Corporate Governance and International Business

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1 Introduction to Corporate Governance

1.1 Introduction

The concept of governance is not a new one but nowadays we hear words as corporate governance, organizational governance or good governance frequently. Actually corporate governance or, as defined in ISO FDIS 26000, organizational governance is the system by which an organization makes and implements decisions in pursuit of its objectives. Simply put "governance" means: the process of decision-making and the process by which decisions are implemented (or not implemented). And according to ISO FDIS 26000, it is the most crucial factor in enabling an organization to take responsibility for the impacts of its decisions and activities and to integrate social responsibility throughout the organization and its relationships.

Communities and their environments are increasingly impacted by any kind of organization including small, medium, large-sized, domestic or multinational, private or governmental enterprises. Some people tend to relate the prominence and importance of social responsibility to issues raised by international organizations although social responsibility has ever been important for the world business long before the emergence of multinational companies. However in this book we are trying to focus on the effects related to international business.

1.2 Governance

The concept of 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 organisations[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 therefore used. The effect of this is that governance is decided according to power relationships, which tend to be coercive for the less powerful (eg 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 & 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 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.

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.

1.3 Corporate Governance

Corporate governance can be considered as an environment of trust, ethics, moral values and confidence – as a synergic effort of all the constituent parts – 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.

One of the main issues, therefore, which has been exercising the minds of business managers, accountants and auditors, investment manages and government officials – again all over the world – is that of corporate governance. 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 than 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[5]. 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 firm 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' decisions. Because of these reason companies can not 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 and Basel III) 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 have to pay attention to corporate governance rules also. 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 relation between corporate governance mechanisms and performance (eg Agrawal and Knoeber, 1996; Millstein and MacAvoy, 2003). Most of the 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 the 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.

1.4 Governance systems and corporate social responsibility

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 argue 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.

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.

1.5 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 of 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 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 book. 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 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.

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 utilising renewable resources, minimising pollution and using new techniques of manufacture and distribution. It also implies the acceptance of any costs involved in the present as an investment for the future.

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 wellbeing, 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.

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1.8 Self-test questions

1. What is meant by governance?
2. What is meant by corporate governance?
3. Which is the dominant model of governance?
4. What is the relationship between corporate governance and corporate social responsibility?
5. What has caused the current interest in corporate governance?

2 Development of codes of governance and international comparisons

2.1 Introduction

Every organization has its own decision-making processes and structures according to its structure and objectives which may range from formal and sophisticated ones subject to laws and regulations, to informal ones rooted in its organizational culture and values. The world has now realised the importance of harmonised codes of governance and considerable effort has been put into developing such codes. In this chapter we consider the various approaches.

2.2 Systems of governance

It is probably true to say that there is a considerable degree of convergence on a global scale as far as systems of governance are concerned, and this convergence is based on the dominance of the Anglo Saxon model[6] of the state, the market and of civil society. As a consequence there tends to be an unquestioning 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). It is important however to recognise that there are other models so in this chapter we state that there were historically 3 significant approaches to governance. Each has left its legacy in governance systems around the world. The Anglo Saxon model is important but just one of the 3 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.

2.2.1 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 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 inseperably intertwined

The abuses which have been revealed within this system of governance[7] 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 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 asymmetric. If the relationship is too asymmetric then the safeguards in a governance system do not operate satisfactorily whereas one of the features of globalisation is an increase in such power asymmetries.

The Anglo Saxon model is hierarchical but other forms of governance are allowed and even encouraged to operate within this framework. Thus the market form features prominently in the Anglo 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 the Anglo Saxon model; rather it is the dependence on rules and adjudication which distinguishes this system of governance.

2.2.2 The Latin model of governance

The Latin model[8] 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 Ango 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 in Chapter 1 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.

2.2.3 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 propaganda 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.

2.3 Developing a framework for corporate governance

The first report which set out a framework for corporate governance was the Cadbury Report which was published in 1992 in the UK. Since then there have been a succession of codes on corporate governance each making amendments from the previous version. 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 was revised in 2006 and became the UK Corporate Governance Code in 2010. 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.

2.4 Company management

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 makeup 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-executives 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 statutory regime like the Sarbanes-Oxley Act in the U.S., 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% of the FTSE 350 companies were fully compliant with all dimensions of the code while by 2003 more than 60% were fully compliant.

Now compliance is more or less 100%. 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. Clearly the code is not yet fully complete – hence the continued revisions – and has not succeeded in eliminating all of the problems. Indeed governance issues have been considered to be one source of the recent crisis.

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% 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 organizations. As a rule, compliance with these governance recommendations is not mandated by law, although the codes which are linked to stock exchange listing requirements[9] 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.

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2.7 Self-test questions

1. When did the UK Combined code come into effect
2. What is the requirement regarding compliance in the UK?
3. Explain the difference between the Anglo Saxon approach and the Latin approach.
4. What is the role of the Board of Directors?
5. Outline the main difference between the 3 forms of governance

3 The principles of corporate governance

3.1 Introduction

We have considered the need for governance for all organisations. In the last chapter we considered the various forms of governance and the codes which have been created. In this chapter we want to look in more detail into the principles – firstly of governance generally and then as applied to corporations.

3.2 The principles of governance

There are 8 principles which underpin every system of governance:

3.2.1 Transparency

Transparency, as a principle, 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 details and knowledge available to internal users of such information. Equally therefore the decisions which are taken and their enforcement must be 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.

Here is where another issue arises which is conflict of interests. So it should be noticed that transparency doesn't mean to reveal proprietary information, which belong and are owned only by the organisation. This is the right of a company to compete in a healthy environment so it can freely keep such information as confidential.

As a whole any kind of privileged information or that which would breach legal, commercial, security or personal privacy obligations should not be considered as requiring to be transparent. However, it is also important for citizens and civil society organisations to have public information available, so that they can ask questions, raise issues, and if needed challenge the information itself . Therefore an enterprise should reveal information related to such matters as its objectives, missions and visions, relationships and authorities, responsibilities, revenues, and its rules and standards.

3.2.2 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[10]. 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.[11]

It means that an enterprise should obey all the related rules and regulations already in force in the community. The scale of this community depends on the diversity and breadth of a company's activities. So it can be a district, a city, a region, a country or the world. Although very easy to say, this is actually a very disputable principle. Not all the regulations already devised and in force are necessarily conforming to the requirements of good governance. And abiding by such rules does not always mean to be socially responsible.

Such conflict can arise from the reluctance or inability of some countries to abide by the internationally agreed principles such as those of human rights, labor practice, etc.. This is due to nonconformities related to religion, culture, power concerns, and the like. So a powerful country claiming to govern the world resists adopting environmental agreements, and the other ever-developing avoids laws regarding child labour; whereas the other heralding the world to entail prescriptions for the world's prosperity oppresses its nation according to its religious laws not conforming the human rights. Therefore despite the emphasis of ISO 26000, it is not always easy to both comply with legal requirements and to be socially responsible.

3.2.3 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 (ie Parliament). Participation of course would involve everyone, or at least all adults both male and female.

3.2.4 Responsiveness

This is a corollary 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.

3.2.5 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.

3.2.6 Efficiency and Effectiveness

Efficiency of course implies the transaction cost minimisation 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.

3.2.7 Sustainability

This of course 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 definitions 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 & Crowther 2007a).[12]

Sustainability therefore implies that society must use no more of a resource than can be regenerated (Aras & 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. We will consider this principle in detail in chapter 5.

3.2.8 Accountability

Accountability is concerned with an organisation recognising 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 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 in that society 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.

According to ISO 26000, accountability is the state of being answerable for decisions and activities to the organization's governing bodies, legal authorities and, more broadly, its stakeholders. To make it more clear, to be accountable means to provide proof (e.g. reports) on what you are responsible for. Accountability explains that a company is not isolated from its environment and that it is a part of a wider societal network and has responsibilities to all of that network rather than just to the owners of the organisation.

A company has to be accountable both for the consequences of its activities and also for not repeating any negative activity. So it follows from the principle of transparency in that transparency needs to reveal relevant information to stakeholders and accountability is the means to reveal such information. There has not been a consensus generally on how to deal with this necessity. Is it always possible to rely on a company's self declaration? Or should there be third parties to scrutinize on behalf of all the stakeholders? The reluctance of some countries representing their national industries and companies to respect principles of social responsibility, including accountability, and the efforts to lobby against an international standard has impacted the strength of such a document to be implemented. This fact is observable in different parts of ISO 26000.

3.3 Good governance and corporate behaviour

Good governance is of course important in every sphere of society whether it be the corporate environment or general society or the political environment. Good governance 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 utilising renewable resources, minimising pollution and using new techniques 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 firms' route to becoming global and what will be necessary in order to get global competitive power. There is more than 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 UK Corporate Governance Code, which came into effect in 2010. Of course, as we have previously stated, 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. Although many companies regard corporate governance as simply a part of investor relationships, 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 v principles based or Anglo-Saxon v 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.

3.4 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:

- Transparency,
- Accountability,
- Responsibility,
- 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
- Enhanced company image
- Enhanced staff morale

3.5 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 relationship between corporate governance and competitiveness 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 good governance 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 a 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 and subsequently Basel III.

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.

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3.7 Further reading

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3.8 Self-test questions

1. What are the 4 principles of corporate governance?
2. What does the rule of law mean?
3. Explain transparency.
4. What is meant by stewardship?
5. Why will good governance mechanisms create competitive advantage?

4 Stakeholders & the social contract: a broader view of corporate governance

4.1 Introduction

It is becoming increasingly common to take a very wide view of what corporate governance is all about. In this chapter we consider it in the context of all stakeholders to the business. We show the evidence of this approach by firms and the limits of the approach.

4.2 The Social Contract

In 1762 Jean-Jacques Rousseau produced his book on the Social Contract which was designed to explain – and therefore legitimate – the relationship between an individual and society and its government. In it he argued that individuals voluntarily give up certain rights in order for the government of the state to be able to manage for the greater good of all citizens. This was the idea of the Social Contract which has been generally accepted.

More recently the Social Contract has gained a new prominence as it has been used to explain the relationship between a company and society. In this view the company (or other organisation) has obligations towards other parts of society in return for its place in society.

