectors in Lebanon.

THE DEPENDENT VARIABLE

Nine questions in Part I of the questionnaire contain items that measure the awareness of corporate governance and the attitude towards using technology in advancing corporate governance in Lebanon. A scale from 1 to 5 where '1' means Strongly Disagree and '5' means Strongly Agree was used in feeding data to SPSS.

Q1 Corporate Governance basically means using DSS or eCRM in dealing with internal and external customers.

Q2 Corporate Governance basically means using computers and technology in dealing with stakeholders.

Q3 Corporate Governance basically means that priority is given to my family members in managing the firm in case of vacancy in managing our family business.

Q4 Corporate Governance basically means that while involving you and your brother/sister in management the final decision-maker is your father (mother).

Q5 Corporate Governance basically means the right of companies to promote product and services by invading my email, my mobile or by using technology.

Q6 Corporate Governance basically means continuous control of bank over management (board of directors).

Q7 Corporate Governance basically means continuous control of government over management (board of directors).

Q8 Corporate Governance means continuous control of shareholders over management (board of directors).

Q9 Corporate Governance basically means the separation between ownership and management.

THE INDEPENDENT VARIABLES

Five questions in Part II of the questionnaire contain the items that measure independent variables:

1. Type of organization;
2. Years of experience;
3. Number of employees;
4. Academic qualification; and
5. Type of industry.

SAMPLE SELECTION

Since, as a researcher in this study, I was unable to randomly select a representative sample because I did not have access to the names of managers in Lebanon therefore, I decided to use a large sample which consisted of 300 managers. Only 60 valid self administered questionnaires were returned.

MAJOR FINDINGS OF THE STUDY

The data of this research were collected by means of self-administered questionnaire. Forty out of sixty managers (66.7 per cent) work for private sector, Thirty four (56.7 per cent) have less than five years experience and sixteen (26.7 per cent) have between five and ten years experience, Fifty four (90 per cent) have university and post graduate degrees. Five managers (8.3 per cent) work for organizations having less than six employees while two thirds (68.3 per cent) work for companies having 120 employees or below. Ten managers (16.7 per cent) work in the industrial sector, eight (13.3 per cent) work in the business sector, four (6.7 per cent) work in the educational sector. Twenty six (43.3 per cent) work for the service sector and two (3.3 per cent) work in the tourism sector. Graph 1 below shows that more than three quarters of the selected sample believes that 'Corporate Governance basically means using DSS or eCRM in dealing with internal and external customers'.

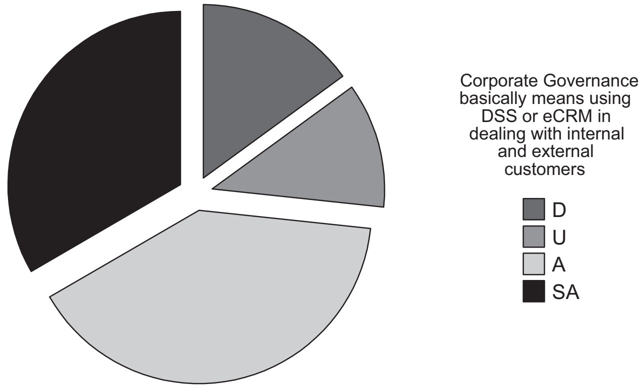

Figure 9.1 Use of DSS or eCRM

Thirty four of the selected sample (56.7 per cent) agree and strongly agree that 'Corporate Governance basically means using computer and technology in dealing with stakeholders. Only nine (15 per cent) of the sample agree and strongly agree on the two questions that 'Corporate Governance basically means that priority is given to my family members in managing the firm in case of vacancy in managing our family business' and that 'Corporate Governance basically means that while involving you and your brother/sister in management the final decision-maker is your father (mother)'. Forty eight (80 per cent) of the sample agree and strongly agree on the two questions that: Corporate Governance means continuous control of shareholders over management (board of directors)'. Forty five (75 per cent) of the sample disagree and strongly disagree on the question that 'Corporate Governance basically means that priority is given to my family members in managing the firm in case of vacancy in managing our family business'. Table 9.1 shows that more than 75 per cent of the sample disagree or strongly disagree that 'Corporate Governance basically means that while involving you and your brother/sister in management the final decision-maker is your father (mother)'.

Table 9.1 Stakeholder responses

Corporate Governance basically means that while involving you and your brother/sister in management, the final decision-maker is your father (mother)

	Frequency	Per cent	Valid Per cent	Cumulative Per cent
Valid SD	23	38.3	38.3	38.3
D	23	38.3	38.3	76.7
U	5	8.3	8.3	85.0
A	7	11.7	11.7	96.7
SA	2	3.3	3.3	100.0
Total	**60**	**100.00**	**100.00**	

Conclusions and Recommendations

This investigation was conducted to discover the awareness of corporate governance and the attitude towards using technology in advancing corporate governance in Lebanon. The selected sample of 60 managers was asked nine questions in specific areas related to corporate governance that were identified by previous research. The sample was highly educated and it seems to me that their undergraduate and graduate study tie-in with their work experience. The findings of this study shows that the majority of the managers in the sample are highly educated and they believe in separating management from ownership and in having control over management. More important they do belong to the current information age and they understand the importance of implementing eCRM and DSS systems in advancing corporate governance in Lebanon. A cross validation of the findings across different industries and different sectors becomes imperative before we can generalize the findings to all managers in Lebanon.

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PART 3
Theoretical Perspectives

It is relatively unquestioned that corporate governance is fundamental to the continuing operating of any corporation; hence much attention has been paid to the procedures of such governance. Equally there is a growing acceptance that corporate social responsibility is equally fundamental. A significant part of the reason for this is due to the developments brought about through globalisation. The phenomenon known as globalisation is a multidimensional process involving economic, politic, social and cultural change. However, the most important discussion about globalisation is related to the economic effect it has upon countries and the corporations operating within and across these countries. There has been much written about globalisation – either positive or negative – and the effects which it is having. One consequence of globalisation though is manifesting itself in the structure and organisation of corporations. This is concerned with the harmonisation procedures and structures which many argue will manifest itself through the emergence of global norms for corporate governance. We have seen through the preceding chapters a variety of issues concerned with corporate governance and corporate social responsibility and the effects of globalisation. Equally we have seen many examples of the overwhelming importance of cultural issues in the operation of whatever systems or procedures are introduced. Nevertheless some form of commonality and harmonisation continues to be a subject of debate. This final section attempts to set this debate within a theoretical context before offering a prognosis.

In the first chapter Strasser takes a legal perspective and argues that we naturally expect responsible behaviour from business enterprises and these expectations are increasingly enforced by pressures from the marketplace, civil society, and sometimes by specific legal requirements, such as rules about labour standards, environmental protection, and civil liability for harm. Nevertheless the law has a problem enforcing these requirements because it frequently

looks to the constituent parts of the business, rather than to the whole business enterprise. In this chapter therefore he proposes a solution which he describes as enterprise analysis.

Following on from Strasser is a chapter by Clarke and Klettner which takes a fresh look at the perennial debate between increasing regulation of corporate activity and the initiatives undertaken when corporations are given freedom of action. This debate is situated within the increasingly vociferous debate concerning sustainability. They aim in this chapter to outline and clarify the continuing and emerging legal and commercial basis for corporations to pursue corporate social and environmental responsibility; the ongoing legal and material support for institutional trustees to prioritise socially and environmentally responsible investments; to examine developments in verification on corporate reporting of CSR performance.

In the final chapter Aras and Crowther deal with what might be the future of corporate governance and corporate social responsibility. They show that some discussion has taken place as to whether corporate governance is an aspect of corporate social responsibility, or vice versa but argue that they are inevitable interrelated – good governance must recognise CSR and effective CSR must accommodate governance. These issues have a certain commonality throughout the world and so one thing that is apparent is that these are issues of considerable significance all over the world. In this final chapter therefore they consider the issues raised and explore commonalities and differences. And finally in this chapter – the last one in the book – they take these debates and the arguments from the chapters in this book in order to consider a prognosis of what the future might hold for corporate governance and social responsibility procedures and practices.

10

An Enterprise Theory of Legal Obligation for Corporate Social Responsibility

Kurt A. Strasser[1]

Introduction

We expect responsible behavior from business enterprises and these expectations are increasingly enforced by pressures from the marketplace, civil society, and sometimes by specific legal requirements, such as rules about labor standards, environmental protection, and civil liability for harm. Yet the law has a problem enforcing these requirements because it frequently looks to the constituent parts of the business, rather than to the whole business enterprise. This chapter proposes a solution – enterprise analysis.

Modern large business enterprises are typically made up of layers of legally separate corporations – subsidiaries – owned and controlled by another corporation – the parent. While this separation has little or no significance as a matter of business reality and social expectation, the standard legal analysis is infatuated with it, focusing on separate subsidiary corporations and imposing legal requirements of responsible behavior only on them. The result is often poor legal decisions on the requirements of corporate social responsibility. Yet there are exceptions, such as the examples discussed in areas of labor standards, environmental protection, and foreign corrupt practices in which law considers whether it should look to the whole enterprise to be effective. These examples illustrate the more general theory of enterprise analysis which we now need to adopt as the general rule.

1 Phillip Blumberg provided valuable comments of a prior draft of this chapter and Eric King provided invaluable research assistance. The remaining errors are my own.

Social Expectations, Business Reality and Legal Theory.

What is the 'corporation' in corporate social responsibility? At first blush, the question sounds silly. The obvious answer is that we look to General Motors to make cleaner cars, Nike to ensure better treatment for employees of its suppliers, and BP to provide the new technologies and products which can take us 'beyond petroleum'. Exxon should clean up Prince William Sound and pay for the damage caused by its Exxon-Valdez tanker's spill of over eleven million gallons of oil there. Shell should be responsible for the Brent Spar platform, and the James Hardie Group should pay for the harm caused by asbestos exposure to its Australian workers.

Corporate social responsibility is expected of business and, increasingly, the marketplace and civil society enforce this expectation. Markets, supported by civil society, sometimes reward responsible business behavior and increasingly punish irresponsible behavior. For example, when Nike initially failed to ensure that its suppliers treated their employees responsibly, it was met with a sharp rebuke in the marketplace which eventually lead to a change in corporate policy and behavior. When the Hardie Group in Australia sought to avoid paying for occupational asbestos disease which its subsidiaries' activities caused, as is discussed further below, pressure from the marketplace and aroused public opinion forced it to reverse course and provide adequate remedies. In each of these cases, the company had not been determined to be legally liable to meet its social responsibilities, and each company had at least a plausible case that it was not legally liable under prevailing law, but this made no effective difference to the social demand for corporate social responsibility. In these and many other examples, corporate social responsibility was required by civil society and enforced by real marketplace and other social controls, although not ones which included enforceable legal requirements. The requirements of corporate social responsibility are imposed by markets and other social pressures, and they are imposed on the whole business enterprise. Unfortunately, the law's efforts to reach the whole enterprise to enforce social responsibility have been much less successful.

In a number of specific areas, the law has developed rules to require responsible corporate behavior, as will be discussed in specific sections below. However, even these legal requirements are hard to enforce throughout a modern business organization because of the law's myopic view of it. Mainstream legal thinking and analysis is stuck in a conceptual trap of its own making and thus has a hard time looking to the whole business enterprise to

enforce social responsibility (and many other) obligations. For example, if the United States were to require better gasoline mileage from its vehicles, the legal obligation might well fall not on General Motors, but rather on its individual subsidiary companies through which it makes and sells its cars. In legal terms, Nike might well claim that it is not responsible for legal violations committed by its suppliers, and the James Hardie Group continues to claim it is not legally responsible for asbestos exposure caused by its subsidiaries. In all these cases, and numerous others, the standard legal analysis says that only the particular subsidiary corporation engaging in the conduct at issue will be responsible. As a result, the whole corporate enterprise which conducts the business – the parent company and all the subsidiaries – may not have legal responsibility. This is important because virtually all large business today is organized into separate corporations, subsidiaries, which are owned in a hierarchical structure by a parent corporation which is in actual control of the whole enterprise.[2] Standard legal analysis treats each of these subsidiaries as a separate legal entity, with its own rights and responsibilities. A further corollary in the standard analysis is that the shareholders of these separate legal entities are not responsible for its obligations beyond the extent of their investments, even when the shareholder is the parent corporation which controls the whole enterprise. Thus, the parent may not be held responsible for the obligations of the whole enterprise.

Of course, this flies in the face of both business reality and general social expectation. The business reality is that General Motors, Shell, Nike and BP are each one integrated business enterprise. (Strasser and Blumberg, 2008) They may split themselves up into myriad subsidiaries as a business management strategy, a tax avoidance mechanism, a way to avoid legal responsibility, or for other diverse management and legal reasons. Whatever the business's reason for choosing one or another corporate structure, the choice does not have an effect on society's expectations of its corporate social responsibility obligations, and it should not have an effect on the business's legal obligations to behave responsibly. While the technical craftsmanship of a business's corporate structure may be of interest to corporate lawyers, it does not determine the general social expectation we have of the business, and it should not determine the business's legal liability. We expect Nike to police its suppliers regardless of legal liability for their misdeeds, and we expect BP to make good on its promise

2 While the parent company many choose to have subholding companies as well as operating subsidiaries, for clarity of exposition in this discussion, we will assume those subholding companies are included in our references to parent companies. Nothing in the argument presented here is changed by the parent's management decision to interject one or more tiers of subholding companies between itself and the operating subsidiaries.

to move 'beyond petroleum' even if the legal responsibility doesn't reach this high in the whole enterprise. Why does the law look at it differently?

The section below will discuss how this myopic standard legal analysis developed, offering a largely historical explanation. This section will also consider how this flawed legal conception can lead to poor legal decision-making on issues of corporate social responsibility. But the law is not forever fixed, the next section will sketch a legal theory of enterprise analysis which will lead to a more modern, realistic, and useful legal concept of the business enterprise. On closer examination, the theory of enterprise analysis is not so novel as first appears, and the subsequent section will discuss specific examples of legal rules and regulations which have in fact applied an enterprise analysis to require responsible corporate behavior in labor standards, oil spill clean up liability, and controlling foreign corrupt practices. These examples show how the theory of enterprise analysis can be applied to reach the right result. Finally, the last section will then conclude.

The Problem of Traditional Legal Theories of Entity Liability.

SEPARATE CORPORATE ENTITIES AND LIMITED LIABILITY.

While the traditional legal theory that each corporation is a separate legal entity is ancient, its significance exploded as the legal structure of business enterprise transformed early in the 19th century from 1800 to 1850. With the increasing popularity of the corporate form for the conduct of business activities, states enacted general incorporation statutes allowing investors to freely organize corporations to conduct most forms of business. As a result of this transformation, much of American business came to be conducted by corporations – the newly created legal entities which each had a legal status and personality separate from its shareholders (Strasser and Blumberg 2008; Blumberg, Strasser, Georgakopoulos and Gouvin, 2005).[3] This legal status included the right to contract, buy and sell property, operate a business, and incur liability separate from its shareholders.

3 Limited liability came to New England in the 1830, Act of Feb. 23, 1830, ch. 53, §8, 1830 Mass Acts 325, 329 (Dodd 1960), the UK in 1855, but remarkably not until 1930 in California, Cal. Const. of 1849, art. IV, §36; Cal. Const. of 1879, art. XII, §§3, 15 (replaced 1931); Cal. Civ. Code §322 (repealed 1931). For a review of the history of the idea of corporate separateness, see (Muchlinski 2007, Blumberg 1993).

Along with this widespread use of the corporate form to conduct business came limited liability for corporate shareholders. Business interests successfully pressed for limited liability to enable them to raise larger and larger amounts of capital, expand the scale of their operations, and take advantage of the technological advances of the Industrial Revolution. Investor-shareholders were given limited liability to encourage them to provide capital for the growing enterprises, making shareholders generally not liable for the obligations of the corporation. In the political struggle over the adoption of this new principle, business interests argued that individual shareholders were primarily investors, not primarily managers, with only incomplete power to supervise the activities of the increasingly larger and more professionally managed business of the corporation. Business interests argued that if shareholders couldn't supervise the business in detail, they shouldn't be generally liable for its activities, particularly since the corporation was a separate entity anyway. The argument generally prevailed and the result was that shareholders became protected by limited liability.

Of course there were limits. The courts devised the doctrine of 'piercing' or 'lifting the veil' of limited liability to deal with 'exceptional cases'. This is a theory familiar to all common law lawyers which authorizes shareholder liability in the 'exceptional' situation where the corporation is not really separate, or when the corporate form is abused.[4] Readers from Civil Law jurisdictions will doubtless recognize similar problems and analogous doctrines. In general, relief from limited shareholder liability is similarly limited to unusual situations, often based either on specific statutory provisions for insolvency, or on vague doctrines emphasizing 'abuse' or, in Italian law, 'tyrant' shareholders. (Antunes, 1994, pp. 250–58). But limited liability for shareholders was and remains the norm, and a finding of shareholder liability in a particular case is conventionally thought to be an unusual result prompted by extraordinary circumstances.

The modern justification for limited shareholder liability argues that it facilitates investment by investor shareholders, and thus capital formation for society, by reducing three types of transaction costs which investors would face if they were liable for all corporate obligations.[5]

4 This common law theory is much maligned in the academic literature. Perhaps the most quoted criticism is from Easterbrook and (Fischel 1985). '"Piercing" seems to happen freakishly. Like lightning, it is rare, severe, and unprincipled.' (Bainbridge 2001), and (Michael 2000), discuss the different strengths of the rationale for limited liability in contract and tort cases. Despite this criticism, 'piercing the veil' continues to be the primary approach applied by courts.