This can be depicted thus:

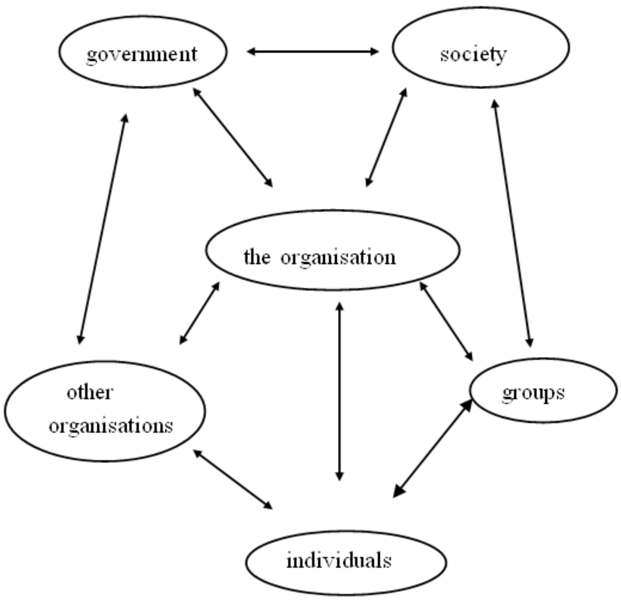

Fig 4.1 The Social Contract

This in turn led to the development of Stakeholder Theory, which we will consider in the next section.

4.3 What is a stakeholder?

There are several definitions. The most common ones are:

- Those groups without whose support the organization would cease to exist
- Any group or individual who can affect or is affected by the achievement of the organization's objectives

We can see from these definitions that a lot of people can be a stakeholder to an organisation. The most common groups who we consider to be stakeholders include:

- Managers
- Employees
- Customers
- Investors
- Shareholders
- Suppliers

Then there are some more generic groups who are often included:

- Government
- Society at large
- The local community

Many people consider that only people can be stakeholders to an organisation. Some people extend this and say that the environment can be affected by organisational activity. These effects of the organisation's activities can take many forms, such as:

- the utilisation of natural resources as a part of its production processes
- the effects of competition between itself and other organisations in the same market
- the enrichment of a local community through the creation of employment opportunities
- transformation of the landscape due to raw material extraction or waste product storage
- the distribution of wealth created within the firm to the owners of that firm (via dividends) and the workers of that firm (through wages) and the effect of this upon the welfare of individuals
- pollution caused by increased volumes of traffic and increased journey times because of those increased volumes of traffic

Thus many people also consider that there is an additional stakeholder to an organisation, namely:

- The environment

As we will see in the next chapter the actions of an organisation have a big effect upon future possibilities. It is for this reason that we also add one extra stakeholder:

- The future

It should be noted however that others do not generally include the future as a stakeholder.

4.4 Multiple stakeholdings

It is normal to consider all of these stakeholder groups separately. It should be noted however that each person will belong to several stakeholder groups at the same time. For example a single person might be a customer of an organisation and also an employee and a member of the local community and of society at large. He or she may also be a shareholder and a member of a local environmental association and therefore concerned about the environment. Most probably that person will also be concerned about the future also, on their own behalf or on behalf of their children.

We can therefore see that it is often not helpful to consider each stakeholder group in isolation and to separate their objectives. Reality is more complex.

4.5 The classification of stakeholders

There are two main ways to classify stakeholders:

Internal v external

Internal stakeholders are those included within the organisation such as employees or managers whereas external stakeholders are such groups as suppliers or customers who are not generally considered to be a part of the organisation. Although this classification is fine it becomes increasingly difficult in a modern organisation to distinguish the two types when employees might be subcontractors and suppliers might be another organisation within the same group.

Voluntary v involuntary

Voluntary stakeholders can choose whether or not to be a stakeholder to an organisation whereas involuntary stakeholders cannot. For example a supplier can choose to not deal with the organisation and therefore is a voluntary stakeholder. The local society or the environment are not able to make this choice and must therefore be considered to be involuntary stakeholders.

4.6 Stakeholder Theory

The argument for Stakeholder Theory is based upon the assertion that maximising wealth for shareholders fails to maximise wealth for society and all its members and that only a concern with managing all stakeholder interests achieves this.

Stakeholder theory states that all stakeholders must be considered in the decision making process of the organisation. The theory states that there are 3 reasons why this should happen:

It is the morally and ethically correct way to behaveDoing so actually also benefits the shareholders

- It reflects what actually happens in an organisation

As far as this third point is concerned then this is supported by research from Cooper at al (2001) into large firms. This research shows that the majority of firms are concerned with a range of stakeholders in their decision making process:

	Concerned with	**Very concerned with**
Stakeholder	%	%
Customers	89	57
Employees	89	51
Shareholders	100	78
Suppliers	70	3
The environment	62	5
Society	73	3

Fig 4.2 Stakeholder inclusion in decision making

According to this theory, stakeholder management, or corporate social responsibility, is not an end in itself but is simply seen as a means for improving economic performance. This assumption is often implicit although it is clearly stated by Atkinson, Waterhouse and Wells (1997) and is actually inconsistent with the ethical reasons for adopting stakeholder theory. Instead of stakeholder management improving economic, or financial, performance therefore it is argued that a broader aim of corporate social performance should be used (Jones and Wicks, 1999).

4.6.1 Details of Stakeholder Theory

A fundamental aspect of stakeholder theory, in any of its aspects, is that it attempts to identify numerous different factions within a society to whom an organisation may have some responsibility. It has been criticised for failing to identify these factions (Argenti, 1993) although some attempts have been made. Indeed Sternberg (1997) suggests that the second of Freeman's (1984) definitions of stakeholder, which is now the more commonly used, has increased the number of stakeholders to be considered by management adopting a stakeholder approach to; in fact this definition includes virtually everything whether alive or not.

However attempts have been made by stakeholder theorists to provide frameworks by which the relevant stakeholders of an organisation can be identified. Clarkson (1995) suggests that a stakeholder is relevant if they have invested something in the organisation and are therefore subject to some risk from that organisation's activities. He separated these into two groups: the voluntary stakeholders, who choose to deal with an organisation, and the involuntary stakeholders, who do not choose to enter into – nor can they withdraw from – a relationship with the organisation. Mitchell, Agle and Wood (1997) develop a framework for identifying and ranking stakeholders in terms of their power, legitimacy and urgency. If a stakeholder is powerful, legitimate and urgent then its needs will require immediate attention and given primacy.

Irrespective of which model is used, it is not controversial to suggest that there are some generic stakeholder groups that will be relevant to all organisations. Clarkson (1995) suggests that the voluntary stakeholders include shareholders, investors, employees, managers, customers and suppliers and they will require some value added, or otherwise they can withdraw their stake and choose not to invest in that organisation again. It is argued that involuntary stakeholders such as individuals, communities, ecological environments, or future generations do not choose to deal with the organisation and therefore may need some form of protection maybe through government legislation or regulation. Other more specific interest groups may be relevant for certain industries due to the nature of the industry or the specific activities of the organisation.

For example in the UK utility industries have been regulated by a regulator since privatisation and thus the regulator is a stakeholder of these organisations. Similarly certain industries are more environmentally, politically or socially sensitive than others and therefore attract more attention from these stakeholder groups, and again the water or nuclear industries provide examples here.

4.6.2 Informational needs

Stakeholder management has significant informational needs. It is extremely difficult to manage for a variety of stakeholders if there is no measurement of how the organisation has performed for those stakeholders. Thus for each stakeholder identified it is necessary to have a performance measure by which the stakeholder performance can be considered. Due to the nature of the stakeholders and their relationship with the organisation this will not necessarily be easy nor will it necessarily be possible in monetary terms.

Therefore non-financial measures will be of great importance but this information is often considered more subjective than financial information. Therefore measures of customer satisfaction are sometimes based on surveys and sometimes on statistical performance measures such as numbers of complaints or returns, or market share or customer retention. Recently there have been a number of multi-dimensional performance measurement frameworks that can be argued to have some level of stakeholder orientation.

Probably the best known of the multi-dimensional performance measurement frameworks is the "balanced scorecard" (Kaplan and Norton 1992, 1993, 1996a, 1996b). Another example is the service profit chain (Heskett et al. 1994) that specifically considers three stakeholders; namely employees, customers and shareholders. Again this model specifically considers the first two stakeholders as means to achieving superior financial results.

Thus they argue that satisfied and motivated employees are essential if service quality is to be of a high standard and hence customers are to be satisfied. Further it is then argued that satisfied customers provide the base for superior financial results. Both of these models acknowledge the needs of stakeholder groups and thus deem it necessary to measure performance for these groups but still target financial performance as the ultimate goal.

A stakeholder managed organisation therefore attempts to consider the diverse and conflicting interests of its stakeholders and balance these interests equitably. The motivations for organisations to use stakeholder management maybe in order to improve financial performance or social or ethical performance howsoever these may be measured. In order to be able to adequately manage stakeholder interests it is necessary to measure the organisation's performance for these stakeholders and this can prove complicated and time-consuming.

Recently the Centre for Business Performance, Cranfield University, has set up a "Catalogue of measures" related to their Performance Prism that contains measures of each of the "dimensions of performance" – stakeholder satisfaction; strategies; processes; capabilities; and stakeholder contributions. The stakeholders identified were customer, employee, investor, regulator & community, and suppliers and in total the catalogue includes over 200 relevant measures.

This shows the vast number of stakeholder measures that could be used to any organisation although it is not expected that all of these will be relevant for an individual organisation. This again highlights the potential complexity of measuring performance for stakeholders as these numerous measures will provide conflicting evidence on performance that somehow must be reconciled. In comparison Value Based Management techniques that propose the use of a single metric to measure performance as well as set objectives and reward executives appear far simpler.

4.6.3 Research findings

In its Global Investor Opinion Survey of over 200 institutional investors first undertaken in 2000 (and subsequently updated), McKinsey found that 80% 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 (and requests from other stakeholders) for information on governance issues. The size of the premium varied by market, from 11% for Canadian companies to around 40% for companies where the regulatory backdrop was least certain (eg 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.

4.7 Governance and stakeholders

A company's structure is nowadays more complex than before and there are other people, in addition to 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 that the next step will be to comply with other socially responsible policies.

This 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: 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: 264), which means to "attend" to social policies in a better way.

This double-side 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 have been for many years some companies whose objectives include philanthropic aims. We can cite examples of the Quaker companies – such as Cadburys[13] and Rowntrees – which emerged in the UK Industrial Revolution or the Spanish 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 conventional objective of profit maximisation. It may be considered that the initial values of the company are ones promoting concern, 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 such a company is improved, which provides a direct relationship with economic performance.

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 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.

4.8 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.

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 (Aras & Crowther 2009). 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 utilising renewable resources, minimising pollution and using new techniques of manufacture and distribution. It also implies the acceptance of any costs involved in the present as an investment for the future.

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 wellbeing, 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.

4.9 Relating social responsibility with governance: the evidence

There has been a variety of research over time investigating the relationship between the characteristics of a firm and its disclosure (eg Cowen et al 1987; Gray et al 2001) and equally there is research (eg Burke & Longsdon 1996) showing the benefits of CSR. It is clear that these benefits are also directly related to the sustainability of a firm and that firm's success. It would seem apparent therefore that there should be some attention paid to social responsibility within the corporate governance of a corporation. It is therefore apposite to conduct an investigation as to what exactly is mentioned about CSR within such corporate governance. It is to be expected that good corporate governance will foster social responsibility in general.

There has been much work undertaken which investigates the failures of corporate governance and the ensuing problems which arise and this could be adapted to a consideration of our concern with the relationship between corporate governance and social responsibility. We argue however that this approach is not an appropriate methodology for this kind of research. Rather our starting assumption is that effective corporate governance will be largely unnoticed and that this will be manifest in examples of good practice rather than in the exceptional instances of poor practice.

Although there is a clear link between good corporate governance and all aspects of a firm's performance, which will ultimately affect the sustainability of that firm's activity our research does not show that this is at all clearly understood by many firms. Furthermore, although the majority of firms consider that corporate social responsibility is important, they do not make any connection between this and corporate governance. They clearly do not understand the link between good governance, the management of all stakeholder relations, corporate social responsibility and the longer term economic performance of their company.

4.10 Conclusions

Stakeholder Theory is one approach to the managing of an organisation. It is particularly important for an understanding of CSR and its incorporation into organisational activity. There are various aspects to this which we have considered in this chapter. At the same time we have introduced a variety of other aspects which are related. Our purpose is to show that all of these concepts are inter-related in the management of an organisation and that CSR cannot be considered in isolation from the rest of organisational activity. We will see this more clearly throughout this book.

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4.13 Self-test Questions

1. What justification does Stakeholder Theory use for considering stakeholders?
2. How can we classify stakeholders?
3. Name a multi-dimensional performance measurement framework.
4. What are the origins of the Social Contract?
5. What evidence is there of a broader approach to corporate governance by firms?

5 Issues concerning Sustainability

5.1 Introduction

Of the major principles of governance and the one which is most prominent at the present time is sustainability. Consequently we are devoting a complete chapter to dealing with this topic. It is one that has recently become very important for businesses, and all large businesses – and many smaller ones – have a sustainability plan, or at least claim to have such a plan. We need therefore to start by establishing exactly what we mean by sustainability.

5.2 Defining sustainability

Sustainability is concerned with the effect which action taken in the present has upon the options available in the future. The starting point for every definition of sustainability comes from the Brundtland Report, which was published in 1987. This is actually a report named Our Common Future which was produced by the World Commission on Environment and Development. It is generally known however as the Brundtland Report after the commission chair.

Strictly speaking the Brundtland Report was concerned with sustainable development which they regarded as unquestionningly both possible and desirable. Their definition of sustainability starts from the premise that if resources are utilised in the present then they are no longer available for use in the future. This has led to the standard definition of sustainabile development which states that this is:

”Development which meets the needs of the present without compromising the ability of future generations to meet their own needs”

This principle has been incorporated in the Maastricht and Amsterdam Treaties on European Union, as well as in the Rio Declaration and Agenda 21, adopted by the United Nations Conference on Environment and Development (UNCED), meeting in Rio de Janeiro 3 to 14 June 1992. The European Community and its Member States subscribed to the Rio Declaration and Agenda 21 and committed themselves to the rapid implementation of the principal measures agreed at UNCED.

5.3 The Brundtland Report

This report is considered to be extremely important in addressing the issue of sustainability. The report described seven strategic imperatives for sustainable development:

- Reviving growth;
- Changing the quality of growth;
- Meeting essential needs for jobs, food, energy, water and sanitation;
- Ensuring a sustainable level of population;
- Conserving and enhancing the resource base;
- Reorienting technology and managing risk;
- Merging environment and economics in decision-making.

It also emphasized that the state of our technology and social organisation, particularly a lack of integrated social planning, limits the world’s ability to meet human needs now and in the future.

This report made institutional and legal recommendations for change in order to confront common global problems. More and more, there is a growing consensus that firms and governments in partnership should accept moral responsibility for social welfare and for promoting individuals’ interest in economic transactions (Amba-Rao, 1993).

Significantly however the Bruntland report made an assumption – which has been accepted ever since – that sustainable development was possible and the debate since has centred on how to achieve this. Thus ever since the Bruntland Report was produced by the World Commission on Environment and Development in 1987 there has been a continual debate concerning sustainable development. Similarly emphasis has been placed on such things as collaboration, partnerships and stakeholder involvement. It has however been generally accepted that development is desirable and that sustainable development is possible – with a concomitant focus on how to achieve this. Quite what is meant by such sustainable development has however been much less clear and a starting point for any evaluation must be to consider quite what is meant by these terms.

There is a considerable degree of confusion surrounding the concept of sustainability: for the purist sustainability implies nothing more than stasis – the ability to continue in an unchanged manner – but often it is taken to imply development in a sustainable manner (Marsden 2000; Hart & Milstein 2003) and the terms sustainability and sustainable development are for many viewed as synonymous. For us we take the definition as being concerned with stasis (Aras & Crowther 2008a); at the corporate level if development is possible without jeopardising that stasis then this is a bonus rather than a constituent part of that sustainability. Moreover, sustainable development is often misinterpreted as focusing solely on environmental issues. In reality, it is a much broader concept as sustainable development policies encompass three general policy areas: economic, environmental and social. In support of this, several United Nations texts, most recently the 2005 World Summit Outcome Document, refer to the ”interdependent and mutually reinforcing pillars” of sustainable development as economic development, social development, and environmental protection.

5.4 Critiquing Brundtland

For more than 20 years the starting point for any discussion of sustainable corporate activity has been the Brundtland Report. Its concern with the effect which action taken in the present has upon the options available in the future has directly led to glib assumptions that sustainable development is both desirable and possible and that corporation can demonstrate sustainability merely by continuing to exist into the future.

The problem with Brundtland is that its concern with the effect which action taken in the present has upon the options available in the future has directly led to easy assumptions that sustainable development is both desirable and possible and that corporation can demonstrate sustainability merely by continuing to exist into the future (Aras & Crowther 2008b). It has also led to an acceptance of what must be described as the myths of sustainability:

- Sustainability is synonymous with sustainable development;
- A sustainable company will exist merely by recognising environmental and social issues and incorporating them into its strategic planning.

Both are based upon an unquestioning acceptance of market economics predicated in the need for growth and are based upon the false premise of Brundtland to which we will return later. An almost unquestioned assumption is that growth remains possible and therefore sustainability and sustainable development are synonymous. Indeed the economic perspective considers that growth is not just possible but also desirable and therefore that the economics of development is all that needs to be addressed and that this can be dealt with through the market by the clear separation of the three basic economic goals of efficient allocation, equitable distribution, and sustainable scale.

Concomitantly all corporations are becoming concerned about their own sustainability and what the term really means. Such sustainability means more than environmental sustainability. As far as corporate sustainability is concerned then the confusion is exacerbated by the fact that the term sustainable has been used in the management literature over the last 30 years to merely imply continuity. Thus Zwetsloot (2003) is able to conflate corporate social responsibility with the techniques of continuous improvement and innovation to imply that sustainability is thereby ensured. Consequently the trajectory of all of these effects is increasingly being focused upon the same issue.

There have been various descendents of Brundtland, including the concept of the Triple Bottom Line. This in turn has led to an assumption that addressing the three aspects of economic, social and environmental is all that is necessary in order to ensure not just sustainability but to also enable sustainable development. And all corporations imply that they have recognised the problems, addressed the issues and thereby ensured sustainable development. Let us start with the Triple Bottom Line - 3 aspects of performance:

- Economic
- Social
- Environmental

It is our argument that these conceptions are not just incorrect but also positively misleading through an obfuscation of the key issues and have led to an inevitable outcome of false security. It is therefore time to re-examine the legacy of Bruntland and to redefine what is meant by sustainable activity.

5.5 Sustainability and the Cost of Capital

It is recognised in the financial world that the cost of capital which any company incurs is related to the perceived risk associated with investing in that company – in other words there is a direct correlation between the risk involved in an investment and the rewards which are expected to accrue from a successful investment. Therefore it is generally recognised that the larger, more established companies are more certain investments and therefore have a lower cost of capital. This is all established fact as far as finance theory is concerned and is recognised in the operating of the financial markets around the world. Naturally a company which is sustainable will be less risky than one which is not. Consequently most large companies in their reporting mention sustainability and frequently it features prominently. Indeed it is noticeable that extractive industries – which by their very nature cannot be sustainable in the long term – make sustainability a very prominent issue. The prime example of this can be seen with oil companies – BP being a very good example – which make much of sustainability and are busy redesignating themselves from oil companies to energy companies with a feature being made of renewable energy, even though this is a very small[14] part of their actual operations.

All businesses[15] recognise the business benefits of CSR activity in their reporting. Equally all business recognise that sustainability is important and it features prominently in their reporting. For example an investigation of the FTSE100 companies (see Aras & Crowther 2007a) reveals the following:

Mention on corporate website	*% of companies*
Sustainability	100
Sustainable development	35
Express link sustainability to CSR policy	70

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 discussed in this chapter, 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. Our argument is not just that this focus upon such a vague notion of sustainability is misleading and obfuscates the need for a rigorous debate about the meaning of sustainability. Our argument is that this treatment of sustainability is actually disingenuous and disguises the very real advantages that corporations obtain by creating such a semiotic of sustainability.