5 The classic modern statements are (Easterbrook and Fischel 1985) and (Ribstein 1991). Excellent recent summaries are in (Bainbridge 2001), pp. 487–506, and (Mendelson 2002), pp. 1217–47.

First, with limited liability, shareholders and creditors do not need to monitor the solvency of other shareholders, something they would otherwise need to do to evaluate the extent of their own potential liability. Second, limited liability reduces the need for shareholders and creditors to monitor management to ensure that the corporation's managers are not engaged in excessively risky business activities and thereby exposing the shareholder's personal assets to excessive risk. Third, the argument runs, limited liability facilitates ownership of more diversified portfolios by investors because diversification in the form of owning shares in more companies does not expose their personal assets to a greater risk of liability. (Strasser and Blumberg, 2008). These justifications for limited liability emphasize the investor role of shareholders. They simply do not sensibly apply to parent company shareholders in modern corporate groups.

In the modern corporate group, while there are investor shareholders who own the parent company, the parent company owns the shares of the subsidiaries. However, the parent company is not in the same economic position as the individual investor shareholder. The business reality is that the whole group of corporations, both parent and subsidiaries, is one business enterprise, operating under the unitary control of the parent and possessing a high degree of economic integration. Interdependence of the business functions is its hallmark in administration, finance, employee selection and management, and in the use of the corporate public persona (Blumberg et al., 2005; Muchlinski, 2007, ch. 2; Antunes, 1994, ch. 2). The parent company shareholder is not in the same economic and functional role as an individual investor shareholder and the justifications for limited liability for the latter do not apply to the former.

Specifically, the transaction cost justifications for giving limited liability to investor shareholders do not fit the economic functions of a parent company shareholder. First, the parent need not monitor the assets of its fellow shareholders to determine its contingent liability. Indeed, it frequently owns 100 per cent of the subsidiary and there are no other shareholders.[6] The second transaction cost justification – monitoring management – doesn't fit either. The controlling parent company shareholder is making the decisions about the relative riskiness of the business operations to undertake and it has no need to further monitor its own decisions in order to limit its liability. The third justification, reducing the costs of diversification, similarly fails to apply here. Investors diversify to spread risk among investments; the parent company

6 When there are non-controlling minority shareholders, they do not manage the enterprise and their interest receives the limited protection it gets only as they are treated as investors.

is an operating entity and, as such, it does not have the investors' interest in diversifying its investments. While the parent company may choose to diversify the businesses within its enterprise, it can do so as an internal management decision, one which will have operating costs and benefits quite different from those involved in investment diversification.[7] In sum, the justifications for limited liability for investor shareholders simply don't fit the economic reality of parent companies as shareholders. (Antunes, 1994, pp. 113–55)

Why then, do the courts routinely find limited liability for parent company shareholders? More generally, why do legal thinkers treat subsidiaries as if they are separate business entities from their controlling parent companies? The answer comes from the courts' original and continuing failure to appreciate the importance of a technical rule change in corporate law. As noted above, operating a business through the corporate form came to be generally allowed and accepted from roughly 1800 to 1850, and the enactment of limited liability for shareholders followed shortly thereafter. Yet, at that time, corporations were not generally permitted to own shares in other corporations (Blumberg et al., 2005, ch. 3). As a result, corporate groups with parent and subsidiaries could not exist.

The key change in corporate law came later, soon after 1890, when corporations were generally allowed to own shares in other corporations.[8] In relatively short order the current structure of modern large business emerged, with a parent holding company controlling the enterprise through its ownership of the shares of its subsidiaries. The result is the structure we see commonly today. Yet when this change happened, courts did not change the exceptions to rules of limited liability to correspond to this changed business reality. Although controlling parent companies, as shareholders, are in a fundamentally different economic position from investor shareholders, with fundamentally different roles in managing the business, the courts failed to perceive this difference; instead, courts applied to parent companies the same rules of limited liability based on the same principles of corporate separateness. As a result, parent companies were able to use layers of subsidiaries to effectively insulate themselves from much of the liability which could arise

7 Thus it can choose to include diverse businesses within its enterprise, but doing so will require the enterprise to allow for the costs and benefits of operating and managing diverse businesses, which are simply not presented to an investor seeking to diversify.

8 New Jersey was the first to change its law, from 1889–93. Act of Apr. 4, 1888, ch. 269, §1, 1888 NJ Laws 385–56; Act of Apr. 17, 1888, ch. 295, §1, 1888 N.J. Laws 445–6; Act of May 9, 1889, ch. 265, §4, 1889 NJ Laws 412, 414; Act of Mar. 14, 1893, ch. 171, §2, 1893 NJ Laws 301. Virtually all other US jurisdictions followed.

from operating their business enterprises (Blumberg et al., 2005, ch. 3). Legal thinkers today, including courts, generally presume the same corporate entity separateness and the same limited liability for parent company shareholders as for investor shareholders, failing to recognize their essential differences. Along with these traditional rules of separateness and limited liability have most frequently come the same exceptions, primarily 'piercing the veil' and analogous civil law doctrines discussed above. The result of this analytical confusion is often poor legal decision-making in many legal areas, including corporate social responsibility.

PROBLEMS FOR CORPORATE SOCIAL RESPONSIBILITY

While corporate social responsibility is often an expectation of civil society enforced by the marketplace, there are rules in a number of specific areas in which legal requirements enforce specific corporate social responsibility norms. Yet when the law imposes these rules, the traditional corporate law ideas of the separate identity of corporate parents and subsidiaries, and the associated idea of limited shareholder liability, undercut effective implementation of the legal requirement. In the business world today, legal thinkers see separate parent and subsidiary corporations while business and civil society see integrated enterprises which have chosen to structure themselves into separate legal entities. The result of this fundamental legal misconception of the enterprise is often poor legal and regulatory decision-making.[9]

For example, consider the US Supreme Court's relatively recent decision on environmental contamination clean-up liability in the *Bestfoods* case. In that case the Court applied the most traditional idea that each corporation is a separate entity, complete with limited shareholder liability for parent company shareholders. Thus, the Court interpreted the applicable environmental clean-up statute, the Comprehensive Environmental Response Compensation and Liability Act, to include limited liability for a parent company shareholder, subject only to 'classic piercing' with all its limitations, and the Court gave no consideration to whether this result would impair the statute's effectiveness (*US v Bestfoods, Inc.* 1988; Strasser and Blumberg, 2008). As a result, the decision about the extent of clean-up liability throughout the business enterprise turned on traditional notions of corporate separateness and did not consider the public policy of environmental law statutes. The statute in question was concerned to accomplish environmental clean-up of contaminated sites which are no

9 When recovery is sought for corporate social responsibility claims, several procedural issues are also raised by this legal misconception (Blumberg 2002).

longer operating. Yet, the Court did not inquire whether implementation of the statute's environmental contamination clean-up purpose would be better served by imposing liability on the parent company shareholder, even if it meant bypassing the limitations of classic 'piercing'. Instead, the Court relied on a priori reasoning to conclude that Congress must have intended to establish limited liability and the classic 'piercing' doctrine.[10]

This is particularly unfortunate for it simply ignores one of the basic environmental law policies of the statute – polluters are to pay for clean-up (United States Code Title 42, Sec. 9607). As a result, the liability of parent companies for environmental clean-up responsibilities of parts of their business conducted by subsidiaries will not be determined by application of the publicly determined policy of the underlying statute – polluter pays. Rather, parent company liability will be determined by traditional 'veil piercing' tests, themselves often uncertain, which emphasize corporate formalities and are thereby subject to manipulation by clever counsel. This is poor environmental policy and should also be poor corporate law. It results from applying deeply ingrained legal attitudes of corporate separateness and limited liability where they simply do not fit either the policy needs of modern law or the economic reality of modern corporate structure.

The long saga of liability of the James Hardie Group, formerly of Australia, offers another example of the poor fit between traditional corporate law thinking and modern business realities of implementing corporate responsibility, although one in which markets and social expectations ultimately filled the gap in legal liability.[11] The James Hardie Group (Hardie Group) was an Australian business which, among other things, manufactured products from asbestos through two wholly-owned subsidiaries for about 70 years, until 1987 (Jackson, 2004). As a result of exposure during the manufacturing process, many workers have become ill and others are expected to suffer similarly. With claims pending and more threatened, in 2001 the Hardie Group took two major corporate actions to try to limit its present and future liability. First, it set up a foundation, the Medical Research and Compensation Foundation ('Foundation') to pay claims, and transferred $293 million to it to fund payment of asbestos claims. The amount was based on an outside consultant's report

10 The statute is silent on this point, concerned as it is with environmental policy rather than traditional corporate structure. When veil piercing is used, the court must decide whether to use federal or state law, and in this area federal law can potentially vary from traditional state rules. However, the court declined to answer this issue in *Bestfoods*, and the other authorities have been mixed (Blumberg et al., 2005, §99.03, §13.02).

11 I am indebted to Prof. Thomas Clarke who brought this example to my attention (Clark 2008).

although it proved to be completely inadequate to pay for the harm caused. As part of this transaction, the Hardie Group transferred ownership of the two manufacturing subsidiaries to the Foundation. This was clearly an effort to separate itself from its former subsidiaries and their asbestos liability.

The Hardie Group's second major corporate action was to relocate out of Australia. It moved its state of incorporation from Australia to the Netherlands and its real business headquarters and base of operations to the United States. As part of the reincorporation, the Hardie Group represented that it had made sufficient provision for asbestos liability in Australia and that it could draw on additional reserves from the new Netherlands corporation if needed. The first claim has proved to be false, and the right to draw on the reserves was subsequently cancelled by the company in 2003. The government of New South Wales is currently investigating the then company directors for these actions and representations ('Spinning Out of Control', 2007).

In taking these actions, the Hardie Group was trying to exploit the traditional legal separation between parent companies and subsidiaries, and use the traditional limited liability of parent companies for obligations of the subsidiary, to avoid paying for its workers' asbestos disease caused by their occupational exposure. While the subsidiaries were legally separate entities, in a real business sense they were part of the Hardie Group. The Group profited from their operations and should be responsible for their liabilities which resulted from business operations. Throughout the entire matter the Hardie Group has steadfastly maintained that it has no legal liability for this asbestos harm because it was caused by the operations of its subsidiaries. While this claim has a surface plausibility, based on the traditional corporate law doctrines discussed above, it has never been tested in court and, given the eventual settlement of the matter, is unlikely ever to be.

This blatant attempt to avoid responsibility lead to a public outcry and subsequent investigation by the government of New South Wales.

The resulting report found:

> *The negligence of the James Hardie companies occurred in the past, but the liabilities flowing from that negligence only arise day-by-day, now and in the future, as the diseases are acquired or manifest themselves … [m]embers of the public will contract asbestos-related diseases over many years because of the negligence of Amaca and Amaba [the Hardie*

> *Group subsidiaries]. The notion that the holding company would make the cheapest provision thought 'marketable' in respect of those liabilities … is singularly unattractive. Why should the victims and the public bear the cost not provided for? … The second observation concerns the quite misleading statement made on behalf of JHIL [the Hardie Group] at the time of separation, and the culture of denial adopted as the shortcomings in the Foundation's funding began to emerge (Jackson, 2004, 1.25–1.26).*

It must be pointed out that the legal doctrines of corporate separateness did not cause the Hardie Group to try to behave irresponsibly, but they did empower its decision and efforts to do so.

Despite the weaknesses in the available legal doctrine, the story has a happier progress to date. In response to the public outcry, the public investigation discussed above, as well as threats of further litigation, the Hardie Group agreed to a settlement which provides much more adequate compensation for claimants. Under the terms of the settlement, the Hardie Group has agreed to a compensation system which is valued at $1.5 billion in today's dollars and could be worth up to $4 billion over its 50-year lifespan ('James Hardie (Civil Liability) Bill', 2005; 'Spinning Out of Control' 2007; Birnbauer 2004). Payments to the settlement fund are to be made annually by the Hardie Group at the amount of expected costs for the following year, calculated by actuaries, although the payments in any given year are limited to an agreed percentage of the company's cash flow if that is less. Ironically, the settlement means that the continued corporate survival and financial success of the Hardie Group is critical to compensation for the claimants. As part of the settlement, the Hardie Group is otherwise released from liability ('James Hardie (Civil Liability) Bill', 2005).

This example shows clearly the risks to corporate social responsibility posed by application of traditional legal analysis to modern business enterprise. That analysis served to empower a business group operating with a 'culture of dishonesty' (Jackson, 2004, pp. 1–26) to try to avoid its responsibilities. Yet, despite this legal loophole, public pressure, a governmental investigation, and the threat of future litigation eventually brought about a responsible outcome. Of course, this was a notorious, high profile case involving a business which wished to continue operating and feared public notoriety. All these factors coalesced here to trump the traditional legal doctrine. Without all these factors,

such a successful outcome is by no means assured. The legal doctrine needs to be changed.

Enterprise Analysis as the Legal Theory of Responsibility.

To change the traditional legal mindset and avoid these poor results, we should abandon both the presumption that corporate subsidiaries are separate entities and the presumption of limited liability for parent company shareholders and replace them with enterprise analysis. Enterprise analysis takes a fundamentally different approach to determining the legal responsibilities within the modern business enterprises. (Strasser and Blumberg, 2007, 2008). It changes the traditional starting point – that subsidiaries are separate entities because they are formally separate corporations. As argued above, this is not an accurate description of either the business and economic reality of modern business enterprises or of the expectations of civil society. The legally separate subsidiaries are in fact part of a larger economic enterprise controlled by a parent company. I propose that legal decision-making in this area, whether being done by courts, legislatures, or administrative agencies, start with this fundamental reality. Parent company shareholders are different from investor shareholders, they perform different economic roles, and their legal rights and responsibilities should be determined by different rules.[12] We need a new starting point for this new enterprise analysis.

The starting point for consideration should, then, be the actual operating business enterprise rather than the formal legal structures. If the legal entities are under common control and economically integrated, then we should start by thinking of them together as one enterprise. Control over the subsidiary and integration of it into the economic enterprise are key; the details of internal division of power and responsibility, as with the details of formal legal separation, should not be determinative because they reflect strategic management decisions of those in control and as such can be changed in response to operating circumstances or looming legal liability. In deciding that the group of corporations is one enterprise, as noted above, control and economic integration are fundamental. In addition, the extent of administrative and financial integration will be important indicators, as will employee selection

12 German law offers the most developed model of a system of corporate law based on the idea that corporate groups rather than individual corporate entities are the key element – the Konzernrecht. Use of this model is optional with the business. Antunes (1994, pp. 313–47) has an excellent introduction and discussion. There have been a number of proposals for such a system in the EU (Antunes 1994, pp. 277-94).

and management. (Blumberg et al., 2005, ch. 6) Where the enterprise chooses to present itself as one business, using a consistent corporate persona across all its activities, this will be an important indicator, although the failure to do so should count as no more than another strategic management decision.

Of course, determining the scope and outer boundaries of a particular enterprise can become complex in specific cases. The commonly owned and integrated corporate group presents few problems. But what of the enterprise formed by contract, such as a franchise system, rather than by ownership? (Blumberg et al., 2005, pp. 160–170, 175; Muchlinski 2007, pp. 51–55) Contractual enterprises can also take the form of joint ventures. Industry groups based on financial and other long term commercial relationships, such as the Japanese 'Keiretsu' will also present these questions (Muchlinski, 2007, pp. 63–65). A particular question for corporate social responsibility is the extent to which an enterprise will be responsible for the conduct of other firms in its supply chain. Increasingly, enlightened management thinking realizes that policing the behavior of companies in its supply chain is part of the expected social responsibility. This may eventually prove to be an example for legal thinking as well. In these and other cases of current and emerging new forms of business organization, enterprise analysis will have to contend with the difficult question of determining the scope of the enterprise. Although these specific cases will surely not be easy, they should be amenable to determination by application of the basic principles of enterprise thinking to decide the cases and, over time, more precise rules will develop.

Enterprise analysis is concerned with pursuit of the fundamental legal policy issues at stake, including policies which support corporate social responsibility, by looking to the whole business enterprise in the light of the surrounding economic realities. Thus, enterprise analysis requires legal thinkers to be guided by the underlying policies and objectives of the specific area of the law at issue in determining the rights and duties of a parent and subsidiary company. Insofar as this particular corporate group with its particular pattern of control and integration is concerned, enterprise analysis asks whether the application of enterprise concepts rather than traditional entity doctrines will better implement those underlying policies and objectives. Is the application of enterprise concepts required to prevent facile frustration of those policies and objectives by the interposition of a subsidiary?

We are, after all, ultimately determining the scope of enterprise for a reason – to determine the scope of responsibility for legal rights or legal responsibilities

throughout the enterprise. Should the parent company be responsible for its subsidiary's environmental clean-up liabilities? Should labor and employment law obligations of the subsidiary also be the responsibility of the parent? Should the parent be accountable for subsidiary company violations of corrupt practices law? These are all intrinsically legal questions and their answers should consider legal policies and rules in light of the underlying business reality. Corporate restructuring and corporate forms are lawyer's devices which can be used to defeat social policy. Without the corrections of enterprise analysis, entity law resting on the doctrine of the separate legal personality and on an unrestricted concept of limited liability all too often becomes misguided and dysfunctional. By ignoring the realities of large modern corporate structures, traditional corporate law which emphasizes legally separate entities has ceased to serve well the needs of 20th and 21st century society.

Yet there are many chinks in the armor of traditional legal doctrine. Phillip Blumberg and I have argued elsewhere that this doctrine is itself imprecise and malleable, and courts have sometimes used this imprecision to reach results consistent with enterprise analysis (Strasser and Blumberg, 2007). However, in some areas, the developments have been more fundamental, with legislatures, administrative agencies, and courts sometimes consciously adopting an enterprise approach to better accomplish the goals and policies of the particular area of law involved.