5.6 Redefining sustainability

It is therefore time to re-examine the legacy of Bruntland and to redefine what is meant by sustainable activity.

These are the components of sustainability:

- 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;
- Environmental Impact, which we define as the effect of the actions of the corporation upon its geophysical environment;
- Organisational culture, which we define as the relationship between the corporation and its internal stakeholders, particularly employees, and all aspects of that relationship; and

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

These are all necessary in order to ensure not just sustainability but to also enable sustainable development. Moreover it is the balance between them which is crucial.

These four must be considered as the key dimensions of sustainability, all of which are equally important. This analysis is therefore considerably broader – and more complete – than that of others. Furthermore Aras & Crowther (2007b, 2007c) consider that these four aspects can be resolved into a two-dimensional matrix along the polarities of internal v external focus and short term v long term focus, which together represent a complete representation of organisational performance. This can be represented as the model below:

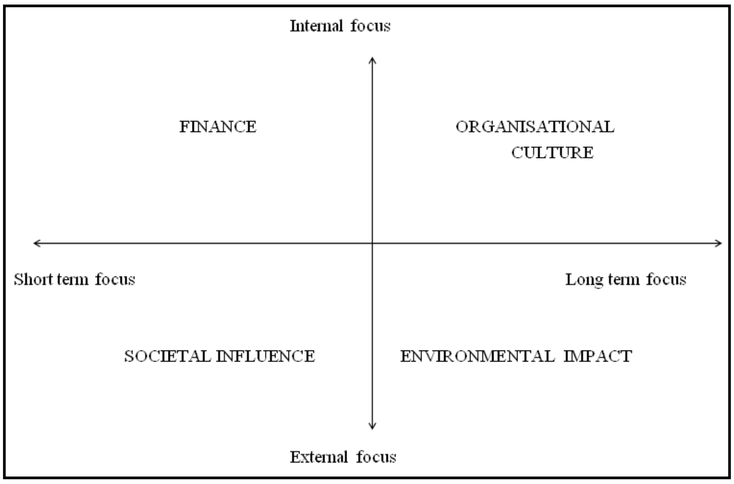

Fig 5.1 Model of Corporate Sustainability (Aras & Crowther 2007b)

These can be described differently:

- Maintaining economic activity, which must be the central raison d'etre of corporate activity and the principle reason for organising corporate activity. This of course maps onto the finance aspect.
- Conservation of the environment, which is essential for maintaining the options available to future generations. This maps onto the environmental impact aspect.
- Ensuring social justice, which will include such activities as the elimination of poverty, the ensuring of human rights, the promotion of universal education and the facilitation of world peace. This maps onto the societal influence aspect.
- Developing spiritual and cultural values, which is where corporate and societal values align in the individual and where all of the other elements are promoted or negated; sadly at present they are mostly negated

5.7 Distributable sustainability

At this point we deliberately use the term distributable sustainability in order to reflect one of the key components of this argument. This is that true sustainability depends not just upon how actions affect choices in the future but also upon how the effects of those actions – both positive and negative – are distributed among the stakeholders involved. A central tenet of our argument is that corporate activity, to be sustainable, must not simply utilise resources to give benefit to owners but must recognise all effects upon all stakeholders and distribute these in a manner which is acceptable to all of these – both in the present and in the future. This is in effect a radical reinterpretation of corporate activity.

It is necessary to consider the operationalisation of this view of sustainability. Our argument has been that sustainability must involve greater efficiency in the use of resources and greater equity in the distribution of the effects of corporate activity. To be operationalised then of course the effects must be measurable and the combination must of course be manageable.

This can be depicted as a model of sustainability.

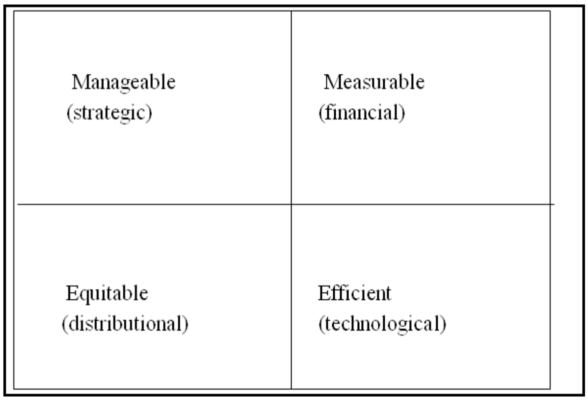

Fig 5.2 Distributable sustainability (Aras & Crowther 2009)

This acts as a form of balanced scorecard to provide a form of evaluation for the operation of sustainability within an organisation. It concentrates upon the 4 key aspects, namely:

- Strategy
- Finance
- Distribution
- Technological development

Moreover it recognises that it is the balance between these factors which is the most significant aspect of sustainability. From this a plan of action is possible for an organisation which will recognise priorities and provide a basis for performance evaluation.

5.8 Summarising Sustainability

To summarise, sustainability requires a radical rethink and a move aware from the cosy security of the Brundtland definition. Aras & Crowther (2009) therefore reject the accepted terms of sustainability and sustainable development, preferring instead to use the term durability to emphasise the change in focus.

The essential features of durability can be described as follows:

- Efficiency is concerned with the best use of scarce resources. This requires a redefinition of inputs to the transformational process and a focus upon environmental resources as the scarce resource.
- Efficiency is concerned with optimising the use of the scarce resources (ie environmental resources) rather than with cost reduction.
- Value is added through technology and innovation rather than through expropriation;
- Outputs are redefined to include distributional effects to all stakeholders

5.9 ISO 26000

In 2010 the new standard ISO 26000 was introduced. This standard is concerned with social responsibility and sustainability and offers guidance on socially responsible behavior and possible actions; it does not contain requirements and, therefore, in contrast to ISO management system standards, is not certifiable. Although this standard by its current concept is just a collection of previously existed and globally agreed codes and principles, however there is a hope for its progressive movement to more specific requirements and procedures for implementation internationally. In this document it is emphasised that effective governance should be based on incorporating the principles of social responsibility where these principles are accountability, transparency, ethical behaviour, respect for stakeholder interests, respect for the rule of law, respect for international norms of behaviour and respect for human rights into decision making and implementation.

This document is quite different to the previously existing and well known codes of governance known as the Anglo-Saxon model of governance. We have already explained the latter and other codes of governance in previous chapters. Actually the Anglo-Saxon model which has 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, has caused the loss of a sense of community responsibility which removed any sense of social responsibility from business. According to a socially responsible code of governance, all organizations should put in place processes, systems, structures, or other mechanisms that make it possible to apply the principles and practices of social responsibility.

According to ISO FDIS 26000, an organization's decision-making processes and structures should enable it to:

- Develop strategies, objectives, and targets that reflect its commitment to social responsibility;
- Demonstrate leadership commitment and accountability;
- Create and nurture an environment and culture in which the principles of social responsibility are practised;
- Create a system of economic and non-economic incentives related to performance on social responsibility;
- Use financial, natural and human resources efficiently;
- Promote a fair opportunity for underrepresented groups (including women and racial and ethnic groups) to occupy senior positions in the organization;
- Balance the needs of the organization and its stakeholders, including immediate needs and those of future generations;
- Establish two-way communication processes with its stakeholders, identifying areas of agreement and disagreement and negotiating to resolve possible conflicts;
- Encourage effective participation of all levels of employees in the organization's social responsibility activities;
- Balance the level of authority, responsibility and capacity of people who make decisions on behalf of the organization;
- Keep track of the implementation of decisions to ensure that these decisions are followed in a socially responsible way and to determine accountability for the results of the organization's decisions and activities, either positive or negative; and
- Periodically review and evaluate the governance processes of the organization. Adjust processes according to the outcome of the reviews and communicate changes throughout the organization.

5.10 Conclusions

The two key components of sustainability and sustainable development therefore are efficiency and equity. But efficiency needs to be redefined to prioritise the efficient use of environmental resources rather than the efficient use of financial resources. And equity requires as a minimum the satisficing of all stakeholders, and not merely the provision of returns to owners and investors. These are the prerequisites for sustainable development.

Recycling is of course an integral part of the discourse of sustainability as far as environmental issues are concerned. The concept of recycling applies equally to corporate sustainability in terms of the recycling relationship with each stakeholder. By this we mean that a sustainable corporation needs to invest in all of its stakeholders in order to maintain and improve relationships between the company and its stakeholders but that the investment in stakeholder relations is returned to the company through being recycled. So a stakeholder who is well treated both receives benefit from the company and returns benefit to that company. For example employees will work better when they receive better conditions; similarly suppliers will reciprocate the receipt of good conditions while customers will pay a premium for quality. This can be considered to be renewable performance.

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5.13 Self-test Questions

1. What does the Triple Bottom Line consist of?
2. What are the 4 factors of sustainability?
3. What are the factors of distributable sustainability?
4. What is Brundtland and why is it important?
5. What is ISO 26000 about and how does it differ from other standards?

6 Ethics, corporate governance and corporate behavior

6.1 Introduction

Ethics is not new for people in business. The corporate world has always had some rules, standards and norms for doing business. However these are generally changing with some social and cultural basis which can be different country by country, even though we might expect universal rules. When the company applies these standards or norms as a part of its responsibility we can call them an ethical code of conduct of business. Moreover ethics is also inevitably a part of business responsibility. Corporate behaviour should be ethical and responsible; that is why corporate promises for their shareholders and stakeholders have to behave fair, ethical and equitable. And of course ethics is inevitably related to governance

6.2 Defining ethics

Ethics shows a corporation how to behave properly in all its business and operations. However, business ethics is characterised by conflicts of interests. Businesses attempt to maximize profits as a primary goal on one hand while they face issues of social responsibility and social service on the other. Ethics is the set of rules prescribing what is good or evil, or what is right or wrong for people. In other words, ethics is the values that form the basis of human relations, and the quality and essence of being morally good or evil, or right or wrong. Business Ethics means honesty, confidence, respect and fair acting in all circumstances. However, such values as honesty, respect and confidence are rather general concepts without definite boundaries. Ethics can also be defined as overall fundamental principles and practices for improving the level of wellbeing of humanity.