Corporate Social Responsibility Examples of Enterprise Analysis

'INTEGRATED ENTERPRISE DOCTRINE' IN LABOR LAW

American labor law presents a clear illustration of the application of enterprise principles to corporate social responsibility legal concerns (Strasser and Blumberg, 2007). One of the fundamental obligations labor law imposes on companies is the duty to bargain with a labor union which represents a majority of its employees. Can an employer simply form a new subsidiary and shift economic activity to it as a means to avoid the legal duty to bargain with an existing subsidiary? While the new subsidiary will doubtless be a legally separate corporate entity, it will also undoubtedly be part of the same economic enterprise simply being conducted through the vehicle of a different subsidiary corporate entity. If this corporate slight of hand is allowed, the employer's statutory obligation to bargain can be effectively evaded by strategic use of corporate subsidiaries.

In response, the National Labor Relations Board formulated what has come to be known as the 'integrated enterprise' doctrine in administering the National Labor Relations Act (Blumberg et al., 2005, §103.5 *et seq*.). Under this doctrine, two affiliated corporations are treated as a 'single employer' to impose a subsidiary corporation's duty to bargain on a parent or other subsidiary, for purposes of the Act. Use of this 'integrated enterprise' doctrine rests on four factors: '(a) interrelationship of operations; (b) centralized control of labor relations; (c) common management; and (d) common ownership and control' (National Labor Relations Board, 1956). The doctrine has subsequently been reviewed and received the blessing of the Supreme Court; it has become a foundational concept in much federal and state labor relations law since *Radio & Television Broadcast Technicians Local Union v Broadcast Serv. of Mobile, Inc.* (1965) (per curiam).

The doctrine originated as a judicially approved administrative agency rule for labor relations purposes, but it has since been used more widely and has served the same important role under a series of federal statutes in the employment and discrimination area. These include the Age Discrimination in Employment Act, the Americans with Disabilities Act, and the Equal Pay Act. The doctrine has also been accepted as a standard for imposing duties on parent corporations under a number of state statutes in these areas (Blumberg et al., 2005, *supra*, §§105.01, 105.03). In a striking affirmation of the 'integrated enterprise' standard, the US Congress incorporated the doctrine in its amendments to sex and age discrimination statutes to assure extraterritorial application of those statutes to Americans employed abroad by the foreign affiliates of American-based corporate groups ('Public Law No. 102–66', 1991; Blumberg et al., 2005, §105.03).

The 'integrated enterprise' standard was formulated and has been employed to require corporate responsibility in the application of federal labor, employment, and discrimination laws. It focuses primarily on the degree to which the labor and employment policy of the parent and subsidiaries are integrated, rather than on the extent of managerial and operational integration or the exercise of 'control' in other management areas. As a labor and employment law doctrine, it's application should be determined by labor and employment law policies. This is clear enterprise analysis. The administrative agency, and eventually the courts and congress, crafted a legal doctrine for labor law's application to the entire business enterprise which was based on the needs of implementing fundamental labor policies. Enterprise analysis teaches us to look to the underlying body of law giving rise to duties and rights, here

labor law, to determine that sound labor policy requires the law to look to the whole enterprise. The resulting 'integrated enterprise' doctrine in labor law is good labor law policy, based on a sound enterprise analysis

ENVIRONMENTAL LAW – THE AMOCO CADIZ OIL SPILL

The resolution of disputes growing out of the Amoco Cadiz oil spill off the coast of France offers another example of the application of enterprise principles to extend legal responsibility to the whole corporate enterprise. The Amoco Cadiz was a supertanker filled with crude oil. Approximately 30 years ago, on 16 March, 1978, it drifted onto a rocky shore and broke apart in a storm, spilling its entire cargo and polluting a large stretch of shoreline. It was drifting because its steering system had broken down and could not be repaired onboard. Attempts to tow the ship away from the coast before it struck were unsuccessful. (In re Oil Spill by the Amoco Cadiz, 1992, pp. 2129–73). The Court found that the ship's owner had been negligent in maintaining the steering system and this caused it to fail in the stress of a storm, although the system was also improperly designed and built (In re Oil Spill by the Amoco Cadiz, 1992, p. 2162 and pp. 2191–95). The result was large scale contamination of a segment of the French coastline. Unsurprisingly, the court found the responsible parties liable for damages.

Yet who were the responsible parties? The ship was owned by one Liberian subsidiary, built under the supervision of another, and operated by Amoco International, which owned both of the others either directly or through intervening subsidiaries, and was itself wholly-owned by Standard Oil. The potential liability was large, as was the public relations opprobrium falling on the responsible party. Ultimately, the court held the parent company, Standard Oil, liable on two theories. First, it used very traditional 'piercing the veil' analysis to show that Standard and Amoco were managing and controlling the enterprise, with only limited discretion given to lower subsidiaries. (In re Oil Spill by the Amoco Cadiz, 1992, pp. 2173–88). For example, the president of the subsidiary which owned the ship was not even contacted about the problem until after the ship had run aground, over 16 hours after the incident began, although other Standard personnel had been working feverishly on it for a number of hours. The court found that 'Standard treated its subsidiaries operations as its own; its officers and directors had little on no perception of separateness with respect to the various Standard companies' (In re Oil Spill by the Amoco Cadiz, 1992, p. 2183). Thus, applying the traditional exception to traditional entity thinking, the court concluded that 'Standard exercised such control over its subsidiaries AIOC [Amoco] and Transport [the subsidiary

which was the nominal owner] that those entities would be considered to be mere instrumentalities of Standard' (In re Oil Spill by the Amoco Cadiz, 1992, p. 2194).

Yet the court went further, also finding liability on an enterprise theory. Standard was really one business: in its required informational filings under US Securities law, it so described itself: 'Standard and its consolidated subsidiaries … form a large, integrated petroleum company and chemical company that conducts operations on a worldwide basis' (In re Oil Spill by the Amoco Cadiz, 1992, p. 2181). Thus, Standard was also liable for the harm caused by its operating entities: 'As an integrated multinational corporation which is engaged through a system of subsidiaries in the exploration, production, refining, transportation and sale of petroleum products throughout the world, Standard is responsible for the tortious acts of its wholly-owned subsidiaries and instrumentalities' (In re Oil Spill by the Amoco Cadiz, 1992, p. 2194). This is liability which goes beyond Standard's specific involvement with individual subsidiaries and reaches it because it directs one integrated business. One cannot say that this is generally the law today but, at least in a highly visible case with substantial public outrage such as this one, this court was willing to bend to this degree.

CORPORATE SOCIAL IMPACT AND THE FOREIGN CORRUPT PRACTICES ACT.

The US Foreign Corrupt Practices Act (15 USC §78dd–1 (Supp. 2003)) (the Act) offers another interesting example of the triumph of enterprise-thinking in corporate social responsibility matters, although a triumph accomplished indirectly. The corporate social responsibility issue is concerned with US multinational corporations use of their tremendous economic power to bribe foreign officials. (Domestic bribery is governed by other law). There was a history of abuse which led to passage of the Act. (Blumberg, et al., 2005, ch. 149; Bialos and Husisian, 1996; Best and Howard, 1997; Timmeny and Von Mehren, 1983). In response, the Act prohibits bribery of foreign government officials, and imposes specific accounting and disclosure requirements which are necessary to implement the prohibition. The focus of the Act is on bribery which is aimed at securing a commercial contract or other commercial advantage.[13] While the act was controversial when passed in 1977, the rest of the developed world has moved in this direction, and commercial bribery of public officials is now considered to be unacceptable business behavior throughout the developed world, at least in principle.

13 The act has a number of technical provisions which are beyond the scope of this chapter.

In a typical case, the bribery is done by a foreign subsidiary of a US multinational corporation. Because the subsidiary is legally a separate entity, the US multinational parent might well claim to have no responsibility for its conduct. If this strategy were permitted, the Act's prohibitions on bribery and its accounting requirements could be easily evaded and the statute rendered impotent. This presents the usual issues of dealing with traditional, if outmoded, concepts of corporate entity. Yet an additional problem is presented by the fact that the operating subsidiary is usually a foreign corporation. There will be serious questions, to say the least, of the ability and wisdom of US law directly regulating the conduct of a foreign corporation which is done in its home country even if the foreign corporation is in reality a wholly-owned subsidiary. These questions will emphasize both the idea of the subsidiary's separate existence, and the fact that it exists legally as a creature of foreign law. While these concepts of separateness have no more real world business validity here than in the domestic context, they will doubtless draw some additional strength from the ideology of national law.

The Act's response to this problem is to direct all its regulatory focus to the US parent; the Act does not address direct commands to the foreign subsidiary. However, it does reach broadly at the parent level. Thus, the Act imposes liability on the parent not only for what it does, but also for the subsidiary's violations of which the parent has 'knowledge', and it reaches a financial advance or credit to the account of the subsidiary which the parent knows will be misused (15 USC §78dd–1(a)(Supp. 2003) 2003).[14] In effect, to avoid liability, the parent will have to claim that it did not know what its subsidiary was doing, including what the subsidiary was doing with its money. This would be an embarrassing defense to make in any circumstances, but the Act's accounting and disclosure requirements applicable to the parent make it considerably worse than just embarrassing. The US parent is required to keep records 'in reasonable detail' and have an internal accounting system to provide 'reasonable assurances' that assets are being used as management has directed (15 USC §78m(b)(Supp. 2003) 2003). Thus, it will be difficult for a US parent to comply with the Act's accounting rules and successfully claim that it did now know what the subsidiary was doing, as the legislative history reflects.

[A] US Company which 'looks' the other way in order to be able to raise the defense that they were ignorant of the bribes made by a foreign subsidiary could

14 The Act originally included coverage of violations of which the parent has 'reason to know' but this was eventually removed because it was considered to be too ambiguous for companies to know how to comply.

be in violation of section 102 [the accounting provisions] requiring companies to devise and maintain adequate accounting controls. Under the accounting section no off-the-books accounting fund could be lawfully maintained, either by a US Parent or by a foreign subsidiary, and no improper payment could be lawfully disguised (Senate Reports, 114, 1978).

The Act reaches widely to encompass parties connected to the US parent, doing so as an additional indirect way to control the activities of foreign subsidiaries. The antibribery provisions also apply to an 'officer, director, employee or agent … or any stockholder' as well as any 'United States citizen, national or resident' (15 USC §78dd–1(a)(Supp. 2003)). Officers, directors and employees of the foreign subsidiary frequently hold positions with the parent company too. In addition, it is common for the foreign subsidiaries to employ US citizens. The rules will reach all these individuals with individual liability, and they will be understandably reluctant to risk it; in addition, as practical matter, the parent will feel real social stigma as well as personal pressure in the face of such liability. In addition to these specific provisions of the Act, general doctrines of US securities law impose liability on 'controlling persons' and further, make it unlawful to do indirectly what one is prohibited from doing directly.[15] This provision has been applied in another context to make the parent liable for its failure to 'maintain and diligently enforce proper systems of internal supervision and control' over its subsidiary, and it stands ready to be so used in this area (*SEC v First Sec. of Chicago*, 1987; cert. den. sub nom. *McKy v Hochfelder*, (1972); Blumberg et al., 2005, §149.06[A]).

The Act's clever use of legal controls on the US parent have enabled practical restriction on the conduct of a foreign subsidiary. This is de facto enterprise-wide control, although it is *de jure* aimed only at the parent and those connected to it, and at other US citizens. There is a most appealing irony here; if the subsidiary were truly a separate business entity, as wrongly supposed by traditional legal theory, then the parent could not exercise this degree of control over it. Indeed, the Act's controls will be effective in reaching foreign subsidiaries, for the most part, only to the extent that they are under the management and supervision of the parent and thus part of a unitary business enterprise it directs. Yet the Act's controls are not imposed for this reason; the Act is not seeking to further a grand jurisprudential evolution toward enterprise analysis. Rather, as in the other examples we have considered, it is imposing controls which practically

15 The liability is limited where the parent acted in good faith and did not directly or indirectly influence the violation (15 USC §78(t)(Supp. 2003).

reach the whole enterprise as a way of accomplishing its antibribery objectives. This is, of course, consistent with the results of enterprise analysis.

Conclusion

When we think of corporate social responsibility, we have not usually focused on who is the corporation. This is understandable because, in both economic reality and common social expectation, we think that the whole business enterprise is the corporation. Yet the traditional legal analysis sees a different reality, one that is skewed by its focus on legal formalities. The traditional legal mind sees a parent corporation which is separate from its subsidiaries as a matter of legal form, and one which is therefore not generally liable for their obligations. This is a transcendental problem for modern corporate law and in this chapter we see that these problems exist in enforcing legal obligations for corporate social responsibility as well.

The alternative approach proposed here is enterprise analysis. With it, one looks not at the corporate formalities of separation, but at the business realities that the separate legal corporate entities are in fact integrated into common business enterprise, with one set of legal and social obligations for responsible behavior. A key question is which view – entity or enterprise – best serves the purposes social responsibility in implementing the requirements of the area of law involved. While this approach is new when offered at this level of generality, on closer examination one finds examples of legal decision-making which have used enterprise analysis in social responsibility areas as diverse as labor law, environmental protection, and corporate bribery. Taken together, these specific examples illustrate the application of a general theory of enterprise analysis to enforce corporate social responsibility legal obligations. Yet they now are only a group of disconnected examples; it is time to implement a new general theory of enterprise analysis, to replace the traditional entity view of corporate separateness and serve as the vehicle to move legal thinking into line with modern corporate structure and social expectations of business.

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11

Implementing Corporate Social Responsibility: A Creative Tension Between Regulation and Corporate Initiatives?

Thomas Clarke and Alice Klettner

Introduction

A substantial increase in the range, significance and impact of corporate social and environmental initiatives in recent years suggests the growing materiality of sustainability. Corporate social and environmental responsibility (CSR) appears to becoming established in many corporations as a critical element of strategic direction, and one of the main drivers of business development, as well as an essential component of risk management. CSR seems to be rapidly moving from the margins to the mainstream of corporate activity, with greater recognition of a direct and inescapable relationship between corporate governance, corporate responsibility, and sustainable development.

Questions are often addressed to the sincerity of corporate social and environmental initiatives; the legality of company directors engaging in these concerns; equally, the legality of the trustees of investment institutions attending to these interests; and the verifiability of CSR activities and outcomes. The aim of this chapter is to clarify the continuing and emerging legal and commercial basis for corporations to pursue corporate social and environmental responsibility; the ongoing legal and material support for institutional trustees to prioritize socially and environmentally responsible investments; to examine developments in verification on corporate reporting of CSR performance.

This chapter outlines the tensions between the promise of corporate initiatives in CSR and the significance of mandatory regulation. There may well be the case that further legislative and regulatory intervention will be required to ensure all corporations fully respond to the growing public demand that they recognize their wider social and environmental responsibilities. However, it is useful to examine how far CSR objectives can be achieved within existing law and regulation.

The Global Significance and Impact of Corporate Social Responsibility

Corporate social and environmental responsibility (CSR) is rapidly moving from the margins to the mainstream of corporate activity, with greater recognition of a direct and inescapable relationship between corporate governance, corporate responsibility, business performance and sustainable business development.

Corporate social responsibility is receiving considerably increased attention world-wide and is associated with significant economic, environmental and social benefits. It is important to learn from this international experience as well as from local initiatives.

The burgeoning importance of this newly revived movement for corporate responsibility and sustainability is demonstrated by the current frequency and scale of activity at every level (Calder and Culverwell, 2005:43).

Among international organizations the United Nations is coordinating a public-private partnership between UNEP and 170 banks, insurers and asset managers world-wide including Deutsche Bank, Dresdner Kleinwort Wasserstein, Goldman Sachs, HSBC and UBS to explore the financial materiality of environmental, social and governance (ESG) issues to securities valuation (UNEP, 2004a). Early in 2005 the UN convened a group of 20 of the world's largest institutional investors from 12 countries to negotiate a set of *Principles of Responsible Investment*, published in early 2006 as a guide to the investment community on how to incorporate environmental, social and governance issues into their investment decision-making and ownership processes. This document was launched at the New York Stock Exchange in April 2006 it sets out six aspirational principles of responsible investment. In the document's introduction, Kofi Annan neatly sums up the main issue hindering companies' efforts at CSR:

> *One of the main problems has long been the troubling disconnect between corporate responsibility as a broadly stated management imperative, and the actual behaviour of financial markets, which are too often guided primarily by short-term considerations at the expense of longer-term objectives.*

The six principles are designed to help solve this problem. Principle one states, 'We will incorporate ESG issues into investment analysis and decision-making processes'. The other principles go on to back this up through commitments to request ESG disclosure, promote the principles and report on their implementation.

There are three main categories of signatory to the UN principles: asset owners, investment managers and professional service partners. At the time of writing, there were a total of 217 signatories representing eight trillion US dollars. Australian representation is fairly impressive with 12 Australian super funds, nine Australian investment managers and four Australian professional service partners already signed up to the principles. That means Australia makes up just over 11 per cent of signatories worldwide, although we do not know what proportion of overall funds this represents.

This recent work of the UNEP Finance Initiative builds on the work of the UN Global Compact which achieved more than 1,500 corporate signatories, working with the world's leading stock exchanges and the World Federation of Exchanges to advance the principles of corporate responsibility in capital markets and with public corporations (UN, 2000). The Global Compact outlined a set of basic principles of human rights, labour and the environment which manifested a commitment to civilization, decency and responsibility on the part of investors and corporations.

In 2005 institutional investors representing 21 trillion dollars in assets came together for the third Carbon Disclosure Project meeting, collectively requesting the world's largest corporations to disclose information on greenhouse gas emissions and their approach to the management of carbon risks (UNEP FI, 2005a). Finally, 36 of the world's largest banks, representing more than 80 per cent of the global project finance market, have adopted the Equator Principles, a set of voluntary principles outlining environmental, social and human rights disciplines associated with project finance above $50 million (Freshfields Bruckhaus Deringer, 2005a). The principles originally were developed by the

International Finance Corporation (IFC), the private sector investment arm of the World Bank.