Ethics is the natural and structural process of acting in line with moral judgments, standards and rules. Being a concrete and subjective concept, "business ethics" can be discussed with differing approaches and in varying degrees of importance in different fields. Indeed, it is highly difficult to define ethics and identify its limits and criteria. Accordingly, there are difficulties in discussing this concept in literature as it is ubiquitous in business life, at the business level, and in human life. According to what, how, how much and for whom ethics is or should be are important questions. It is not always easy to find answers to these questions (Aras & Crowther 2008a).

A business which does not respect ethical criteria and fails to improve them will disrupt its integrity and unity, i.e., its capacity to achieve its goal, and will lead to internal or external conflicts. Business ethics is the honest, respectful and fair conduct by a business and its representatives in all of its relations. A predicate question to the role of ethics in business is the question of why businesses engage in ethical practices. Some authors, notably Milton Friedman (1962), would strongly deny that a business has a responsibility to any group but the firm's shareholders.

To initiate corporate giving, for example, would be a fiduciary breach of management in Friedman's opinion: an agent for a principal is neither legally nor morally permitted to give away or "waste" the principal's capital (Joyner & Payne, 2002). Milton Friedman also argued that 'there is only one social responsibility of business – use its resources and engage in activities designed to increase its profits so long as it ... engages in open and free competition without deception and fraud' (Friedman, 1962).

However, ethical behaviour and ethical business has effects not only on stakeholders, and shareholders but also on the entire economy. We believe that when we act ethically in business decision-making process this will ensure more effective and productive utilization of economic resources.

6.3 Ethical philosophies

One component of the change to a concern with social responsibility and accountability has been the recognition (or reinstatement) of the importance of ethics in organisational activity and behaviour. In part this can be considered to be a recognition of the changing societal environment of the present time and in part a recognition of the problems brought about through corporate activity taken without any account of ethical implications. Among such activity can be seen the many examples of pollution (for example Union Carbide at Bhopal. India or the Exxon Valdiz oil spill or BP in the Mexican Gulf) and greed such as the Enron incident. These have caused a rethinking of the role of ethics in organisation theory.

Ethics is however a problematical area as there is no absolute agreement as to what constitutes ethical (or unethical) behaviour. For each of us there is a need to consider our own ethical position as a starting point because that will affect our own view of ethical behaviour. The opposition provided by deontological ethics and teleological ethics (regarding the link between actions and outcomes) (see below), and by ethical relativism and ethical objectivism (regarding the universality of a given set of ethical principles) represent key areas of debate and contention in the philosophy of ethics. This provides a starting point for our consideration of ethics.

6.3.1 Deontological Ethics

According to deontologists certain actions are right or wrong in themselves and so there are absolute ethical standards which need to be upheld. The problems with this position are concerned with how we know which acts are wrong and how we distinguish between a wrong act and an omission. Philosophers such as Nagel argue that there is an underlying notion of right which constrains our actions, although this might be overridden in certain circumstances. Thus, there may be an absolute moral constraint against killing someone, which in time of war can be overridden.

6.3.2 Teleological Ethics

Teleological theory distinguishes between 'the right' and 'the good', with 'the right' encompassing those actions which maximise 'the good'. Thus it is outcomes which determine what is right, rather than the inputs (*i.e.* our actions), in terms of ethical standards. This is the viewpoint which is promoted by Rawls in his 'A Theory of Justice'. Under this perspective, one's duty is to promote certain ends, and the principles of right and wrong organise and direct our efforts towards these ends.

6.3.3 Utilitarianism

Utilitarianism is based upon the premise that outcomes are all that matter in determining what is good and that the way in which a society achieves its ultimate good is through each person pursuing his / her own self interest. The philosophy states that the aggregation of all these self interests will automatically lead to the maximum good for society at large. Some Utilitarians have amended this theory to suggest that there is a role for government in mediating between these individual actions to allow for the fact that some needs can best be met communally.

6.3.4 Ethical Relativism

Relativism is the denial that there are certain universal truths. Thus, ethical relativism posits that there are no universally valid moral principles. Ethical relativism may be further subdivided into: 'conventionalism', which argues that a given set of ethics or moral principles are only valid within a given culture at a particular time; and 'subjectivism', that sees individual choice as the key determinant of the validity of moral principles.

According to the 'conventional' ethical relativism it is the mores and standards of a society which define what is moral behaviour and ethical standards are set, not absolutely, but according to the dictates of a given society at a given time. Thus if we conform to the standards of our society then we are behaving ethically. We can see however that ethical standards change over time within one society and vary from one society to another; thus the attitudes and practices of the 19th century are different to our own as are the standards of other countries.

A further problem with this view of ethics is that of how we decide upon the societal ethics which we seek to conform to. Thus there are the standards of society at large, the standards of our chosen profession and the standards of the peer group to which we belong. For example, the standards of society at large tend to be enshrined within the laws of that society. But how many of us rigorously abide by the speed limits and traffic laws of our country?

Different grouping within society tend to have different moral standards of acceptable behaviour and we have a tendency to behave differently at different times and when we are with different groups of people. Equally when we travel to a foreign country we tend to take with us the ethical standards of our own country rather than changing to the different standards of the country which we are visiting. Thus it becomes very difficult to hold to a position of ethical relativism because of the difficulty of determining the grouping to which we are seeking to conform.

6.3.5 Ethical Objectivism

This philosophical position is in direct opposition to ethical relativism; it asserts that although moral principles may differ between cultures, some moral principles have universal validity whether or not they are universally recognised. There are two key variants of ethical objectivism: 'strong' and 'weak'. Strong ethical objectivism or 'absolutism' argues that there is one true moral system. Weak ethical objectivism holds that there is a 'core morality' of universally valid moral principles, but also accepts an indeterminate area where relativism is accepted.

6.3.6 Concluding remarks

We can see that each of these theories of ethics is problematical and that there is no overarching principle which determines either what is ethical or what is not. Nevertheless a concern with ethics has been introduced explicitly into organisation theory and strategy in recent years. This has led to an increased interest in Corporate Social Responsibility.

6.4 Corruption

One issue which is of concern in the Western world is the question of corruption. This has been exhibited at a governmental level for many years and Transparency International produce an annual list to show how corrupt various countries are. In the 2010 list Demark is the least corrupt country while failed states such as Somalia and Afghanistan are at the bottom. From a corporate point of view however the problem is that in certain countries it is necessary to offer payments in order to do business and the debate is concerned with the extent to which it is ethical to do so. We do not offer an answer to this question – there is no definitive answer. Instead we simply point out that under certain governance codes and certain ethical philosophies it is reasonable but under others it is not. The salient point however is that Western values do not easily translate to every other part of the world.

6.4.1 ISO 26000

One of the most certain definitions found in ISO 26000 is that declared the importance of ethical behaviour. This standard has defined ethical behaviour as: behaviour that is in accordance with accepted principles of right or good conduct in the context of a particular situation and is consistent with **international norms of behaviour.**

International norms of behaviour, although already agreed to, are always condemned by some countries. These are the countries with similar interests who show their unwillingness to abide by ethical behaviour when it is time to vote on a related standard, or when the world celebrates a Nobel peace prize winner from China.

We must remember however that international standards are a problematic concept as there are very few universally agreed upon standards and it is very easy therefore to assume that Western norms have international agreement.

6.5 Culture

Culture can be defined as a set of shared attitudes, values and beliefs which are based to a large extent upon common backgrounds and experiences. They determine such things as our understanding of appropriate behaviour and reacting to circumstances. Similarities in culture lead towards similar behavioural patterns whereas differences in culture lead to differences – and these differences are a source of misunderstanding. This cultural component of corporate behaviour sets the tone of governance systems in a way which is very complex and is based in part upon the different systems described earlier. We consider that cultural differences are normally excluded from any analysis of governance but these differences mean that any universal code is applied so differently in different cultures as to render the code almost meaningless. In other words we maintain that culture is the most important determinant of the operation of any system of governance.

6.6 The Gaia Theory

While theorists of organisations were developing the notion of greater accountability to stakeholders during the 1970s, other developments were also taking place in parallel. Thus in 1979 Lovelock produced his Gaia Hypothesis in which he proposed a different model of the planet Earth; in his model the whole of the ecosphere, and all living matter therein, was co-dependant upon its various facets and formed a complete system.

According to this hypothesis, this complete system, and all components of the system, were interdependent and equally necessary for maintaining the Earth as a planet capable of sustaining life. This Gaia hypothesis was a radical departure from classical liberal theory which maintained that each entity was independent and could therefore concentrate upon seeking satisfaction for its own wants, without regard to other entities. This classical liberal view of the world forms the basis of economic organisation, provides a justification for the existence of firms as organs of economic activity and provides the rationale behind the model of accounting adopted by society. The Gaia hypothesis however implied that interdependence, and a consequent recognition of the effect of ones actions upon others, was a facet of life. This consequently necessitates a different interpretation of accountability in terms of individual and organisational behaviour.

Given the constitution of economic activity into profit seeking firms, each acting in isolation and concerned solely with profit maximisation, justified according to classical liberalism, it is perhaps inevitable that organisation theory developed as organisation-centric, seeking merely to manage the activities of the firm insofar as they affected the firm. Any actions of the firm which had consequences external to the firm were held not to be the concern of the firm.

Indeed enshrined within classical liberalism, alongside the sanctity of the individual to pursue his own course of action, was the notion that the operation of the free market mechanism would mediate between these individuals to allow for an equilibrium based upon the interaction of these freely acting individuals and that this equilibrium was an inevitable consequence of this interaction. As a consequence any concern by the firm with the effect of its actions upon externalities was irrelevant and not therefore a proper concern for its managers.

The Gaia hypothesis stated that organisms were interdependent[16] and that it was necessary to recognise that the actions of one organism affected other organisms and hence inevitably affected itself in ways which were not necessarily directly related. Thus the actions of an organism upon its environment and upon externalities was a matter of consequence for every organism. This is true for humans as much as for any other living matter upon the planet. It is possible to extend this analogy to a consideration of the organisation of economic activity taking place in modern society and to consider the implications for the organisation of that activity. As far as profit seeking organisations are concerned therefore, the logical conclusion from this is that the effect of the organisation's activities upon externalities is a matter of concern to the organisation, and hence a proper subject for the management of organisational activity.

While it is not realistic to claim that the development of the Gaia Theory has had a significant impact upon organisational behaviour, it seems perhaps overly coincidental to suggest that a social concern among business managers developed at the same time that this theory was propounded. It is perhaps that both are symptomatic of other factors which caused a re-examination of the structures and organisation of society. Nevertheless organisational theory has, from the 1970s, become more concerned with all the stakeholders of an organisation, whether or not such stakeholders have any legal status with respect to that organisation.

6.7 Corporate Behaviour

Corporate behaviour is important for company success both financially and concerning the relationship between corporate and business interests (stakeholders). We cannot define corporate behaviour without an ethical and CSR base in order to refer to that behavioural aspect. Corporate behaviour involves legal rules, ethical codes of conduct and social responsibility principles (figure1). In other words corporate behaviour is based on all of these components and involves law, ethics and CSR. It is important to recognize also that this behaviour must be ethical but must also be seen to be ethical – perceptions are very important.

Corporate behaviour has effects not only on stakeholders and shareholders but also on the entire economy. When a corporation acts ethically and socially responsibly in its business decisions and strategic planning then that corporation will be more sustainable. As we have seen socially responsible corporate behaviour is increasingly seen as essential to the long term survival of companies.

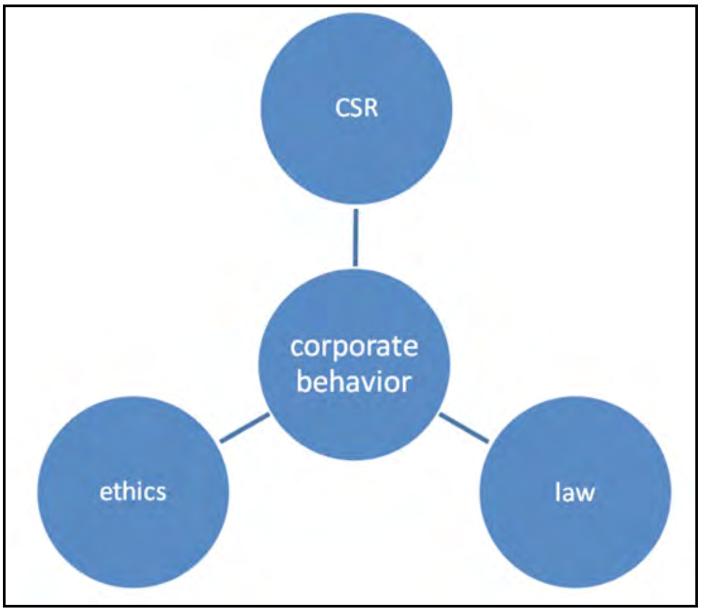

Figure 6.1 The components of Corporate behaviour

6.8 Governance, Ethics and Corporate Behaviour

At this broader level governance and CSR are very interconnected. Carroll (1979: 500) describes CSR in these terms: "the social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time". After his definition, in 2002 Whetten et al. defined CSR as "societal expectations of corporate behavior; a behavior that is alleged by a stakeholder to be expected by society or morally required and is therefore justifiably demanded of a business" (p. 374). Following from the first definition, the CSR definition expanded and covered more corporate behaviour and stakeholder expectation. On the other hand some broad terms – especially society – have been narrowed to stakeholders.

Corporate behaviour toward the stakeholders is becoming a much more important concept in practice and a central part of corporate governance. Corporate behaviour is an important concept because it has to be ethical, legal, and responsible behaviour for organizations, stakeholders and society. This aspect of the corporate behaviour has more benefit for society also and so that is why it is more related with ethics and CSR as well as with governance. We have of course referred to stakeholders in other chapters and this is an increasingly important aspect of governance.

To be a socially responsible corporation, a company must be more than a legal and ethical person also. CSR is not always a legal necessity; increasingly it is an obligation. However a company has to be socially responsible even though it is not a legal obligation (Aras & Crowther 2008b) – which is one of the most important characteristics of CSR. These provide the platform upon which social responsibility is built.

6.9 Corporate Reputation

One concept which is of growing importance for business management is that of corporate reputation. The beginning of the twenty-first century creates a new challenge for corporations – realising the potential of their corporate brands. In today's markets organisations focus on intangible factors in order to compete and differentiate their services/products in an environment, which is characterised by rapid changes. The reputation of the corporation is often the most important factor in gaining a competitive advantage as well as building financial and social success.

Corporations are realising that possessing a well-known name such as Johnson & Johnson, can help them secure a good position in the marketplace. Businesses are not only faced with sophisticated and informed stakeholders but also by rigorous regulation and evolving standards as well as by independent associations and agencies that act as watchdogs guarding the interests of their publics.

There are many benefits claimed for being perceived as having a good corporate reputation. One of the main is concerned with the fact that it improves shareholder value; a strong corporate reputation inspires confidence in investors, which in turn leads to a higher stock price for a company. It brings increased customer loyalty to the products of the company. A positive customer perception of a company extends to its products. Equally a strong corporate reputation is an influential factor for forming partnerships and strategic alliances as the partner company has the potential to improve its own reputation by association. Similarly a company with a solid reputation is more influential on legislative and regulatory governmental decision-making.

Employee morale and commitment are higher at corporations with a good corporate reputation. At a time of a crisis a good corporate reputation can shield the company from criticism and even blame, and can help it communicate its own point of view more easily to audiences that are willing to listen to its point of view. A good example is the Pepsi Cola tampering case according to which products on sale were found to contain material injected by hypodermic syringes. Pepsi dealt effectively with the crisis by defusing public alarm with a public relations campaign that highlighted the integrity of its manufacturing process and its corporate credibility.

6.10 Conclusion

Ethical behaviour and ethical business has effects not only for stakeholders, and shareholders but also on the entire economy. We believe that when acting ethically in the business decision-making process then this will ensure more effective and productive utilisation of economic resources. Corporate behaviour affects responsible and proper economic and institutional improvement. It will be also an influence on all society and a common benefit. Thus corporate governance can be seen to have an effect outside of the corporation itself as it affects society at large and the relationship between the corporation and society, and therefore all stakeholders.

Additionally we can make the following points:

- Organizations affect the external environment - businesses and the wider global environment
- The Gaia hypothesis shows that the whole ecosphere forms a complete system, unlike classical liberal theory which postulates the independence of each entity
- From 1970 there have developed theories and regulations to include all stakeholders inside and outside the organisation

- Corporate reputation is an increasingly important factor for organisations
- Ethics has been reinstated as a standard for organisational activity
- Corporate governance as a subject indicates an increasing concern with social and environmental effects of organisational behaviour and not merely financial performance.

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6.13 Self-test Questions

1. What are the responsibilities of business in their corporate decisions?
2. Why does a company have to be ethical?
3. What is the relationship between CSR and corporate behaviour?
4. Is corporate governance a legal necessity? Why?
5. Why is corruption a problem for corporations?

7 Risk Management and Corporate Governance

7.1 Introduction

It is being recognised everywhere that good governance is important for corporate performance. Indeed firms are being expected to make statements about their governance as part of their annual reporting and every corporate website makes a statement about the company's governance procedures. It is easy to claim that this is because of a reaction to all the corporate scandals which we have witnessed in the last decade, starting with the collapse of Enron.

The relationship is direct and the evidence is overwhelming. The evidence is so great that it is clear that investors are increasingly willing to pay a premium to invest in a company with good procedures for its governance. This is because they recognise that this will lead to expected improvements in sustainable performance which will, over time, be reflected in future dividend streams. In other words it is more profitable for an investor to invest in a well governed company and the benefits accrue both in the short term and in the long term.

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 organization of corporations. This is concerned with the harmonisation procedures and structures which will manifest themselves through the emergence of global norms for corporate governance. One factor which is significantly affected by such governance is that of risk assessment and management. Good governance reduces and facilitates the management of risk.

7.2 Attitudes to risk

Risk management has become an important aspect of business management and governance has a role to play in this because a full understanding of corporate governance and its implications can reduce risk. In terms of their attitude to risk, people can be classified into three types:

7.2.1 Risk seeking

A risk seeker is a person who will value the opportunity of a positive outcome more highly than the risk of a negative outcome. When faced with two equal possibilities of a profit or a loss arising from a particular decision, a risk seeking person will choose to proceed because of the possibility of profit.

7.2.2 Risk averse

A risk averter would value the possibility of a negative outcome more highly than the opportunity of a positive and in the same situation would choose not to proceed because of the possibility of a loss.

7.2.3 Risk neutral

A risk neutral person would value both outcomes equally and would be indifferent about whether to proceed or not in this situation.

Different people have different attitudes to risk and this influences their decision making and how they value possible outcomes. Research has shown however that for important business decisions, such as capital expenditure appraisal, managers tend to be risk averse in their decision making. They therefore tend to choose decisions which might have lower expected values than other decisions but which have less risk associated with them.

Managers of a business have responsibilities to the owners of that business (ie the shareholders) and one of these responsibilities is to act as stewards of that business and to maintain the value of the business and its future viability. It might be thought that this duty will tend to lead managers towards less risky decisions, because they are making them on behalf of the owners of the business, than they would perhaps make on their own behalf. In actual fact the evidence tends to show the opposite – that they are more inclined to take risks because it is not their own money which is being risked.

7.3 Managing risk

In dealing with risk there are three steps to be considered:

- Risk assessment
- Risk analysis
- Risk management

These can be considered as separate steps in the treatment of risk. The meaning of each steps is as follows:

7.3.1 Risk assessment

This is concerned with the identification of risks which might occur and an identification of which particular risks might occur in the situation with which we are concerned. Once these risks have been identified then it is possible to plan strategies to manage those risks and also to undertake analysis of the possible effects of the risk.

7.3.2 Risk analysis

This is the statistical quantification of the effects of the risks identified through risk assessment. The technique is based upon the probabilistic treatment of risk through the quantification of the effect of any particular risk and its consideration in terms of a probability distribution.

7.3.3 Risk management

This is concerned with the development of strategies for dealing with risk. The development of these strategies is dependant upon the assessment of the types of risk to which the situation is susceptible and the quantification of the possible effects through analysis.