The OECD also is active in the promotion of corporate social responsibility in its guidelines for the operations of multinational corporations; and the European Union is actively encouraging corporate social responsibility as the business contribution to sustainable development (OECD, 2000; European Commission 2003; 2004). At the national level a growing number of governments in Europe, and across the globe, have identified strongly with the call for corporate social and environmental responsibility, even with the evident difficulties in applying the Kyoto Protocol and creating an effective international climate policy regime.

At the corporate level the World Business Council for Sustainable Development, and World Economic Forum Global Corporate Citizenship Initiative has projected corporate responsibility in the minds of the international business elite (WBCSD, 2002; 2004 and WEF, 2005). The World Business Council for Sustainable Development published *Beyond Reporting: Creating Business Value and Accountability* (2005) which was co-authored by several large companies and thus has a fairly unique perspective on CSR. The report delves into the detail of how CSR should be integrated across different business functions and not simply delegated to a specialist unit. It suggests that value can only be created if the majority of employees understand how to frame business challenges in a way that links with an overall sustainability agenda. Using company case studies, the report gives examples of how CSR can become value-driving rather than compliance-driven.

Other business organizations active in promoting CSR include the Business Leaders Initiative on Human Rights, the Conference Board, Business in the Community, and Business for Social Responsibility. A large number of leading corporations have signed up for the Global Reporting Initiative and more than 2,000 international corporations now publish reports on their CSR performance (many accessible on www.csrwire.com) (GRI, 2002). Reinforcing the new found willingness on the part of corporate executives to disclose their commitments to CSR are the new indices including the Dow Jones Sustainability Index and FTSE4Good. Finally there are a proliferating number of consultancies, NGOs and campaign groups offering guidance and actively monitoring CSR activities along the entire length of the global value chain (World Bank, 2003).

Questions are often addressed concerning the sincerity of corporate social and environmental initiatives; the legality of company directors engaging in these concerns; equally, the legality of the trustees of investment institutions attending to these interests; and the verifiability of CSR activities and outcomes. It is intended in this paper to briefly clarify the continuing and emerging legal and commercial basis internationally for corporations to pursue corporate social and environmental responsibility; the ongoing legal and material support for institutional trustees to prioritize socially and environmentally responsible investments; to examine developments in verification on corporate reporting of CSR performance; and to consider some illustrations of current best practice.

The Integrity of CSR

Despite the recent burst of enthusiasm for corporate social and environmental responsibility in some quarters of the business community, the concept and practice still provoke a degree of understandable skepticism, (partly due to CSR's record of lapsing into apologetics for unacceptable corporate behaviour) (Najam, 2000; Christian Aid, 2004; Corporate Responsibility Coalition, 2005; OECD Watch, 2005). David Vogal in a review conducted for the Brookings Institute, *The Market for Virtue: The Potential and Limits of CSR* (2005), contends there are many reasons why companies may choose to behave more responsibly in the absence of legal requirements to do so, including strategic, defensive, altruistic or public spirited motivations. However despite pressure from consumers for responsibly made products, the influence of socially responsible investors, and the insistent call for companies to be accountable to a broader community of stakeholders, there are important limits to the market for virtue:

> *CSR is best understood as a niche rather than a generic strategy: it makes sense for some firms in some areas under some circumstances. Many of the proponents of corporate social responsibility mistakenly assume that because some companies are behaving more responsibly in some areas, some firms can be expected to behave more responsibly in more areas. This assumption is misinformed. There is a place in the market economy for responsible firms. But there is also a large place for their less responsible competitors … Precisely because CSR is voluntary and market-driven, companies will engage in CSR only to the extent that it makes business sense for them to do. Civil regulation has proven capable of forcing some companies to internalize some of the negative*

> *externalities associated with some of their economic activities. But CSR can reduce only some market failures (2005:3–4).*

Vogal concludes that CSR has a multidimensional nature, and that companies, like individuals, do not always exhibit consistent moral or social behaviour, and may behave better in some countries than others depending on the social and environmental policies existing within them. Since the origins of industrialism, there have always been more or less responsible firms, and though it may be heartening that executives in many highly visible firms may becoming more responsive (if only as a result of external stakeholder pressures) the reality is that the amounts wasted on the losses due to financial fraud, and the very substantial – and some would argue unwarranted – increases in executive compensation in corporations in the recent period far exceed any resources companies have devoted to CSR.

In a similar vein Deborah Doane who is Chair of the Corporate Responsibility Coalition in the UK, is skeptical regarding optimism about the power of market mechanisms to deliver social and environmental change, referring to the key myths informing the CSR movement as:

- The market can deliver both short-term financial returns and long term social benefits.
- The ethical consumer will drive change.
- There will be a competitive 'race to the top' over ethics amongst businesses.
- In the global economy countries will compete to have the best ethical practices.

In support of her argument these are largely mythological trends, she highlights the insistence of stock markets upon short term results, and the failure of companies to invest in long term benefits; the considerable gap between green consciousness expressed by consumers and their consumer behaviour; the inconsistency between companies' alignment to CSR schemes and their successful efforts to bring about the sustained fall in corporate taxation in the United States and other jurisdictions in recent decades; and finally the evidence emerging in developing countries of governments competing to *reduce* their

insistence on the observance of social and environmental standards to attract international investment (Doane, 2005).

It may well be the case that further legislative and regulatory intervention will be required to ensure all corporations fully respond to the growing public demand that they recognize their wider social and environmental responsibilities. However, it is useful to examine how far CSR objectives can be achieved within existing law and regulation. If there is substantial evidence of leading corporations demonstrating it is possible to voluntarily commit to social and environmental performance and to achieve commercial success – perhaps because of, rather than in spite of, ethical commitments – then it will be more straightforward to press for the legislative changes necessary to deal with corporations that refuse to acknowledge their wider responsibilities, as well as finding appropriate legislative support for companies that wish to develop further their CSR commitments.

In the meantime the practical fact is that corporations and governments currently are struggling with an 'almost bewildering array of international CSR initiatives' (Calder and Culverwell, 2005:7; McKague and Cragg, 2005). Reviewing the efforts to develop CSR following the World Summit on Sustainable Development, a survey by the Royal Institute for International Affairs of stakeholders from governments, businesses and civil society groups identified a range of significant weaknesses in current approaches to promoting CSR which governments should seek to address:

- An over-proliferation of CSR initiatives at the international level and lack of clarity about how these initiatives relate to each other in a coherent way.

- An excessive focus on getting businesses to make commitments to CSR and not enough focus on enabling them to implement them effectively.

- An absence of credible monitoring and verification processes of CSR initiatives.

- A lack of effective mechanisms of redress for communities affected by companies that flout national or international norms on sustainable development or human rights.

- A lack of engagement with developing country governments and their sustainable development priorities (e.g. economic development and poverty reduction).

- A failure to bridge the governance gap created by weak public sector governance of the private sector in many developing countries.

- The limited impact on national and international sustainable development goals.

- A lack of government involvement and/or investment in international CSR initiatives, which is contributing significantly to their underperformance (Calder and Culverwell 2005:7).

Defining Social and Environmental Sustainability

The rapidly developing interest in sustainability and corporate social and environmental responsibility has resulted in a plethora of definitions and interpretations of the two concepts from international agencies, consultancies and practitioners (Calder and Culverwell, 2005; McKague and Cragg, 2005). A first difficulty is that the most commonly employed acronym CSR refers to corporate social responsibility, though in most interpretations it is also meant to include environmental responsibility. The use of the simpler term corporate responsibility and acronym CR is not in widespread use, though it would more readily embrace all corporate responsibilities. The UN's recent adoption of the environmental, social and governance (ESG) acronym may become influential, since it explicitly links governance to social and environmental responsibility.

More confusingly still, in some definitions CSR is subsumed under sustainability, while in others sustainability is included within CSR. One source of this confusion is that often different levels of analysis are being addressed. At the highest level the sustainability of the planet is at issue, and at lower levels the sustainability of economies and societies, industries and organizations. Corporate sustainability is a critical issue because of the economic scale and significance of these entities and their growing impact on the economy, society and environment. 'Corporations have magnified capacities relative to individuals, in their financial resources, scale of operations, organizational capacity and capacity for social and individual harm' (Redmond, 2005:1). Once the primary (in some cases sole) concern was to produce goods and services

that might generate the profits to achieve the financial sustainability of the corporation (everything else was written-off as externalities).

Increasingly today the social and environmental impact of the corporation will be assessed in deciding whether it is viable or not, by governments, regulators, or other stakeholders, even if the corporations' management are reluctant to make this assessment. The *license to operate* can no longer be readily assumed for any corporation, and in an increasing number of contexts needs to be earned with verifiable evidence of the social and environmental responsibility of the corporation.

Definitions of CSR and sustainability range from the basic to the most demanding, from a specific reference to a number of necessary activities to demonstrate responsibility, to a general call for a comprehensive, integrated and committed pursuit of social and environmental sustainability. The following representative range of definitions of CSR is broadly in ascending order from the least to the most demanding:

- The integration of stakeholders' social, environmental and other concerns into a company's business operations (EIU, 2002:2).

- The commitment of businesses to contribute to sustainable economic development by working with their employees, their families, the local community and society at large to improve their lives in ways which are good for business and for development (World Business Council for Sustainable Development, 2002).

- Corporate social responsibility is at heart a process of managing the costs and benefits of business activity to both internal (for example, workers, shareholders, investors) and external (institutions of public governance, community members, civil society groups, other enterprises) stakeholders. Setting the boundaries for how those costs and benefits are managed is partly a question of business policy and strategy and partly a question of public governance (World Bank, 2002:1).

- A concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis (EU, 2001).

- A company's commitment to operating in an economically, socially, and environmentally sustainable manner, while recognizing the interests of its stakeholders, including investors, customers, employees, business partners, local communities, the environment, and society at large (Certified General Accountants Association of Canada, 2005:20).

- CSR is essentially about how the company makes its profits, not only what it does with them afterwards. CSR is about how the company manages first, its core business operations – in the boardroom, in the workplace, in the marketplace, and along the supply chain; second, its community investment and philanthropic activities; and third, its engagement in public policy dialogue and institution building (Kennedy School of Government Corporate Responsibility Initiative: 2004:33).

- A business approach embodying open and transparent business practices, ethical behaviour, respect for stakeholders and a commitment to add economic, social and environmental value (SustainAbility, 2005).

- Sustainability performance refers to an organization's total performance, which might include its policies, decisions, and actions that create social, environmental and/or economic (including financial) outcomes (AccountAbility, 2005:10).

Sustainability as a whole (planet, environment, species) is an altogether more ambitious project with more expansive definitions than CSR. Corporations have a vital role to play in this also, beginning with a modest recognition of their necessary subordination to the interests of maintaining a balanced ecosystem. Sustainability is defined as:

- Meeting the needs of the present generation without compromising the ability of future generations to meet their needs (Bruntland Commission, 1987)

- Sustainable development, sustainable growth, and sustainable use have been used interchangeably, as if their meanings were the same. They are not. Sustainable growth is a contradiction in terms: nothing physical can grow indefinitely. Sustainable use, is

> only applicable to renewable resources. Sustainable development is used in this strategy to mean: improving the quality of human life whilst living within the carrying capacity of the ecosystems (IUCN, UNEP, WWF, 1991).

Putting the entire field into perspective, according to the Global Reporting Initiative (GRI) *2002 Sustainability Reporting Guidelines*:

- *environmental impact* means an organization's impact on living and non-living natural systems, including eco-systems, land, air and water. Examples include energy use and greenhouse gas emissions
- *social impact* means an organization's impact on the social system within which it operates. This includes labour practices, human rights and other social issues
- *economic impact* means an organization's impact both direct and indirect on the economic resources of its stakeholders and on economic systems at the local, national and global levels.

The world has reached the limits of the paradigm of the freedom of business to destroy in the name of wealth generation. For example with regard to the environment the *Stern Review of the Economics of Climate Change 2006* has definitively stated:

> *The scientific evidence is now overwhelming: climate change is a serious global threat, and it demands an urgent global response … The evidence gathered by the Review leads to a simple conclusion: the benefits of strong and early action far outweigh the economic costs of not acting. Climate change will affect the basic elements of life for people around the world – access to water, food production, health, and the environment. Hundreds of millions of people could suffer hunger, water shortages and coastal flooding as the world warms. Using the results from formal economic models, the Review estimates that if we don't act, the overall costs and risks of climate change will be equivalent to losing at least 5 per cent of global GDP each year, now and forever. If a wider range of risks and impacts is taken into account, the estimates of damage could rise to 20 per cent of GDP or more.*

Corporate objectives described as *wealth generating* too frequently have resulted in the loss of well-being to communities and the ecology. But increasingly in the future the *licence to operate* will not be given so readily to corporations and other entities. A licence to operate will depend on maintaining the highest standards of integrity and practice in corporate behaviour. Corporate governance essentially will involve a sustained and responsible monitoring of not just the financial health of the company, but the social and environmental impact of the company.

As Sustainable Asset Management Group (SAM) 2003:5 argue:

> *Understanding the implications of these trends on business is central to sustainability investing as, despite lower interest rates, increased risk-premia have effectively erased the benefits of low costs of capital for business. The implications of environmental degradation and weakened eco-system have been starkly demonstrated by the spiralling costs of environmental catastrophes. Financial losses due to natural disasters have doubled each decade since the 1950s, and UNEP estimates that natural disasters caused by climate change could cost US$150 billion a year by 2012. Socio-cultural disruptions have also had severe financial implications recently: insurers had to cover US$40 billion in losses after the September 11th disaster.*

This lead SAM (2003:2) to conceiving of a hypothesis of enlightened self-interest:

> *Should extreme climactic events such as flooding occur, the civility of society is disrupted and hence the healthy functioning of the economy undermined. This impacts the possibility of a vigorous population of enterprises thriving which, in turn, compromises the possibility of successful investment. Sustainability investing therefore selects companies that contribute to the vibrancy of the socio-economic system and a sustainable planet.*

In the past companies did not recognize or acknowledge the environmental and social effects of their operations, such as the impacts releases of water have on river systems, or the effects of particular emissions upon human health. The United States Environmental Protection Agency (1995:1) has developed a useful dichotomy – private versus social costs. The term environmental cost has at least two major dimensions: it can refer solely to costs that directly impact

a company's bottom line (termed *private costs*) or it can also encompass the costs to individuals, society, and the environment for which a company is not directly accountable (termed *societal costs* by the EPA but typically referred to as externalities). 'Externalities generated by an organization, although possibly ignored from an accounting perspective, are often recognized as costs by other entities.' (ICAA, 2003:19) Consideration of the range of environmental costs an entity might be encouraged to consider widens the scope of accounting systems, though makes measurement more difficult.

Together the trends, indicated provide the context in which business must operate in future, suggest the following imperatives which all corporations will face:

- Maintaining a licence to operate via transparency and accountability.
- Serving society.
- Generating more value with less impact.
- Preserving the resource base.
- Doing business in a networked world.

In summary the challenge is to find means of enduring value creation without social or environmental harm. As the *Economist* has recently noted, '*Everybody's Green Now*', even the big American energy companies that resisted environmental awareness most fiercely, are facing up to the realities of emerging carbon markets (*Economist*, 2 June 2007).

From the Margins to the Mainstream?

However challenging the prospects, there are growing indications of large corporations taking their social and environmental responsibilities more seriously, and of these issues becoming more critical in the business agenda. KPMG since 1993 have conducted an international survey of corporate responsibility every three years which has revealed the developing prevalence of this commitment. Surveying the largest 100 companies in a sample of advanced industrial OECD countries (with the addition of the Global 250 companies from

1999), KPMG (2005) find a steadily rising trend in companies issuing separate corporate responsibility annual reports. From 13 per cent of national 100 companies reporting on corporate responsibility matters in 1993, by 2005 this had risen to 33 per cent (up to 41 per cent if including information in annual reports). A more substantial increase in the Global 250 reporting occurred with 35 per cent reporting in 1999 and 52 per cent in 2005 (64 per cent including information in annual reports). Publication of corporate responsibility reports as part of the annual financial reports of companies often implies the issue is regarded as of greater salience, and companies often progress from separate to integrated CSR and financial reports.

More importantly, the substance of company reports is changing, from purely environmental reporting up until 1999, to sustainability reporting (social, environmental and economic), which has become the mainstream approach of the G250 companies, and is becoming so among the national 100 companies. The two leading countries in terms of separate corporate responsibility reporting are Japan (80 per cent of top 100 companies) and the UK (71 per cent of top 100 companies) in 2005. The industrial sectors with the highest environmental impact tend to lead in reporting (in one sense self-evidently important, in another sense deeply curious). At the Global 250 level over 80 per cent of companies report in electronics and computers; utilities; automotive; and oil and gas sectors. The most remarkable increase in the Global 250 was in the finance sector, with a doubling of the rate of CSR reporting from 24 per cent in 2002 to 57 per cent in 2005. At the national level over 50 per cent of top 100 companies are reporting in utilities; mining; chemicals and synthetics; oil and gas; and forestry and paper sectors.

Finally the KPMG survey reveals a balanced range of business drivers for CSR reporting, beginning with economic considerations (74 per cent of companies); ethical considerations (54 per cent); innovation and learning (53 per cent); employee motivation (47 per cent); risk management (47 per cent) and access to capital (39 per cent). The survey suggests there were solid business reasons for acting and reporting on CSR: 'The economic reasons were either directly linked to increased shareholder value or market share or indirectly linked through increased business opportunities, innovation, reputation, and reduced risk. 39 per cent of the companies reported improved shareholder value, and one in five (21 per cent) reported increased market share as an important reason for sustainability' (KPMG, 2005:18).

In a further recent international survey of 136 corporate executives and 65 executives of institutional investors on the importance of corporate responsibility (CR) the Economist Intelligence Unit (EIU) discovered a similar growth in interest:

> *A total of 88 per cent of executives said that CR is a 'central' or 'important' consideration in decision-making. This compares with 54 per cent of executives who said it was a 'central' or 'important' consideration five years ago. The biggest percentage change between now and five years ago was among European executives. A total of 46 per cent said CR was 'central' or 'important' five years ago compared with 84 per cent at the present time. In Asia, the proportion rose from 49 per cent to 82 per cent and in North America from 66 per cent to 88 per cent. The survey of professional investors reveals a sharper trend. Eighty-one per cent of those surveyed said CR was currently a 'central' or 'important' consideration in their investment decisions, compared with 34 per cent who said it was 'central' or 'important' five years ago. In fact, 14 per cent of them said CR was not a consideration at all five years ago. Now, not a single investor said it was not a consideration (EIU, 2005:5).*

As with the gap noticed earlier between consumer consciousness and behaviour, it is likely there will be a mighty gap between the expressed concerns of executives for corporate responsibility and their actual behaviour in different circumstances in the exigencies of difficult situations, however simply expressing concerns is an advance over stony faced refusals to even acknowledge responsibilities that may have occurred in the past. 'Corporate responsibility is really about ensuring that the company can grow on a sustainable basis, while ensuring fairness to all stakeholders,' says N.R. Murthy, the chairman of an Indian IT firm, Infosys' (EIU, 2005:2). Though some of the expressed concern may be part of the discourse of political correctness, there does appear to be a significant shifting of opinion among executives, as the EIU comments:

> *Until recently, board members often regarded corporate responsibility as a piece of rhetoric intended to placate environmentalists and human rights campaigners. But now, companies are beginning to regard corporate responsibility as a normal facet of business and are thinking about ways to develop internal structures and processes that will emphasize it more heavily. In the not-too-distant future, companies that are not focusing on corporate responsibility may come to be seen*

> *as outliers. As companies focus on non-financial performance, an important yardstick of corporate responsibility, the measurement of intangibles, such as customer satisfaction and employee morale, are likely to become less vague and more credible (EIU, 2005: 3).*

One of the surprising results of the EIU survey was that after more than a decade of the exhortation of the primacy in all circumstances of shareholder value, the executives surveyed still possessed a balanced appreciation of the relative importance of key stakeholders to the company, identifying customers, employees and shareholders in that order. The EIU compiled some of the contextual highlights for these changes in executive views in the emerging evidence that corporate social and environmental responsibility is moving substantially from the margins to the mainstream of economic activity:

- 'The New York-based Governance Metrics International (GMI), which covers corporate governance and CR, now produces in-depth rating reports on 2000 companies around the world and has a growing client base including TIAA-CREF, State Street Bank and ABP, the largest pension fund in Europe.

- More than 10,000 individuals and 3,000 listed companies have helped to develop the standards of the Global Reporting Initiative (GRI), an organization based in Amsterdam, trying to create a single global measure for CR performance. Among its corporate clients implementing GRI standards are Bayer, Canon, Deutsche Bank, General Motors, Heineken and Shell.

- A group of five major European institutional investors, including the second-largest pension fund in the UK and the largest pension fund in the Netherlands, jointly stated in October 2004 that they would allocate 5 per cent of their budgets for the purchase of non-financial research analysis of such topics as corporate governance, labour management and environmental practices.

- One in every nine investment dollars under professional management in the US is now invested in socially responsible funds. This amounts to US$2 trillion (trillion) out of a total of US$19 trillion in investible funds, according to the 2003 report on socially responsible investing (SRI) produced by the Social Investment Forum, the national trade body for the SRI industry.' (EIU, 2005:4–5)

At the confluence of these multiple emerging initiatives and trends towards greater corporate social and environmental responsibility there is emerging a dynamic stakeholder model for driving enlightened shareholder value. At many leading corporations the pieces of what admittedly is a very large and demanding puzzle are beginning to come together. The wider commitments to building engaged and inclusive relationships with employees, economic partners, the community and the environment becomes a means of achieving enlightened shareholder value through access to a lower cost of capital, enhanced reputation, minimized risks and new business opportunities.

Corporations Enlightened Shareholder Value? The Duty to Promote the Success of the Company

The impact of the adoption of corporate commitments to wider forms of social and environmental engagement and reporting will be determined essentially by initiatives of leading companies and, in turn, this will be influenced by the insistent pressures companies encounter from the market, investors and stakeholders, and the perceived commercial benefit of assuming a broader accountability. However, the role of the law and of accounting standards in establishing a framework of accountability and management discipline is a significant factor. Historical analysis of the perception of company directors' duties, including legal interpretations, reveals much greater sympathy for corporations adopting a wider view of their responsibilities than the recently imposed tenets of shareholder value would suggest.

This balance of pursuing market opportunities while maintaining accountability has proved a defining challenge for business enterprise since the arrival of the joint-stock company in the early years of industrialism. The accountability and responsibility of business enterprise was constantly subject to question, and historically failed this test often in the view of the public. Maurice Clark deplored how business 'inherited an economics of irresponsibility' from the laissez-faire beliefs and practices of early industrialism (1916). He argued business transactions do not occur in isolation, but have wider social and economic consequences that need to be considered, impacting directly on employment, health and the environment. He insisted legal regulation may be required to ensure protection from abuses, but that this could never replace a general sense of responsibility in business that goes beyond the letter of the law, preventing competitive forces leading to a race to the bottom. Hence the periodic outbreak of destructive competition needed to be restrained in

Clark's view by 'an economics of responsibility, developed and embodied in our working business ethics (1916).'

The debate concerning the true extent of the accountability and responsibility of business enterprise has continued to the present day, punctuated by occasional public outrage at business transgressions, and calls for greater recognition of the social obligations of business. At the height of the economic depression in the United States in 1932 Dodd made a dramatic plea in the pages of the *Harvard Law Review,* '…There is in fact a growing feeling not only that business has responsibilities to the community but that our corporate managers who control business should voluntarily and without waiting for legal compulsion manage it in such a way as to fulfill these responsibilities' This resonated with Berle and Means insistence that large corporations 'serve not alone the owners or the control, but all society.' Though Berle subsequently commenced a prolonged debate with Dodd on the subject of 'For Whom Are Corporate Managers Trustees', Berle (1955) later conceded to Dodd's argument that management powers were held in trust for the entire community (Wedderburn, 1985:6)

Such forthright views did not remain at the level of academic speculation, but often were translated into legal, policy and business interpretations and practice. For example in *Teck Corp Ltd v Millar*, the Supreme Court of British Columbia, while retaining the identification of company interests with those of shareholders, nonetheless was prepared to grant directors a license under their fiduciary duties to take into account wider stakeholder interests:

> *The classical theory is that the directors' duty is to the company. The company's shareholders are the company … and therefore no interests outside those of the shareholders can legitimately be considered by the directors. But even accepting that, what comes within the definition of the interests of the shareholders? By what standards are the shareholders' interests to be measured? A classical theory that once was unchallengeable must yield to the facts of modern life. In fact, of course, it has. If today the directors of a company were to consider the interests of its employees no one would argue that in doing so they were not acting bona fide in the interests of the company itself. Similarly, if the directors were to consider the consequences to the community of any policy that the company intended to pursue, and were deflected in their commitment to that policy as a result, it could not be said that they had not considered bona fide the interests of the shareholders (Teck Corp Ltd v Millar, 1973:313–4).*

Wedderburn (1985:12) documents an equivalent deep-seated and practical commitment of corporate responsibility to a wide constituency in the post-war beliefs of leaders of the British business community. A lively debate continues worldwide concerning the scope of directors' duties. In Australia, the Corporations Act Section 181 obliges directors and other corporate officers to exercise their powers and discharge their duties

- In good faith and in the best interests of the corporation.
- For a proper purpose.

Under common law directors are obliged to act in the interests of 'the company as a whole'. Traditionally, this phrase has been interpreted to mean the financial well-being of the shareholders as a general body. (Though directors are obliged to consider the financial interests of creditors when the firm is insolvent or near-insolvent). A recent generation of financial economists helped to translate this broad shareholder *primacy principle* into a narrow pursuit of shareholder value. There is a wider interpretation of shareholder value which suggests that only when all of the other constituent relationships of the corporation – with customers, employees, suppliers, distributors and the wider community – are fully recognized and developed that long term shareholder value can be released. However the restrictive definition of shareholder value has often been associated with short-termism and a neglect of wider corporate responsibilities in the interests of immediate profit maximization. Concerns have arisen that directors who do wish to take account of other stakeholder interests may be exposed.

Traditionally, commercial law in many European countries has supported a sense of the wider social and environmental obligations of companies, which continues despite a recent enthusiasm for the principle of shareholder value as some large European companies for the first time seek the support of international investors. The UK has stood apart from Europe as an influential exponent of the Anglo-American market based approach to corporate governance. However in an effort to jettison the company law rhetoric formed in the 19th century, and to make the law more accessible a Company Law Review (CLR) steering group was established. The ensuing consultative document *Modern Company Law for a Competitive Economy: Developing the Framework* (2000), proposed for the first time that there should be a statutory statement of directors duties (presently the core components of those duties is found in case law), and made a significant

step in the direction of endorsing fuller corporate social and environmental reporting:

> *Current accounting and reporting fails to provide adequate transparency of qualitative and forward looking information which is of vital importance in assessing performance and potential for shareholders, investors, creditors and others. This is particularly so in the modern environment of technical change, and with the growing importance of 'soft', or intangible assets, brands, know-how and business relationships. The full annual report must be effective in covering these, both as a stewardship report and as a medium of communication to wider markets and the public … we believe the time has come to require larger companies to provide an operating and financial review, which will cover the qualitative, or 'soft', or intangible, and forward looking information which the modern market and modern business decision-making requires, converting the practice of the best run companies into a requirement for all (CLR, 2000: 180–1).*

These issues were extensively considered in the UK for several years in the deliberations of the Modern Company Law Review. Two approaches were considered:

- A pluralist approach under which directors' duties would be reformulated to permit directors to further the interests of other stakeholders even if they were to the detriment of shareholders.
- An enlightened shareholder value approach allowing directors greater flexibility to take into account longer term considerations and interests of various stakeholders in advancing shareholder value.

In considering these approaches, the essential questions of what is the corporation, and what interests it should represent are exposed to light, as Davies eloquently argues:

> *The crucial question is what the statutory statement says about the interests which the directors should promote when exercising their discretionary powers. The common law mantra that the duties of directors are owed to the company has long obscured the answer to this question. Although that is a statement of the utmost importance when it*

> *comes to the enforcement of duties and their associated remedies, it tells one nothing about the answer to our question, whose interests should the directors promote? This is because the company, as an artificial person, can have no interests separate from the interests of those who are associated with it, whether as shareholders, creditors, employers, suppliers, customers or in some other way. So, the crucial question is, when we refer to the company, to the interests of which of those sets of natural persons are we referring? (2005:4).*

As a member of the Corporate Law Review Steering Group, Davies goes on to defend the 'enlightened shareholder value' view, suggesting the pluralist approach produces a formula which is unenforceable, and paradoxically gives management more freedom of action than they previously enjoyed. An Australian legal expert, Redmond endorses this critique of widening the scope of directors' duties too greatly:

> *The pluralist or multifiduciary model rests on a social, not a property, view of the corporation. It identifies the corporate purpose with maximizing total constituency utility. This is an indeterminate outcome measure which poses particular difficulties in translation into a legally enforceable duty. The indeterminacy of the criteria for decision and performance measurement also points to a probable loss of accountability for directors since it offers broad scope to justify most decisions. It is difficult to resist the conclusion of the UK review that either it confers a broad unpoliceable policy discretion on managers themselves or must give a broad jurisdiction to the courts. The model needs either practical rehabilitation or a superior performance metric. It is not clear where either might be found (Redmond, 2005:27).*

In the resulting UK Company Law Reform Bill 2005 the enlightened shareholder value view has prevailed in Clause 156, which defines the essential directoral duty as:

DUTY TO PROMOTE THE SUCCESS OF THE COMPANY

1. A director of a company must act in the way he considers, in good faith, would be most likely to promote the success of the company for the benefit of its members as a whole.

2. Where or to the extent that the purposes of the company consist of or include purposes other than the benefit of its members, his duty is to act in the way he considers, in good faith, would be most likely to achieve those purposes.

3. In fulfilling the duty imposed by this section a director must (so far as reasonably practicable) have regard to:

   a) the likely consequences of any decision in the long term;
   b) the interests of the company's employees;
   c) the need to foster the company's business relationships with suppliers, customers and others;
   d) the impact of the company's operations on the community and the environment;
   e) the desirability of the company maintaining a reputation for high standards of business conduct; and
   f) the need to act fairly as between members of the company.

4. The duty imposed by this section has effect subject to any enactment or rule of law requiring directors, in certain circumstances, to consider or act in the interests of creditors of the company.

This clause replaces the *discretion* of directors to have regard for stakeholder interests with a *duty* for directors to do this:

> *As far as directors' duties are concerned, this is the heart of the enlightened shareholder value approach. The aim is to make it clear that although shareholder interests are predominant (promotion of the success of the company for the benefit of its members), the promotion of shareholder interests does not require riding roughshod over the interests of other groups upon whose activities the business of the company is dependent for its success. In fact, the promotion of the interests of the shareholders will normally require the interests of other groups of people to be fostered. The interests of non-shareholder groups thus need to be considered by the directors, but, of course, in this shareholder-centred approach, only to the extent that the protection of those other interests promotes the interests of the shareholders. The statutory formulation can be said to express the insight that the shareholders are not likely to do well out of a company whose workforce is constantly on strike, whose*

> *customers don't like its products and whose suppliers would rather deal with its competitors (Davies, 2005:5).*

In this way the Company Law Reform Bill treads a fine legal line between a sense of 'enlightened shareholder value' which is becoming best practice in many leading companies, and more radical claims for company law to adopt a more 'pluralist' sense of the ultimate objectives of the enterprise and the interests to be served. The reform manages this balancing act by suggesting that the pluralist objectives of maximizing company performance to the benefit of all stakeholders can best be served by professional directors pursuing commercial opportunities within a framework of standards and accountability:

> *The overall objective should be pluralist in the sense that companies should be run in a way which maximizes overall competitiveness and wealth and welfare for all. But the means which company law deploys for achieving this objective must be to take account of the realities and dynamics which operate in practice in the running of a commercial enterprise. It should not be done at the expense of turning company directors from business decision-makers into moral, political or economic arbiters, but by harnessing focused, comprehensive, competitive decision making within robust, objective professional standards and flexible, but pertinent accountability (CLR, 2000:14).*

The reform supports the ultimate power of shareholders to appoint or dismiss directors for whatever reasons they choose, and to intervene in management to the extent the constitution permits, and confesses:

> *There is clearly an inconsistency between leaving these powers of shareholders intact and enabling or requiring directors to have regard to wider interests … the effect will be to make smaller transactions within the powers of directors subject to the broad pluralist approach, but larger ones which are for shareholders subject only to the minimal constraints which apply to them (CLR, 2000: 26).*

The United Kingdom Company Law Review (2000) in its comprehensive review of company law recommended a recasting of directors' duties to give effect to its notion of 'enlightened shareholder value' ultimately contained in the *Companies Bill* 2006 (UK) which received Royal Assent on 8 November 2006. The possibility that this will be accompanied by an extension of the requirements for company reporting to include social and environmental matters may appear

to have receded, with the UK Chancellor's dramatic abandonment of the obligatory Operating and Financial Review for listed companies in November 2006. However this was in the context of the European Union's Accounts Modernization Directive 2003/51/EC which also requires companies include environmental and social reports with their annual accounts necessary for an understanding of the companies performance. Many large UK corporations have continued with their intention to publish Operating and Financial Review's despite it no longer being mandatory. It is likely that these modern company law proposals will over time facilitate the wider and more conscious adoption by UK companies of social and environmental commitments, and the willingness to report fully on them. In time it is possible that such social and environmental commitments will become part of a widespread company and management best practice, in the way that the commitment to quality in the production of goods and services has become universal.

Moreover just as the UK in the publication of the Cadbury Code of corporate governance ultimately influenced a considerable number of other countries to adopt a similar code, it is possible that other countries, particularly that share a common law tradition to the UK, will begin to review their company law with similar objectives in mind. The twin inquiries that took place into corporate responsibility in Australia are illustrative of this widening interest . The Corporations and Markets Advisory Committee (CAMAC) commenced in March 2005 to consider whether directors' duties under the Corporations Act 2001 should include corporate responsibilities or obligations to take into account certain classes of stakeholders. The Committee published an excellent Discussion Paper on *Corporate Social Responsibility* (available free at www. camac.gov.au).

The second inquiry, the Parliamentary Joint Committee on Corporates and Financial Services (PJC) began in June 2005 with a call for submissions on corporate social responsibility, and has received over 120 extensive submissions from companies, consultancies, academics and other interested parties (available at http://www.aph.gov.au/Senate/committee/corporations_ ctte/corporate_responsibility/index. htm). Together these inquiries served to raise awareness of the issues involved in corporate responsibility considerably in Australia.