The steps in the treatment of risk can be modelled as follows:

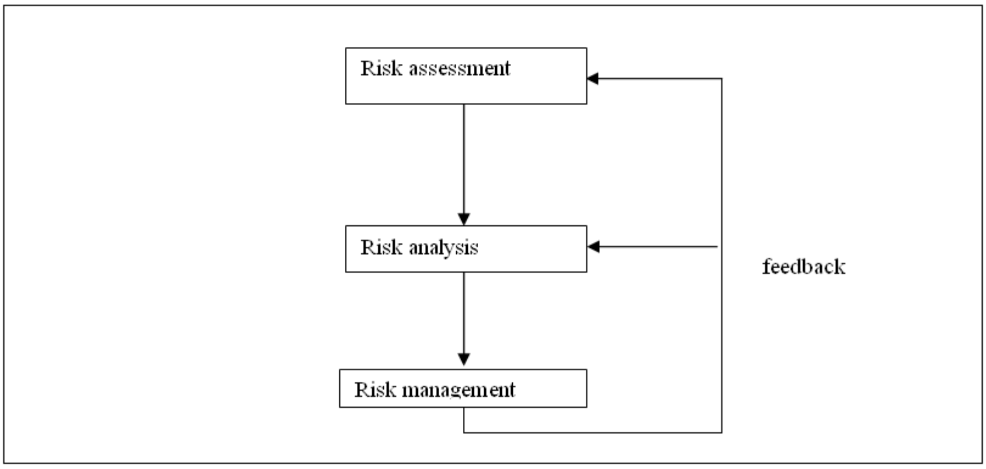

Fig 7.1 Steps in the treatment of Risk

7.4 Risk Management Strategies

From this diagram it can clearly be seen that feedback and reiteration is a constant part of the risk management process. This is necessary in order to continually reassess the effectiveness of the risk management strategies adopted. Possible strategies are:

7.4.1 Risk avoidance

Avoidance would involve not becoming involved in the situation in the first place. For example a building project in an unstable country might be considered so risky that the company would not tender for the project in the first place.

7.4.2 Risk reduction

This would involve taking steps to reduce the probabilities of certain unfavourable events happening in the assessment. For example for a building contract in an unstable country it might involve going into partnership with a firm from that country.

7.4.3 Risk protection

Protection would involve taking steps to limit the risk so in this example it might involve setting up security procedures to prevent sabotage to the building works.

7.4.4 Risk managing

This would involve contingency planning to cope with both foreseen and unforeseen situations arising during the course of the contract.

7.4.5 Risk transfer

One strategy for containing risk is to transfer that risk onto another party. Possible ways of doing this include taking out insurance or sub-contracting and passing on the risk in this manner.

In all cases of strategy development the selection of an appropriate strategy depends upon a realistic assessment of the risk and a quantification of possible effects through analysis. It is to risk analysis therefore that we now turn.

7.5 Risk probability profiles

When a range of possible outcomes for an event exist then obviously the sum of the probabilities for all of the possible outcomes must equal 1 – as one of the outcomes must occur. The assignment of probabilities to each of the outcomes however enables us to construct a probability distribution showing the range of possible outcomes and their respective probabilities. Such a distribution may well be important to the analysis because merely selecting the most likely outcome might not reflect the level of risk involved.

For example, in two projects the best estimate of profitability for each of the projects is

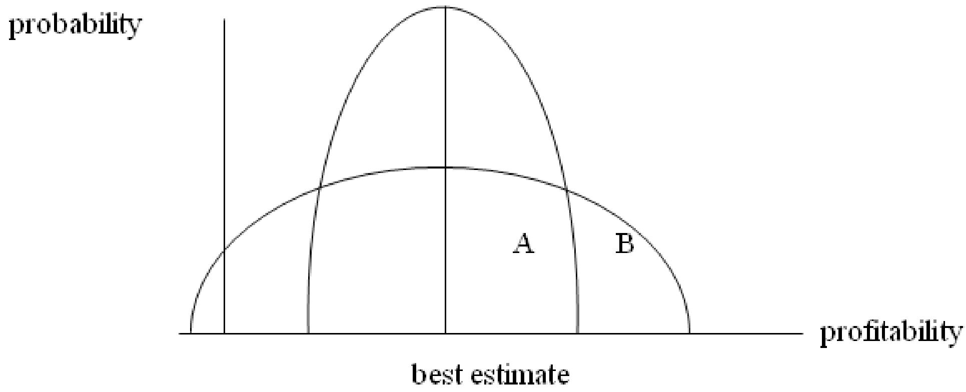

Fig 7.2 Profitability distribution profiles

The likely profit from each of them is identical but it can be seen from the probability distributions that the risk associated with them is quite different, with one of the projects having a risk of incurring a loss (project B). Without the probability distributions therefore a firm would be indifferent as to which project was chosen but with an understanding of the distribution of risk then it can be seen that project A is the preferable project, providing always that the expected returns for the two projects are similar.

Risk analysis can be used to quantify the expected values of the return from each project but assessing the relative relationship between risk and rewards inevitably relies upon managerial judgement and a person's attitude to risk.

7.6 A Typology of risk

There are a variety of pressures acting upon organisations in terms of risk to which they are subject, and these can be viewed as representing different dimensions of risk. In order to consider the way in which the various aspects of risk affect an organisation and its behaviour in relation to sustainability it is possible to construct a typology of these different types of risk:

7.6.1 Global risk

As the world has become more integrated – a facet of the globalisation which we considered in the last chapter – the risk from global competition has naturally increased. Consequently both the nature of the risks and the scale of the risk have increased.

7.6.2 Environmental risk

An organisation affects its environment and this includes not just the physical environment, in geophysical terms, but also the local environment through such things as pollution, noise or traffic congestion.

7.6.3 Social risk

A firm is of course part of society and reacts with that society, both positively and negatively. Risk naturally arises from this interaction.

7.6.4 Cultural risk

Much has been written[17] about the relationship between a firm and its employees, which is often negative in nature. This relationship is a source of risk which is particularly significant when the relationship breaks down and litigation or industrial action ensues.

7.6.5 Financial risk

All corporate activity has financial implications. Indeed the nature of a corporation requires the undertaking of financial risk and the acceptance of the consequences. Ideally these will result in financial rewards which are commensurate with the level of risk[18] undertaken but sometimes small rewards lead to a high level of exposure to risk[19] . Here we will mention that good governance is one way to prevent, or at least minimise the possible consequences of this kind of risk.

7.6.6 Long term/short term risk

Often consequences of corporate activity become manifest in the long term and all decisions are subject to both long as well as short term risks. This is of particular significance as some of the long term risks might not be apparent[20]when decisions are taken and action is commenced. Some risk therefore might exist which cannot even be recognised.

7.6.7 Stakeholder/shareholder interests

The power and influence of various stakeholder groups is increasing – something to which we will return – and this might increase the level of risk brought about by conflicts of interest between shareholders and other stakeholders, or between different groups of stakeholders.

7.6.8 Technical risk

Developments take place for all corporations and these include product or service development and mechanisms for delivery. We will return to this later as this is very significant for our consideration of sustainability, at this point however we must recognise that developments have associated risks.

Once risk has been identified then it is possible to develop appropriate strategies to manage it. Risk management is an important topic for a business in its own right. In fact it is a topic which is of increasing importance in the current economic climate. But it is a topic which is too specialist for this book. Here we will focus upon the relationship between risk and governance. Consequently we are considering primarily financial risk.

7.7 Risk analysis: the cost of capital

7.7.1 Components of the cost of capital

The level of risk for a company – or rather the level of risk that it is perceived to be exposed to – determines the cost of capital. And the lower the level of risk then the lower the cost of capital, and so the cost of borrowing is lowered. This is obviously beneficial for the company.

Understanding how to calculate the cost of capital is important for understanding its impact upon risk. It is also important for the measurement of performance of the company as many techniques measure performance against the cost of capital. There are primarily two sources – share capital and debt. The cost of capital for a firm is therefore made up of these two elements:

- the cost of share capital
- the cost of debt

The weighted average of these gives the cost of capital for a company, known as the weighted average cost of capital – the WACC.

For example:

A company has debt of £1,000,000 and share capital of £500,000. The cost of debt is 8% while the cost of share capital is 5%.

The WACC of the company therefore is

$$\text{WACC} = \frac{1{,}000{,}000 \times 8 + 500{,}000 \times 5}{1{,}500{,}000}\ \%$$

$$= 7\%$$

Of course the actual calculation of the cost of capital is considerably more complex than this and the managers of many companies spend considerable periods of time in trying to arrive at an accurate calculation of the cost of capital of the company. This is because so many strategic decisions for the company depend upon the NPV[21] calculations, and these in turn depend upon a cost of capital being applied. Different costs of capital will result in different NPV calculations, and therefore different decisions being made. Thus the calculation of the cost of capital is a crucial part of decision making.

This calculation is of particular difficulty for shares, which have no fixed rate of return but rather a fluctuating return based upon results. Nevertheless this fluctuating return is based upon share price, which is determined by market expectations. In general terms the financial return on the use of capital can be expected to increase as risk increases. We have however to define the precise relationship between risk and return.

The Capital Asset Pricing Model (CAPM) is used to describe an explicit relationship between the degree of uncertainty in income flow for a financial investment and the level of return, and therefore helps to explain how discount rates are established and how shares can be valued.

7.7.2 Systematic risk

The CAPM divides a shares' risk into two parts: systematic and unsystematic. Systematic risk refers to the extent to which share returns vary when the returns on the market as a whole change; it is measured by beta. A share with a beta of 1 tends to rise by 10% for a 10% rise in the market index; a share with a beta of 2 tends to rise by 20% when the returns to the market rise by 10 %. In other words shares of companies with higher betas are more volatile.

The systematic risk element for a firm is determined by risk factors common to all firms to a greater or less extent – for example such things as changes in GDP or in exchange rates. No firm is entirely unaffected by changes in these variables and as a result the prices of nearly all shares tend to move together – they are generally positively correlated.

7.7.3 Unsystematic risk

Unsystematic risk is that portion of total risk which is unique to a firm (or possibly an industry); examples include the quality of management, equipment failure, or new inventions. Because this type of risk is specific to the firm it is possible to reduce the variability of an investors' returns by choosing not to place all funds in one company. That is, the investor diversifies with the expectation that if one or two shares in the portfolio are doing badly this is compensated for by the good performance of others. In a fully diversified[22] portfolio unsystematic risks cancel each other out.