The notion that a change in company law was required to clarify and strengthen directors duties on corporate social responsibility was rejected

by both the Australian reviews, in favour of a range of voluntary measures. CAMAC concluded:

> *The Committee does not support the revision of the Corporations Act in the manner referred to in these questions. The established formulation of directors' duties allows directors sufficient flexibility to take relevant interests and broader community considerations into account. Changes of a kind proposed from time to time do not provide meaningful clarification for directors, yet risk obscuring their accountability (2006:7).*

CAMAC went on to make a series of recommendations concerning the importance of disclosure, and encouraging responsible business practices. Similarly the PJC maintained,

> *The committee strongly supports further successful engagement in the voluntary development and wide adoption of corporate responsibility. The committee has formed the view that mandatory approaches to regulating directors' duties and to sustainability reporting are not appropriate. Consequent on the recommendations of this report, the committee expects increasing engagement by corporations in corporate responsibility activities. This would obviate any future moves towards a mandatory approach. The committee believes that the recommendations contained in this report will play an important part in progressing the future of corporate responsibility in Australia (PJC, 2006:xix).*

Both recent Australian official inquiries acknowledge that 'Corporate responsibility in Australia is still in its developmental stages …' (PJC 2006: xix). Both inquiries stress the importance of monitoring the adoption of their recommendations, and that 'There is scope for additional 'light touch' measures by government, helping corporate and other participants where the opportunity arises, without constraining energy and initiative in the community marketplace' (CAMAC, 2006:169).

However, the role of the law and of regulation in establishing a framework of accountability and management discipline is a significant factor in concentrating attention on this matter. In this sense some might claim the recommendations of the two Australian committees of inquiry, however supportive of an enhanced engagement in CSR on the part of companies, represent a missed opportunity with regard to the ameliorative effect of legal and regulatory change. Company

law reform in the UK treads a fine legal line between a sense of 'enlightened shareholder value' which is becoming best practice in many leading companies, and more radical claims for company law to adopt a more 'pluralist' sense of the ultimate objectives of the enterprise and the interests to be served, and in this way has served to move both policy and practice forward in a dynamic way.

One reason the agenda of corporate responsibility is increasingly irresistible is that while legal liability of corporations is deepening, what has been described as an emerging and hardening *moral liability* is exerting increasing influence. In this respect the legislative process lags behind what society thinks, values and respects. Moral liability occurs when corporations violate stakeholder expectations of ethical behaviour in ways that put business value at risk. There is an increasing convergence between these two forms of liability, as corporations come under scrutiny both by the law and – often more immediately and pointedly – by public opinion (SustainAbility, 2004:5). A graphic illustration of this was the James Hardie building company which having moved its corporate headquarters from Australia to the Netherlands, and the majority of its business activity to the United States, believed it had escaped responsibility for the legal liabilities of its remaining Australian subsidiaries to the thousands of asbestos victims dependent on a seriously under-funded and almost bankrupt medical foundation Hardie had left behind to meet their claims. Massive public disapproval in Australia and internationally, and a commission of inquiry combined with the threat of legislative intervention, dragged James Hardie back to face the consequences of its irresponsible actions over many decades in the Australian market (Jackson, 2004).

Paul Redmond lays out clearly the critical parameters of a fundamental ongoing debate:

> *What should be the legal rule with respect to directors' duties? Should company law require directors and senior managers to act by reference to the interests of all stakeholders in the corporate enterprise, according primacy to no particular interests including those of shareholders (mandatory pluralism)? Or should company law permit (but not require) directors and senior managers to act by reference to the interests of all stakeholders, according primacy to no particular interests including those of shareholders (discretionary pluralism)? The most radical of these models is the mandatory pluralist model creating a multifiduciary duty requiring directors and managers*

to run the company in the interest of all those with a stake in its success, balancing the claims of shareholders, employees, suppliers, the community and other stakeholders. The claims of each stakeholder are recognized as valuable in their own right and no priority is accorded shareholders in this adjustment; their interest may be sacrificed to that of other stakeholders. (Stakeholders are variously defined as those with an interest in or dependence relationship with the company or, alternatively, as those upon whom it depends for its survival). The discretionary pluralist model would permit, but not require, directors to sacrifice shareholder interests to those of other stakeholders. One or other of these models would formalize the managerialist practice that has been displaced by the current shareholder value culture (Redmond, 2005).

Investment Institutions Effective Portfolio Management: The Duty to Address Environmental, Social and Governance Issues?

Similar forces that are impressing corporations towards taking a greater regard of CSR issues are guiding investment institutions towards addressing environmental, social and governance issues more directly in their investment policies and practices. In the UNEP Finance Initiative on *The Materiality of Social, Environmental and Corporate Governance Issues to Equity Pricing* (2004), the interest of a growing number of institutional investors in approaches to asset management that explicitly include environmental, social and governance (ESG) criteria and metrics, either for ethical reasons or as relevant to investment performance was considered. Critical intermediaries are the brokerage firms that often have paid less consideration to ESG issues, often because they are driven by short term performance. A group of eleven international brokerage firms' analysts were commissioned to examine a range of industry sectors regarding the relevance of ESG to investment performance, and to submit detailed reports. Briefly their conclusions were:

- Environmental, social and governance criteria affect shareholder value both in the short and long term, and in some cases the effects could be profound. Research to determine the financial materiality of these criteria should use longer time spans than is currently employed for financial analysis.

- Governments could reduce barriers to environmental, social and corporate governance analysis by mandating and standardizing the inclusion of these criteria in national and international corporate disclosure frameworks.

- Innovative techniques are being developed to perform financial analyses of environmental, social and corporate governance criteria in response to growing investor demand, including ranking surveys, portfolio analysis of best and worst performers, and scenario analysis to evaluate potential impact of upcoming regulation on sectors.

The survey discovered that brokerage houses in Europe are increasingly willing and able to respond to demand for ESG research. In contrast brokerage houses in the United States referred to perceived difficulty in analysis due to barriers associated with inadequate disclosure of these criteria.

A further fascinating research project of the UNEP Finance Initiative considered *A Legal Framework for the Integration of Environmental, Social and Governance Issues into Institutional Investment* (2005). The current value of assets managed by the investment industry worldwide is estimated at US$42 trillion, pension fund assets in the US and UK alone amounting to US$7.4 trillion. However the weighty responsibility of deciding where these assets are invested lies not with the owners, but with a small number of principals and agents. 'By influencing the way investments are made, the legal factors that inform the decisions made by this relatively small group have a profound effect on the behaviour of the entities in which these assets are invested and ultimately on the environments and societies with which these investment vehicles interact (UNEP FI, 2005:6).

Despite the increasing evidence that ESG issues do have a material impact on the financial performance of securities and increasing awareness of the importance of assessing ESG related risks, the effort to achieve a greater regard for ESG issues in investment decision-making is often resisted on the basis that institutional principals and their agents are legally prevented from taking account of these issues. Just as it is assumed corporate directors can only be committed to shareholder value, it is often assumed that investment trustees can only be directed towards profit maximization. However the survey conducted by the international law firm Freshfields Bruckhaus Deringer confirms categorically that in each of the jurisdictions examined (France, Germany, Italy, Japan, Spain,

UK, US, Australia and Canada) investment decision-makers retained some degree of discretion as to how they might invest the funds they control.

In the common law jurisdictions (US, UK, Australia and Canada) the rules are articulated in statute and in court decisions. In the other jurisdictions as civil law applies, rules are articulated as codes or in statutes. Though in none of the jurisdictions do rules prescribe how principals should integrate ESG considerations into their decisions, in most cases it is left to principals to determine their investment approach within their legal obligations.

Fiduciary duties are the key discretionary limits of investment decision-makers in common law countries, the most important duties being the duty to act prudently and the duty to act in accordance with the purpose for which investment powers were granted (the duty of loyalty).

In the US the modern prudent investor rule, which incorporates both a duty of care and a duty of loyalty, emphasizes modern portfolio theory and provides that:

- investments are assessed not in isolation but in the context of their contribution to a total investment portfolio;
- there is no duty to 'maximize' the return of individual investments, but instead a duty to implement an overall investment strategy that is rational and appropriate to the fund;
- the investment portfolio must be diversified, unless it is prudent not to do so; and
- the prudence of an investment should be assessed at the time the investment was made and not in hindsight.

The effect of the modern prudent investor rule is that institutional decision-makers are given latitude to follow a wide range of diversified investment strategies, provided their choice of investments is rational and economically defensible, they are free to construct a balanced portfolio (UNEP FI, 2005:8). Other jurisdictions stipulate the duty to act conscientiously in the interests of beneficiaries, to seek profitability, recognize the portfolio approach to modern investment, and in some jurisdictions limits on the types of assets which may be selected for particular funds.

Two things which are critical in all jurisdictions are following the correct process, and pursuing proper objectives in terms of acting only in the interests of the beneficiaries. As with other investment criteria, different considerations will be given different weight, according to how conditions are defined and analysed. In some circumstances it may be decided that ESG considerations have little material impact on financial performance relevant to a particular investment. However, this does not justify failure to identify such considerations and to assess the weight. It is becoming increasingly difficult to argue that ESG considerations are difficult to quantify, since good will and intangibles are now readily quantified. A majority of the jurisdictions surveyed have already legislated to require investment decision-makers, particularly of pension funds to disclose the extent to which they take ESG considerations into account.

There is increasingly credible evidence that ESG considerations have a vital role to play in the proper analysis of investment value, and cannot be ignored as they would result in investments being given inappropriate value for example:

> *Climate change is an obvious example of an environmental consideration that is recognized as affecting value. Following the recent release of a report by Mercer Investment Consulting noting the financial impact that climate change has already had on companies' costs, revenues, assets and liabilities, the UK Carbon Trust expressed the view that 'Pension fund trustees have a duty to address the financial risk posed by climate change when making investment decisions (UNEP FI, 2005:11).*

Investment institutions are not only becoming more alert regarding the ESG issues in their investment portfolio they are also beginning to take a proactive stance in terms of engaging in the environmental, social and governance performance of the corporations they invest in. Both in the US and UK the traditional passivity of the investment institutions is being cast aside in favour of more active involvement. Certainly they continue to prefer quiet influence to open confrontation, but in an increasing number of instances the institutional investors have demonstrated a willingness to use their power to insist on higher standards of governance, and there are some indications this may occur more frequently in future on wider ESG issues.

Corporate Reporting of CSR

If the revival of interest in CSR is to continue to develop, and not descend into apologetics as previous efforts have done, and if the current wave of interest in ESG issues in the investment community is to bear fruit in more enduring returns, then what is absolutely critical is the accuracy and verifiability of corporate disclosure regarding CSR performance. In this regard the Global Reporting Initiative (GRI) Principles are an invaluable tool for working towards international confidence in the trustworthiness of corporate reporting. The overall aim of the GRI-based reporting is to:

- provide a balanced and reasonable representation of an organization's sustainability performance;
- facilitate comparability;
- address issues of concern to stakeholders.

The GRI reporting principles are the underpinnings of corporate report content, and as such are as important as the content itself. The reporting principles are:

- *Transparency*: Full disclosure of the processes, procedures and assumptions in report preparation are essential to its credibility.
- *Inclusiveness*: The reporting organization should engage its stakeholders in preparing and enhancing the quality of reports.
- *Auditability*: Reported information should be recorded, compiled, analysed and disclosed in a way that enables internal auditors or external assurance providers to attest to its reliability.
- *Completeness*: All material information should appear in the report.
- *Relevance*: Reporting organizations should use the degree of importance that report users assign to particular information in determining report content.
- *Sustainability Context*: Reporting organizations should seek to place their performance in the broader context of ecological, social or

other issues where such context adds significant meaning to the reported information.

- *Accuracy*: Reports should achieve a degree of exactness and low margin of error to enable users to make decisions with a high degree of confidence.

- *Neutrality*: Reports should avoid bias in selection and presentation of information and provide a balanced account of performance.

- *Comparability*: Reports should be framed so as to facilitate comparison to earlier reports as well as to reports of comparable organizations.

- *Clarity*: Information should be presented in a manner that is understandable by a maximum number of users while still maintaining a suitable level of detail (GRI, 2002:6).

Of course the Global Reporting Initiative is only one of a wide set of global principles, guidelines and standards. Hopefully over time greater coherence will be achieved in terms of globally accepted CSR principles, accounting principles, specialized CSR standards, and overall management systems as processes of normative and regulative change coalesce. The work of developing, implementing and verifying these reporting standards for corporate social and environmental responsibility will continue for many years to come, replicating the effort that is now being made in the quest to achieve better measurement and reporting of intangibles. However the whole edifice of CSR and ESG analysis and valuation will rest on the adequacy and rigour of reporting standards.

Future Developments: The Redesign of the Corporation

It could be argued that the whole corporate social and environmental responsibility project, however worthy, is probably too little and too late. A more sympathetic view is that in its revived form CSR represents a new beginning in corporate reform that may be built on to create more substantial and enduring results. Certainly further efforts will be required to further ensure the accountability of corporations, on a universal and not simply voluntary basis. A group of business and community leaders in the US have projected a vision of Corporation 2020 based on the imperative to redesign the corporation. The

principles they advocate are that the purpose of the corporation is to harness private interests to serve the public interest, that fair returns to shareholders should not be at the expense of the legitimate interests of other stakeholders, that corporations should operate sustainably, and that corporations distribute wealth produced equitably among those who contribute to the creation of that wealth. Robert Hinkley offers a 28-word amendment to directors' duties which states that they are to act in the interests of the company 'but not at the expense of the environment, human rights, public health and safety, dignity of employees, or the welfare of communities in which the corporation operates' (Luis, 2005).

It is possible to envisage a business world not characterized by the bipolar disorder of the ongoing shareholder/stakeholder debate. The effective integration of corporate social and environmental responsibilities could potentially release greater value for both shareholders and wider stakeholders. Moving beyond compliance, to creating new value through new products and services that meet societal needs. Collaborating to solve the complex and demanding social and environmental problems that threaten to grow beyond our control. Corporations capable of working in investors, stakeholders, and societies interests in a collaborative, creative and productive way would require a fundamental redesign of the concept of the corporation and the institution of the market. At this stage both prospects appear remote. However we live in an industrial world where the problem of material production has essentially been solved. The primary remaining global dilemmas are that overproduction and massive surpluses still coexist with desperate poverty and need, and that the resource base for industry is rapidly depleting and damaging, potentially irreparably, the eco-system. It is possible that confronting these dilemmas will force the rethinking of corporate objectives, structures, and activities that is necessary.

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12

Convergence: A Prognosis

Güler Aras and David Crowther

Introduction

Some discussion has taken place as to whether corporate governance is an aspect of corporate social responsibility, or vice versa. In this book we have seen various authors adopt one position or the other so all we should say is that they are inevitably interrelated – good governance must recognise CSR and effective CSR must accommodate governance. The various contributors to this book have examined governance and social responsibility in various locations around the world and in various types of business. If space was not a factor, then many more locations and types of business could be examined in a similar manner. So one thing that is apparent is that these are issues of considerable significance all over the world. In this final chapter therefore we need to consider the issues raised and explore commonalities and differences. And lastly in this chapter we will take these debates and the arguments from the chapters in this book in order to consider a prognosis of what the future might hold for corporate governance and social responsibility procedures and practices.

Corporate governance is of course fundamental to the continuing operating of any corporation, hence much attention has been paid to the procedures of such governance.[1] A significant part of the reason for this is due to the developments brought about through globalisation. The phenomenon known as globalisation is a multidimensional process involving economic, politic, social and cultural change. However, the most important discussion about globalisation is related to the economic effect it has upon countries and the corporations operating within and across these countries. There has been much written about globalisation – either positive or negative – and the effects which it is having. One consequence of globalisation though is manifesting itself in the structure

1 See for example Aras and Crowther (2008a).

and organisation of corporations. This is concerned with the harmonisation procedures and structures which will manifest themselves through the possible emergence of global norms for corporate governance. We have seen through the preceding chapters a variety of issues concerned with corporate governance. Equally we have seen examples of overwhelming importance of cultural issues in the operation of whatever systems of governance are introduced. Nevertheless some form of commonality and harmonisation continues to be a subject of debate. So one issue which needs to be considered in our prognosis is the likelihood and desirability of common standards emerging. In considering this issue it is instructive to examine the search for harmonisation of accounting standards.

There is unquestioning acceptance within the discourse of accounting that there is a need for accounting standards and that these should be harmonised on a global basis.[2] From this acceptance two sets of standards have evolved: US GAAP as devised by the Financial Accounting Standards Board (FASB) of the USA, and obligatory for all companies reporting into the New York Stock Exchange, and International Financial Reporting Standards (IFRS) and codified by the International Accounting Standards Board (IASB) and now obligatory for all companies reporting into the Stock Exchanges of the EU. Each set of standards is vying for global dominance as the universal accounting standards. It is generally accepted within the accounting community[3] that there is only room for one set of standards and the debate continues regarding which approach to standard setting is superior and concerning the prognosis as to which approach will eventually win and become the accepted global set of standards.[4] This process has however being going on for a generation and common standards have not yet emerged, suggesting that we might not see common governance standards in the near future.

Globalisation and Corporate Governance

Two features can be considered to describe the modern world – globalisation and the free market. It is widely accepted – almost unquestioningly – that free

2 This acceptance of the need is of course the rationale for Generally Accepted Accounting Principles – GAAP – on both a national and international basis.

3 This includes both practitioners and academics who concur of this issue, even if very little else.

4 Currently the IFRS seem to be becoming dominant, raising the expectation that they will eventually triumph – a distinct change from a decade ago when all the betting would have been upon US GAAP becoming dominant.

markets will lead to greater economic growth and that we will all benefit from this economic growth. Around the world people – especially politicians and business leaders – are arguing that restrictions upon world economic activity caused by the regulation of markets are bad for our well-being. And in one country after another, for one market after another, governments are capitulating and relaxing their regulations to allow complete freedom of economic activity. So the world is rapidly becoming a global market place for global corporations, increasingly unfettered by regulation. We have seen the effects of the actions of some of these corporations within the United States itself – the champion of the free market. We have seen the collapse of the global accounting firm Andersen, we have seen the bankruptcy of major corporations such as Enron and World.com with thousands of people being thrown out of work and many people losing the savings for their old age which they have worked so long and hard to gain.

In considering why this situation has arisen we must acknowledge that basically there are problems with accounting, with auditing, and with peoples' expectations. We must remember that the myth of the free market is grounded in classical liberal economic theory – subsequently developed into Utilitarianism and the foundation of the capitalist economic system, and as propounded by people such as John Stuart Mill in the 19th century, which briefly summarised, states that anything is ok as long as the consequences are acceptable. The regulatory regime of accounting which has been increasingly changed over time to serve the interests of businesses rather than their owners or society. Thus no longer is it expected that the accounting of a business should be undertaken conservatively by recognizing potential future liabilities while at the same time not recognizing future profit. Instead profit can be brought forward into the accounts before it has been earned while liabilities (such as the replacement of an aging electricity distribution network) can be ignored if they reduce current profitability. A study of the changes made in accounting standards over the years shows a gradual relaxation of this requirement for conservatism in accounting as these standards have been changed to allow firms to show increased profits in the present. This of course makes the need for strong governance procedures even more paramount.

The Development of Utilitarianism

Classical Liberal Theory started to be developed in the 17th century by such writers a John Locke, as a means of explaining how society operated, and should

operate, in an era in which the Divine Right of Kings to rule and to run society for their own benefit had been challenged and was generally considered to be inappropriate for the society which then existed. Classical Liberalism is founded upon the two principles of reason and rationality: reason in that everything had a logic which could be understood and agreed with by all, and rationality in that every decision made was made by a person in the light of what their evaluation had shown them to be for their greatest benefit. Classical Liberalism therefore is centred upon the individual, who is assumed to be rational and would make rational decisions, and is based upon the need to give freedom to every individual to pursue his/her own ends. It is therefore a philosophy of the pursuance of self interest. Society, insofar as it existed and was considered to be needed, was therefore merely an aggregation of these individual self interests. This aggregation was considered to be a sufficient explanation for the need for society. Indeed Locke argued that the whole purpose of society was to protect the rights of each individual and to safeguard these private rights.

There is however a problem with allowing every individual the complete freedom to follow his/her own ends and to maximize his/her own welfare. This problem is that in some circumstances this welfare can only be created at the expense of other individuals. It is through this conflict between the rights and freedoms of individuals that problems occur in society. It is for this reason therefore that de Tocqueville argued that there was a necessary function for government within society. He argued that the function of government therefore was the regulation of individual transactions so as to safeguard the rights of all individuals as far as possible.

Although this philosophy of individual freedom was developed as the philosophy of Liberalism it can be seen that this philosophy has been adopted by the Conservative governments throughout the world, as led by the UK government in the 1980s. This philosophy has led increasingly to the reduction of state involvement in society and the giving of freedom to individuals to pursue their own ends, with regulation providing a mediating mechanism where deemed necessary. It will be apparent however that there is a further problem with Liberalism and this is that the mediation of rights between different individuals only works satisfactorily when the power of individuals is roughly equal. Plainly this situation never arises between all individuals and this is the cause of one of the problems with society.

While this philosophy of Liberalism was developed to explain the position of individuals in society and the need for government and regulation of that

society, the philosophy applies equally to organisations. Indeed, Liberalism considers that organisations arise within society as a mechanism whereby individuals can pursue their individual self-interests more effectively that they can alone. Thus firms exist because it is a more efficient means of individuals maximizing their self interests through collaboration than is possible through each individual acting alone. This argument provides the basis for the Theory of the Firm, which argues that through this combination between individuals the costs of individual transactions are thereby reduced.

The concept of Utilitarianism was developed as an extension of Liberalism in order to account for the need to regulate society in terms of each individual pursuing, independently, his or her own ends. It was developed by people such as Bentham and John Stuart Mill who defined the optimal position for society as being the greatest good of the greatest number and argued that it was government's role to mediate between individuals to ensure this societal end. In Utilitarianism it is not actions which are deemed to be good or bad but merely outcomes. Thus, any means of securing a desired outcome was deemed to be acceptable and if the same outcomes ensued then there was no difference, in value terms, between different means of securing those outcomes. Thus actions are value neutral and only outcomes matter. This is of course problematical when the actions of firms are concerned because firms only consider outcomes from the point of view of the firm itself. Indeed accounting as we know only captures the actions of a firm insofar as they affect the firm itself and ignores other consequences of the actions of a firm. Under Utilitarianism, however, if the outcomes for the firm were considered to be desirable then any means of achieving these outcomes was considered acceptable. In the 19th and early 20th centuries this was the way in which firms were managed and accounting information was used purely to evaluate actions and potential actions from the point of view of the firm itself. It is only in more recent times that it has become accepted that all the outcomes from the actions of the firm are important and need to be taken into account.

The Organisational Failure Framework

While the Theory of the Firm explains why firms come into existence and the role of accounting in firms as a tool to aid rational decision-making, it does not sufficiently explain the workings of a firm. Thus the role of accounting within a firm cannot be considered without a consideration of the people involved in that firm. As firm of course consists of a collection of people who are involved.

The people involved in the firm are affected by the accounting systems of that firm as well as affecting those accounting systems, and this will be considered in greater detail in future chapters. The main people involved in the control of a firm are of course its managers and Williamson (1970) argues that because in any large organisation the management of the firm is normally divorced from its ownership then this is a factor which hinders its control and decision making. This leads to internal efficiencies within the firm and conflicts of interests which mean that organisations do not operate efficiently as a means of transaction cost minimisation and value creating maximisation. From this analysis Williamson developed what is known as the Organisational Failure Framework.

Thus, Williamson (1975) develops this analysis and considers organisations to be complex due to their size, which leads to uncertainty, bounded rationality and information impactedness. He argues that the extent of these factors determines the likelihood of organisational failure from organisations becoming the principle means of resource allocation and decision-making. Thus, he argues that there are organisational limits to the size of a firm brought about by such factors as diseconomies of scale, communication distortion and bureaucratic insularity. Furthermore, he argues that the market as a mediating mechanism cannot itself overcome these inefficiencies brought about through the organisation of productive activity into firms. He states that multidivisionalism is a method of overcoming this but that there are still limits to size because of difficulties of communication, resource allocation and lack of entrepreneurial opportunities. He argues therefore that organic growth beyond a certain size leads to failure, thereby limiting the size of a firm. While this theory has a certain logic to it practical examples of such activity are lacking and there do appear to be some very large firms in existence in the world. Perhaps however current trends towards downsizing and returning to core business aims is evidence of the validity of this theory, but some empirical testing seems to be needed which is beyond the scope of this chapter.

These factors together are described as the Organisational Failure Framework. In its simplest form this framework can be summarised as follows:

- people are not perfect and managers are unlikely to ignore their own self-interest in pursuing the interests of the owners of the firm;

- organisations as resources allocation mechanisms are not perfect and inefficiencies arise as the size of firms increases;
- markets are not perfect and cannot by themselves compensate for the other inefficiencies inherent in the organizing of productive activity into firms.

Scandals, Failures, Problems

Every time society faces a new problem or threat then a new legislative process of some sort is introduced which tries to protect that society from a future reoccurrence (Romano, 2004). Recently we have seen a wide range of problems with corporate behaviour, which has arguably led to prominence being given to corporate social responsibility (see for example Boele, Fabig and Wheeler, 2001; Aras and Crowther, 2007a). Part of this effect is to recognise the concerns of all stakeholders to an organisation, and this has been researched by many people (for example Johnson and Greening, 1999; Knox and Maklan, 2004) with inconclusive findings. Accordingly therefore corporations, with their increased level of responsibility and accountability to their stakeholders, have felt that there is a need to develop a code for corporate governance so as to guide them towards appropriate stakeholder relations.

A great deal of concern has been expressed all over the world about shortcomings in the systems of corporate governance in operation: Britain, Australia, most other Anglo-Saxon and English speaking countries, and many other countries, have a similar system of governance. Conversely, Germany is a good example of where the distance between ownership and control is much less than in the United States, while Japan's system of corporate governance is in some ways in between Germany and the United States, and in other ways different from both (Shleifer and Vishny, 1997). By contrast, in India the corporate governance system in the public sector may be characterised as a transient system, with the key players (viz. politicians, bureaucrats, and managers) taking a myopic view of the system of governance. Such international comparisons illustrate different approaches to the problem of corporate governance and the problem of ensuring that managers act in their shareholders' interest. Recently of course, much attention to this issue has been paid by institutional investors (Cox, Brammer and Millington, 2004).

Good governance is of course important in every sphere of the society whether it be the corporate environment or general society or the political environment. Good governance levels can, for example, improve public faith and confidence in the political environment. When the resources are too limited to meet the minimum expectations of the people, it is a good governance level that can help to promote the welfare of society. And of course a concern with governance is at least as prevalent in the corporate world (Durnev and Kim, 2005).

Corporate governance can be considered as an environment of trust, ethics, moral values and confidence – as a synergic effort of all the constituents of society – that is the stakeholders, including government, the general public etc, professional/service providers – and the corporate sector. One of the consequences of a concern with the actions of an organisation, and the consequences of those actions, has been an increasing concern with corporate governance (Hermalin, 2005). Corporate governance is therefore a current buzzword the world over. It has gained tremendous importance in recent years. Two of the main reasons for this upsurge in interest are the economic liberalisation and deregulation of industry and business and the demand for new corporate ethos and stricter compliance with the law of the land. One more factor that has been responsible for the sudden exposure of the corporate sector to a new paradigm for corporate governance that is in tune with the changing times in the demand for greater accountability of companies to their shareholders and customers (Bushman and Smith, 2001).

DEVELOPING A FRAMEWORK FOR CORPORATE GOVERNANCE

In the UK there have been a succession of codes on corporate governance dating back to the Cadbury Report in 1992. Currently all companies reporting on the London Stock Exchange are required to comply with the Combined Code on Corporate Governance, which came into effect in 2003, and has been subsequently amended. It might be thought therefore that a framework for corporate governance has already been developed but the code in the UK has been continually revised while problems associated with bad governance have not disappeared. So clearly a framework has not been established in the UK and an international framework looks even more remote.

One of the problems with developing such a framework is the continual rules versus principles debate. The American approach tends to be rules-based while the European approach is more based on the development of principles

– a slower process. In general, rules are considered to be simpler to follow than principles, demarcating a clear line between acceptable and unacceptable behaviour. Rules also reduce discretion on the part of individual managers or auditors. In practice, however, rules can be more complex than principles. They may be ill-equipped to deal with new types of transactions not covered by the code. Moreover, even if clear rules are followed, one can still find a way to circumvent their underlying purpose – this is harder to achieve if one is bound by a broader principle.

There are of course many different models of corporate governance around the world. These differ according to the nature of the system of capitalism in which they are embedded. The liberal model that is common in Anglo-American countries tends to give priority to the interests of shareholders. The coordinated model, which is normally found in Continental Europe and in Japan, recognises in addition the interests of workers, managers, suppliers, customers, and the community. Both models have distinct competitive advantages, but in different ways. The liberal model of corporate governance encourages radical innovation and cost competition, whereas the coordinated model of corporate governance facilitates incremental innovation and quality competition. However there are important differences between the recent approach to governance issues taken in the USA and what has happened in the UK.

In the USA a corporation is governed by a board of directors, which has the power to choose an executive officer, usually known as the chief executive officer (CEO). The CEO has broad power to manage the corporation on a daily basis, but needs to get board approval for certain major actions, such as hiring his/her immediate subordinates, raising money, acquiring another company, major capital expansions, or other expensive projects. Other duties of the board may include policy setting, decision-making, monitoring management's performance, or corporate control. The board of directors is nominally selected by and responsible to the shareholders, but the articles of many companies make it difficult for all but the largest shareholders to have any influence over the make-up of the board. Normally individual shareholders are not offered a choice of board nominees among which to choose, but are merely asked to rubberstamp the nominees of the sitting board. Perverse incentives have pervaded many corporate boards in the developed world, with board members beholden to the chief executive whose actions they are intended to oversee. Frequently, members of the boards of directors are CEOs of other corporations – in interlocking relationships, which many people see as posing a potential conflict of interest.

The UK on the other hand has developed a flexible model of regulation of corporate governance, known as the 'comply or explain' code of governance. This is a principle-based code that lists a number of recommended practices, such as:

- the separation of CEO and Chairman of the Board;
- the introduction of a time limit for CEOs' contracts;
- the introduction of a minimum number of non-executive Directors, and of independent directors;
- the designation of a senior non-executive director;
- the formation and composition of remuneration, audit and nomination committees.

Publicly listed companies in the UK have to either apply those principles or, if they choose not to, to explain in a designated part of their annual reports why they decided not to do so. The monitoring of those explanations is left to shareholders themselves. The basic idea of the Code is that one size does not fit all in matters of corporate governance and that instead of a statury regime like the Sarbanes-Oxley Act in the US, it is best to leave some flexibility to companies so that they can make choices most adapted to their circumstances. If they have good reasons to deviate from the sound rule, they should be able to convincingly explain those to their shareholders. A form of the code has been in existence since 1992 and has had drastic effects in the way firms are governed in the UK. A recent study shows that in 1993, about 10 per cent of the FTSE 350 companies were fully compliant with all dimensions of the code while by 2003 more than 60 per cent were fully compliant. The same success was not achieved when looking at the explanation part for non-compliant companies. Many deviations are simply not explained and a large majority of explanations fail to identify specific circumstances justifying those deviations. Still, the overall view is that the U.K.'s system works fairly well and in fact is often considered to be a benchmark, and therefore followed by a number of other countries. Nevertheless it still shows that there is more to be done to develop a global framework of corporate governance.

In East Asian countries, the family-owned company tends to dominate. In countries such as Pakistan, Indonesia and the Philippines, for example, the top

15 families control over 50 per cent of publicly owned corporations through a system of family cross-holdings, thus dominating the capital markets. Family-owned companies also dominate the Latin model of corporate governance, that is companies in Mexico, Italy, Spain, France (to a certain extent), Brazil, Argentina, and other countries in South America.

Corporate governance principles and codes have been developed in different countries and have been issued by stock exchanges, corporations, institutional investors, or associations (institutes) of directors and managers with the support of governments and international organisations. As a rule, compliance with these governance recommendations is not mandated by law, although the codes which are linked to stock exchange listing requirements[5] will tend to have a coercive effect. Thus, for example, companies quoted on the London and Toronto Stock Exchanges formally need not follow the recommendations of their respective national codes, but they must disclose whether they follow the recommendations in those documents and, where not, they should provide explanations concerning divergent practices. Such disclosure requirements exert a significant pressure on listed companies for compliance.

In its 'Global Investor Opinion Survey' of over 200 institutional investors, first undertaken in 2000 (and updated in 2002), McKinsey found that 80 per cent of the respondents would pay a premium for well-governed companies. They defined a well-governed company as one that had mostly outside directors, who had no management ties, undertook formal evaluation of its directors, and was responsive to investors' requests for information on governance issues. The size of the premium varied by market, from 11 per cent for Canadian companies to around 40 per cent for companies where the regulatory backdrop was least certain (e.g. those in Morocco, Egypt or Russia). Other studies have similarly linked broad perceptions of the quality of companies to superior share price performance. On the other hand, research into the relationship between specific corporate governance controls and the financial performance of companies has had very mixed results.

International Standards

Governance is concerned with both the rights of shareholders and, increasingly, the rights of other stakeholders. This extended concern has been paralleled in the developments of regulations concerning financial reporting. At the start of

5 Such as, for example, the UK Combined Code referred to earlier.

the 20th century it was generally accepted that accounting served the purpose of facilitating the agency relationship between managers and owners of a business through its reporting function, but that the general public had no right to such information (Murphy, 1979). Thus, as far as the UK is concerned, but paralleled in many other countries throughout the world (Crowther, 2000), the Companies Act 1906 stated that there was no requirement for companies to produce financial statements, although the Companies (Consolidations) Act 1908 amended this to require the production of a profit and loss account and balance sheet. This was further amended by the Companies Act 1929 which required the production of these, together with a directors report and an auditors report for the AGM. Subsequent legislation has extended the reporting requirements of companies to the format seen today.

Such corporate reporting has however been extended in addition to satisfying legislative requirements. Thus the period up to the Second World War[6] saw an increasing use of accounting information for analysis purposes but with an emphasis upon the income statement. This period also saw the extension of the directors' report to contain information about the company which was not to be found in the financial statements. This information was however primarily concerning the past actions of the company as corporate reporting as the emphasis in this period remained firmly upon the reporting of past actions as part of the relationship between the ownership and management of the firm. It is only in the post-war period that this emphasis changed from backward looking to forward looking and from inward looking to outward looking. Gilmore and Willmott (1992) have argued that this was a reflection of the changing nature of such reporting to a focus upon investment decision-making and the need to attract investment into the company in this period of expansion. The emphasis remained firmly upon the needs of the company however and only the emphasis had changed from informing existing investors to attracting new investors and so Jordan (1970: 39) was able to claim that:

> *The purpose of accounting is to communicate economic messages on the results of business decisions and events, insofar as they can be expressed in terms of quantifiable financial data, in such a way as to achieve maximum understanding by the user and correspondence of the message with economic reality.*

At this time the users of such corporate reports have increased so that they are no longer only the shareholders of the company and its managers, but all

6 From 1939–45.

were however still considered to be a restricted set of the population, having specialist knowledge of, and interest in, such reporting. The identification of such specialists had however been extended to include both the accounting profession and investment professionals. Thus Cyert and Ijira (1974: 29) were able to claim that: 'Financial statements are not just statements reporting on the financial activities and status of a corporation. They are a product of mutual interactions of three parties: corporations, users of financial statements, and the accounting profession.' while Leach (1975) stated that: 'In recent years there have been enormous changes in public interest in and understanding of financial statements. The informed user of accounts today is no longer solely the individual shareholder but equally the trained professional acting for institutional investors and the financial news media.'

Thus there was at this time a general acceptance that corporate reporting should be provided for the knowledgeable professional rather than the individual investor or potential investor, who was assumed to be financially naive (Mauntz and Sharif, 1961), and in order to satisfy the needs of these professionals, corporate reports became more extensive in content with greater disclosure of financial and other information. This pressure for greater disclosure was not however new, and Mitchell (1906) argued that the accounts produced did not give an adequate basis for shareholder judgement. All that has changed is the perception of who the reporting should be aimed at with a widening of the perceived intended audience from managers and shareholders to include other professionals. There was at this time little questioning of the assumed knowledge that the financial information is the most important part of the corporate report. The importance of the financial information contained in the reports has changed however and Lee and Tweedie (1977) claimed that the most important financial information contained in the report was details concerning profits, earnings and dividends. They equally claimed that the economic prospects of the firm are the most important information contained in the report (Lee and Tweedie, 1975) but were dismissive of the private shareholder in recording (Lee and Tweedie, 1977) that the majority read the chairman's report but nothing else.

This focus upon the development of the financial reporting aspects of corporate reporting of course ignores the development of the semiotic of such reporting and the changing nature of this semiotic. This lack of recognition is despite the acceptance that such reporting had changed over time to become more forward looking, to include more non-financial information including the chairman's report, and to become used by a wider range of people. It has

been argued (Crowther, 2002; Crowther, Carter and Cooper, 2006) that this semiotic of corporate reporting is the most important use of such reporting and the prime vehicle for developing an understanding of such reporting and the changed nature of the reporting itself. Indeed the function of the semiotic is to aid social construction of corporate activity in a way which is mediated through the semiotic (Vygotsky and Luria, 1994) in such a way that the interpretation of the reader is controlled from without by the creators of the semiotic. It is further argued that the lack of recognition of the semiotic of corporate reporting has also led to a lack of exploration of the dialectics inherent in such reporting.

The most recent stage in the development of reporting is epitomised by the most dramatic changes in corporate reporting. No longer is the firm seeking to communicate internally – to members or potential members – but rather the focus is upon the external environment. Indeed, no longer do results matter, although still contained in the report but relegated to semi-obscurity, and it is only prospects that matter. Thus the report now becomes predominantly forward looking and, perhaps more significantly, the forward orientation is not upon the economic prospects of the firm but upon the prospects for the shareholder community in terms of rewards – both dividends and share price increases. Additionally, the report now acknowledges the rest of the stakeholder community and seeks to demonstrate corporate citizenship by commenting upon relationship with, and benefits accruing to, employees, society, customers and the local community. Indeed the report has tended to become not a communication medium but rather a mechanism for self promotion. Thus the actual results of the firms past performance no longer matter but rather the image of the firm is what matters and the production of the report is the event itself, rather then merely a communication mechanism. And of course the availability of this reporting has increased dramatically as all companies[7] now show their reports via the Internet as well as via paper, thereby making them potentially accessible to everyone.

Standards of CSR

Approaches to CSR activity and reporting have been voluntary and firms have largely made their own decisions. But it is here that a firm runs into problems – how to balance up the conflicting needs and expectations of various

7 It is accepted that not all companies throughout the world yet do this but the number of companies which do not report via the Internet is shrinking rapidly. Moreover, it is a requirement in an increasing number of countries.

stakeholder groups while still being concerned with shareholders, how to practice sustainability, how to report this activity to those interested, how to decide if one activity is more socially responsible than another. The situation is complex and conflicting.

Nevertheless steps have been taken by interested parties to change this voluntary approach and to develop some kind of standards for reporting, but they have not (yet) been adopted by governments to become enshrined into standards. Thus in 1999 the Institute of Social and Ethical Accountability[8] published the AA1000 Assurance Standard with the declared aim of fostering greater transparency in corporate reporting. AccountAbility, an international, not-for-profit, professional institute founded by Simon Zadek, claims to have launched the world's first-ever assurance standard for social and sustainability reporting, designed to improve accountability and performance by learning through stakeholder engagement. It was developed to address the need for organisations to integrate their stakeholder engagement processes into daily activities. It has been used worldwide by leading businesses, non-profit organisations and public bodies. The framework is claimed to be designed to help users to establish a systematic stakeholder engagement process that generates the indicators, targets, and reporting systems needed to ensure its effectiveness in overall organisational performance. The principle underpinning AA1000 is that of inclusivity. The building blocks of the process framework are planning, accounting and auditing and reporting. It does not prescribe what should be reported on but rather the 'how', thereby claiming to be flexible to accommodate the diverse interests of all organisations for disclosure.

According to AccountAbility the AA1000 Assurance Standard is the first initiative offering a non-proprietary, open-source Assurance standard covering the full range of an organisation's disclosure and associated performance (i.e. sustainability reporting and performance). It draws from and builds on mainstream financial, environmental and quality-related assurance, and integrates key learning with the emerging practice of sustainability management and accountability, as well as associated reporting and assurance practices.

At the similar time the Global Reporting Initiative (GRI) produced its Sustainability Reporting Guidelines which have been developed through multi-stakeholder dialogue. The guidelines are claimed to be closely aligned to AA1000, but focus on a specific part of the social and environmental accounting and reporting process, namely reporting. The GRI aims to cover a

8 The Institute of Social and Ethical Accountability is probably better known as AccountAbility.

full range of economic issues, although these are currently at different stages of development. The GRI is an initiative that develops and disseminates a range of Sustainability Reporting Guidelines. These Guidelines are for voluntary use by organisations for reporting on the economic, environmental, and social dimensions of their activities, products, and services. Although originally started by an NGO, GRI has become accepted as a leading model for how social environmental and economic reporting should take place. It aims to provide a framework that allows comparability between different companies' reports whilst being sufficiently flexible to reflect the different impacts of different business sectors.

The GRI aims to develop and disseminate globally applicable Sustainability Reporting Guidelines. These Guidelines are for voluntary use by organisations for reporting on the economic, environmental, and social dimensions of their activities, products, and services. The GRI incorporates the active participation of representatives from business, accountancy, investment, environmental, human rights, research and labour organisations from around the world. Started in 1997, GRI became independent in 2002, and is an official collaborating centre of the United Nations Environment Programme (UNEP) and works in cooperation with UN Secretary-General Kofi Annan's Global Compact. The guidelines are under continual development and in January 2006 the draft version of its new Sustainability Reporting Guidelines, named the G3, was produced and made open for feedback. The GRI pursues its mission through the development and continuous improvement of a reporting framework that can be used by any organisation to report on its economic, environmental and social performance. The GRI has become the popular framework for reporting, on a voluntary basis, for several hundred organisations, mostly for-profit corporations. It claims to be the result of a permanent interaction with many people that supposedly represents a wide variety of stakeholders relative to the impact of the activity of business around the world.

GRI and AA1000 provide a set of tools to help organisations manage, measure and communicate their overall sustainability performance: social, environmental and economic. Together, they draw on a wide range of stakeholders and interests to increase the legitimacy of decision-making and improve performance. Individually, each initiative supports the application of the other – at least this is the claim of both organisations concerned, AA1000 provides a rigorous process of stakeholder engagement in support of sustainable development, while GRI provides globally applicable guidelines for reporting on sustainable development that stresses stakeholder engagement in both its

development and content. The standards are both competing with each other for dominance and flexible enough to be supportive of each other in corporate reporting. Thus the standards are shown to be flexible enough to be adapted when the concerns of corporations evolve and exhibit their current concern with such topics as sustainable development (see Aras and Crowther, 2009)

The Relationship between Governance, Social Responsibility and Business Success

Often the more significant the power that multinational corporations and some groups of stakeholders in a firm have, the more is spoken about corporate social responsibility (CSR). Thus, a concept that was some kind of luxury some years ago, nowadays has reached the top of the public opinion discussion. Some steps taken in the corporation's development, in the environment and in the human values can be the guilty causes of this CSR fashion. If in the beginning firms were small and there was no distinction between ownership and management, the economic development made that there was a necessity to join more capital to set up bigger enterprises. Thus, there were owners, who gave the funds, and experts in management, who managed the company and were paid by the owners. Agency Theory establishes this relationship between the principal, the shareholder, and the agent, the manager, bearing in mind that the goals of the shareholders must be got through the management of the agents. But, which are the shareholders' objectives? Obviously to increase the enterprise value through the maximisation of profits.

But a company's structure is nowadays more complex than before and there have appeared other people, not owners, directly or indirectly implied in the company's operations – known as stakeholders. This complexity has of course increased the need for governance procedures. Multinational corporations have sometimes even more power than governments in their influence, and stakeholders have gained more power through the media and public opinion in order to require some kind of specific behaviour from companies. Within this new environment, although explained in a very simple way, the primary objective of the company has become wider. Although generally speaking, the assumption may be that the first goal is to get financial performance in the company, after it the next step will be to comply with other socially responsible policies. That is because to pay attention to social objectives, or to show an orientation to multiple stakeholders group, could be considered a luxury, because it must have meant that the other basic company's goal had been met.

This argument is the basis of the first hypothesis about the relationship between CSR, linked to pay attention to stakeholders, and business success: Better performance results in greater attention to multiple stakeholders' (Greenley and Foxall, 1997, p. 264). While the other hypothesis about this relationship will run in the opposite direction: 'that orientation to multiple stakeholder groups influences performance' (Greenley and Foxall, 1997, p. 264), which means to 'attend' to social policies in a better way.

This double-sided relationship increases the difficulty to try to empirically prove it. Intuitively it seems as if there is a clear relationship between CSR and business success, but although the measurement of business success may be easy, through different economic and financial tools, such as ratios, the measurement of the degree of compliance of a company with social policies is really difficult. We can have in mind some kind of indicators such as funds donated to charitable objectives, but a company can spend immeasurable quantities of money on charitable questions and have problems in the relationship with labour unions because of bad working conditions, or low wages, for example. In this sense there are, since a long time ago, some companies whose objectives include philanthropic aims. It may be understood as the initial values are ones, and then the market and the capitalism forces the firm to change them in order to survive in this maelstrom. Although at the same time the double-sided relationship operates, because people socially concerned bear in mind these basic aims and the image of the saving banks is improved, which has got a direct relationship with the economic performance. This example may be only one speaking about the market inefficiencies[9] and the trend to acquire human values and ethics must be forgotten when we are surrounded by this society and the market.

The relationship between good governance and business performance is however clearer. As we stated in Chapter 1, investors are increasingly willing to pay a premium for good governance in a business because of the expected improvements in sustainable performance which will, over time, be reflected in future dividend streams. And the relationship between social responsibility and governance is similarly clear and described by us previously (see Aras and Crowther, 2007b, 2008a). In an attempt to satisfy the necessities of the stakeholders there can appear other conflicts between the interests of the different groups included in the wider concept of stakeholders. Sometimes due to this conflict of interests and to the specific features of the company it tries to establish different levels between the stakeholders, paying more attention to

9 See Baumol and Batey (1993).

those that are most powerful, but are there some goals more socially responsible than others? In the end the hierarchy will depend on the other goals of the company, it will give an answer to those stakeholders that can threaten the performance of the economic goals.

The difficulties in measuring the social performance of a company are also due to the ownership concept. This is because the concept of corporate social responsibility is really comprehensive. There are companies whose activities are really different but all of them have to bear in mind their social responsibility, and not only companies, but also people in whatever activity they do. From a politician to a teacher: ethics, code of conducts, human values, friendship with the environment, respect to the minorities (what not should be understood as a dictatorship of the minorities) and so on are values that have to be borne in mind and included in the social responsibility concept. A good example of this diversity can be seen in this directory where are included opinions of different experts in such different topics as 'building and construction' or 'auditing', although everyone has got a deep relationship with the other. The same can be said about the regions, besides the classification according to topics in the directory has been included another classification of CSR in accordance with regions. The point of view of the concept can vary depending on the country or the region, because some important problems linked to basic human values are more evident in some countries than in other ones. These social problems cannot be isolated because they have got an important relationship with the degree of development of the country, so in the end it is the economy that pushes the world. Capitalism allows the differences between people, but what is not so fair is that these differences are not only due to your effort or work but are also due to have taken advantage of someone else's effort. And this can be the case with multinational corporations, which sometimes abuse of their power, closing factories in developed countries and moving them to developing countries because the wages are lower, or for example, because the security and health conditions are not so strict and so much cheaper to maintain for the company. And then the same companies obtain big amounts of profits to expense them in philanthropic ways.

Development conditions of regions can determine the relationship between governance and business success, as we have highlighted, if it is allowed in some developing countries to damage the environment or there are no appropriate labour unions, and so on. Because of lack of requirements or government's attention, the global players use these facilities to obtain a better economic performance although they can be aware of their damaging policies. But

not only the development degree has to do with governance and with social responsibility, countries or regions are also deeply associated with human values through education and culture. The values are so deep inside us that even it is said that people from different regions of the world who have shared the same education, for example, ethics courses at the university, do not share the same human values, because they are marked by their origins. Perhaps it should be understood as the inclusion of ethics courses at the university degrees is useless because finally people will go on thinking what they thought at the beginning, depending on the values of their origin culture. But everything is not so simple, because there have been proof of situations where different values have been imported from one culture to another and accepted as their own values without any problem (only point out the success of McDonalds food all over the world and even in the former communist countries, can it be understood there is a McDonalds restaurant in Red Square, Moscow?). So, it shows that the questions related to CSR are complicated and not so simple as they can seem at a first glance.

This complexity can be argued as a disadvantage to take into account when speaking about the creation of global standards about companies socially responsible behaviour: there are so many different cases, that to establish a general regulation may be really difficult. But at the same time this diversity can be argued to require this regulation, because there have been different initiatives, most of them private, and they have added diversity to the previous one and the subject requires a common effort to try to tackle the problem of its standards and principles. The latest financial scandals have proved that it is not enough with own codes or human values, it is necessary to reach an agreement to establish a homogeneous regulation at least at the level of global players, multinational corporations that play globally.

GOVERNANCE SYSTEMS AND CSR

Most people would say that corporate social responsibility is an Anglo-Saxon concept which has been developed primarily in the UK and the USA. Critics however would say that it is only under the Anglo-Saxon model of governance that there could ever be a need for CSR. They would argument that the Cartesian dichotomy is a peculiarly Anglo-Saxon development which led directly to the notion of a free market as a mediating mechanism and the acceptance of the use of power for one's own end, in true utilitarian style. This has led to the loss of a sense of community responsibility which removed any sense of social responsibility from business. This therefore necessitated its reinvention in the

form of corporate social responsibility, just as it necessitated the development of codes of corporate governance.

The Latin model of governance however is founded in the context of the family and the local community and is therefore the opposite of the Anglo-Saxon model, being based on a bottom-up philsophy rather than a hierarchical top-down approach. Thus this model is based on the fact that extended families are associated with all other family members and therefore feel obligated. In such a model of governance the sense of social responsibility remains strong and is applied to firms just as much as individuals. This sense of social responsibility has never therefore been really lost and consequently there has been no need for its reinvention. As we have seen[10] the Ottoman model is an Islamic model and built into the principles of the Ottoman religion are a sense of the conservation of the environment and the concept of helping rather than exploiting one's fellow human beings (Rizk, 2005; Zurcher and van der Linden, 2004). Thus in this model also there is no need for the concept of corporate social responsibility as it was never lost, indeed such behaviour is so entwined in societal norms that the very idea is alien. The African model is one built upon networks of relationships and rules are to a large extent irrelevant.

The Anglo-Saxon system of governance is of course the dominant model throughout the world and as a consequence the concern with corporate social responsibility has spread to other systems of governance. It would be reasonable therefore to argue that the concept now permeates all business models and all systems of governance, no matter what the antecedents or the necessity might be. Consequently we are able to address global perspectives on the issues of corporate governance and corporate social responsibility in this volume without fear of being regarded as Anglo-centric.

A Prognosis

This book has constituted a contribution towards the debate concerning the role of corporate governance and corporate social responsibility throughout the world and the perceived need to develop appropriate standards and practices. We have sought to show similarities and differences in practice and understanding throughout the world and also that cultural issues are an important element which is often omitted from any analysis. Nevertheless, the debate about such procedures continues and we consider that we need

10 See Chapter 1.

to complete the analysis undertaken in this book by offering some form of prognosis, albeit subject to criticism and challenge for many reasons. So we start by stating that many companies regard corporate governance as simply a part of investor relationships and do nothing more regarding such governance except to identify that it is important to investors/potential investors and to flag up that they have such governance policies. The more enlightened recognise that there is a clear link between governance and corporate social responsibility and make efforts to link the two. Often this is no more than making a claim that good governance is a part of their CSR policy as well as a part of their relationship with shareholders.

It is recognised – and amply demonstrated throughout the contributions from the various authors in this book – that these are issues which are significant in all parts of the world and a lot of attention is devoted to this global understanding. Most analysis however is too simplistic to be helpful as it normally resolves itself into a simple duality of rules-based versus principles-based. Our argument is that this is not helpful as the reality is far more complex. It cannot be understood without taking geographical, cultural and historical factors into account in order to understand the similarities, differences and concerns relating to people of different parts of the world. The aim of this book has been to redress this by asking subject experts from different parts of the world to explain the issues from their particular perspective. Our prognosis is that this debate will continue and mature and that vested interests will seek to develop codes and standards with universal application. This has not yet happened with financial reporting so will take time with governance and CSR. Moreover we argue that any such code or standard will only survive if it is designed to be sufficiently flexible to allow for the full extent of cultural variation throughout the world.

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