This can be illustrated in figure 7.3 where the amount of unsystematic risk reduces as the number of individual types of share in the portfolio increases:

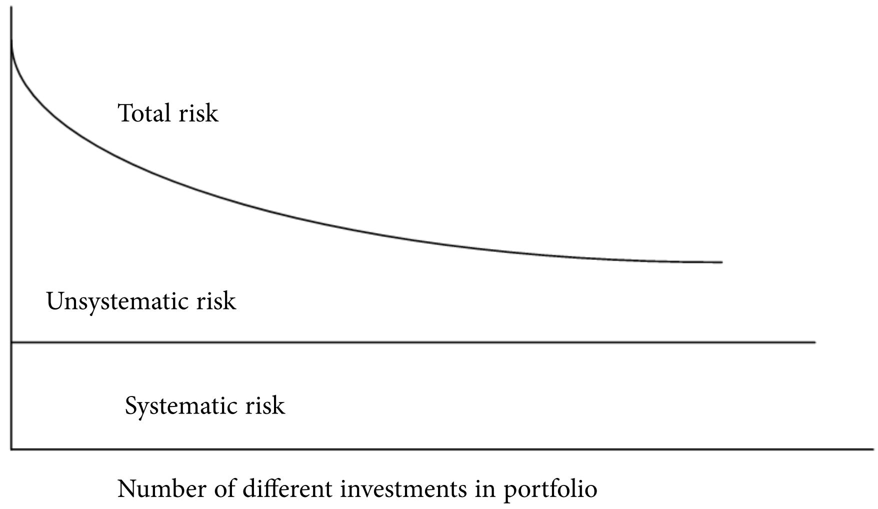

Figure 7.3 Risk and Diversification

A major implication of the CAPM is that investors will not be rewarded for bearing unsystematic risk, since they are able to diversify this risk away. Imagine that you are an investor who is undiversified and you require a return of between 30% and 40% p.a. on shares before you invest to compensate for the variability of returns caused by unsystematic and systematic risk.

You will not find such a share because there are plenty of fully diversified investors willing to buy shares which yield significantly less than 30-40% and so the share prices would never be low enough for you to invest and obtain your target rate of return. Investors continue to bid up the price of shares until only systematic risk is rewarded.

Once unsystematic risk is eliminated the risk of an individual share is measured not as the standard deviation of return of that share but as the volatility of the share relative to the market as a whole i.e. its beta. Using this definition of risk all securities plot along a security market line relating return and systematic risk.

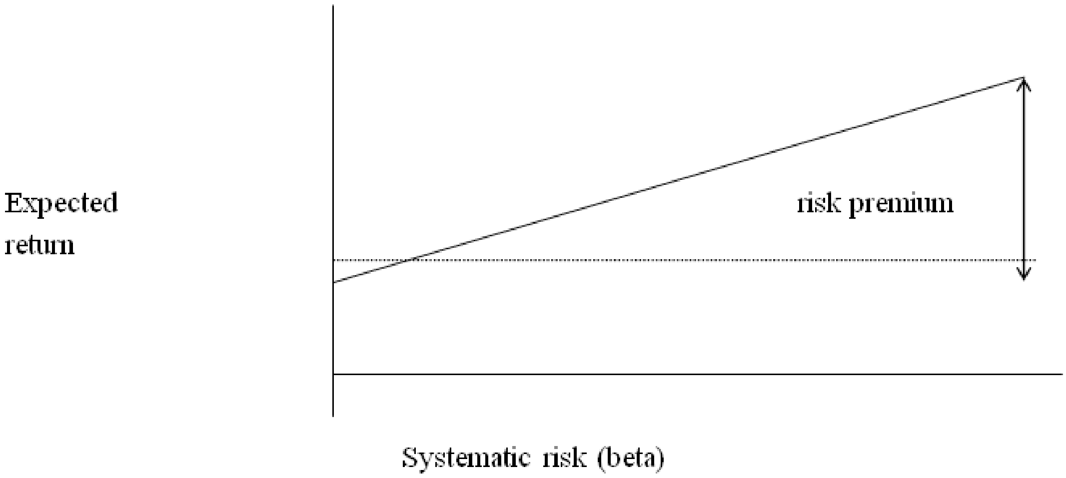

Figure 7.4 The risk premium calculation

7.8 The Capital Asset Pricing model

The Beta of a share measures the expected return for a share in relation to the expected return for the market as a whole. Thus the higher the Beta the greater is the expected return from a particular share when compared to other shares. Consequently the higher the Beta the higher is the cost of share capital for a company because of the greater expected returns and the lower level of risk.

Betas are calculated by a number of organisations. Datastream is one such organisation which derives a beta factor by performing a ”least squares” regression between weekly adjusted prices of the stock and the corresponding Datastream market index for a five year period. Typical values are around 1.00 and might range from 0.7 to 1.3 although higher or lower figures are not unknown.

7.9 The cost of capital for a business

Although this would appear to be a relatively simple calculation, the reality for a business is more complex than this. We have seen that Beta measures the level of risk for a share but that this is based upon an average of past performance, and Beta will tend to change over time. Moreover past performance is no predictor of future performance, whereas investment appraisal is based upon a prediction of future performance.

Thus knowing the Beta for your company at the present will provide an indication of past performance but will not enable an accurate calculation of the cost of capital to be used in the future. This is particularly the case when a proposed investment is based upon factors which are quite different to the past.

Thus, for example, an exercise leading to increased diversification could well be much more risky than current operations (because of such things as lack of experience or uncertainty about future demand) and this may well need to be evaluated using a very different cost of capital in the appraisal. The CAPM provides no basis for calculating such a cost of capital, and managerial judgment is required in this instance to derive an appropriate discount factor.

Most large companies are not composite businesses but consist of a number of different business units. These different units may well be engaged in very different activities for which different rates of return (in terms of either net profit percentage and / or ROCE (return on capital employed)) could be expected. If these business units were separate entities then they would be expected to have different Beta values and different costs of capital.

In such a circumstance a company wide cost of capital is not appropriate, and therefore different costs of capital for each of the business units should be used. However as they are not different entities no such Beta values exist and in this case also the CAPM provides no basis for calculating such a cost of capital and managerial judgment is required in this instance to derive an appropriate discount factor. This argument can also be extended to a consideration of different investment alternatives in a single business unit. If different levels of risk are associated with the different alternatives then the reality is that different discount rates should be used for the different alternatives.

7.10 Summary

It is clear that the definition of corporate governance has extended considerably beyond investor relations and encompasses relations with all stakeholders – including the environment. This is essential for the longer term survival of a firm and is therefore a key component of sustainability. There is evidence that some firms understand this but they are in a minority. So it is possible to say that good corporate governance will address this but that not all firms recognise this.

Similarly the amount of disclosure regarding all activities has been increasing rapidly over the last decade, as firms have recognised the commercial benefits of increased transparency. Therefore it is reasonable to argue – as we are doing – that the amount of information regarding the relationship between governance and social responsibility will also increase, not just as firms gain a clearer understanding of that relationship but also as they understand the benefits of greater disclosure in this respect. Thus we consider that this will become more apparent over time.

The most important point to note however is the relationship between corporate governance and the level of risk to which a firm is exposed. Good governance reduces the exposure of a firm to a whole variety of risks. This is clearly recognised by investors and potential investors and so the cost of capital is lower if a firm has good procedures for its governance.

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7.13 Self-test questions

1. What is the relationship between a beta value and the level of risk?
2. How many risk management strategies are there? Name them.
3. Describe the different attitudes to risk.
4. How does corporate governance affect the cost of capital?
5. List the different types of risk to which a corporation is exposed.

8 The Audit function and the role of regulation

8.1 Introduction

One of the issues which affects the running of a company is that the owners and managers have different sets of information, with managers generally having more information than owners or investors. Agency theory provides one way to deal with this which we discuss in this chapter. Regulation and rating agencies also help and we discuss these. So too does audit. In this chapter we discuss all of these in the context of governance.

8.2 The role of audit

The general definition of an audit is an evaluation but it is normally taken to mean an evaluation of the financial and other records of business and is undertaken on behalf of the owners of a business by some independent experts. The purpose is to ensure that the information presented in the published accounts provides a "true and fair" view of the activities of the business and that the balance sheet provides a realistic assessment of the assets and liabilities of the business. It is undertaken on behalf of owners and investors who tend to need to rely on this information for their assessment.

In the UK, and most countries, audit is a statutory function which must be undertaken by someone appropriately qualified – either a qualified auditor or a qualified accountant with appropriate experience. Increasingly also other information – such as environmental impact assessments are subject to audit by appropriately qualified people. This kind of audit is growing in importance but is not yet subject to control such as for financial auditing.

Although auditors are supposedly impartial they are appointed by the Board of Directors of the company and receive remuneration from the company. This has raised questions about their actual independence from the company and this is one important issue as far as governance is concerned. It should be noted also that an impartial assessment is not always arrived at. For example the accounts of Enron were always audited and confirmed, although the auditors – Arthur Andersen – went out of business at the same time as Enron did. But more recently the accounts of Lehman Bros were also audited and confirmed. Thus the role and impartiality of auditors remains an problematic subject

8.3 The Audit Committee

Every company must have an audit committee. This is an operating committee of the Board of Directors charged with oversight of financial reporting and disclosure. Committee members are drawn from members of the company's board of directors. It should contain independent directors and at least one member must be qualified as a financial expert. The role of audit committees continues to evolve as a result of the passing of the Sarbanes-Oxley Act 2002.

Responsibilities of the audit committee typically include:

- Overseeing the financial reporting and disclosure process.
- Monitoring choice of accounting policies and principles.
- Overseeing hiring, performance and independence of the external auditors.
- Overseeing regulatory compliance, ethics, and whistleblower hotlines.
- Monitoring the internal control process.
- Overseeing the performance of the internal function.
- Discussing risk management policies and practices with management.

8.4 Agency theory and asymmetric power

Agency theory argues that managers merely act as custodians of the organisation and its operational activities and places upon them the burden of managing in the best interest of the owners of that business[23]. According to agency theory all other stakeholders of the business are largely irrelevant and if they benefit from the business then this is coincidental to the activities of management in running the business to serve shareholders. This focus upon shareholders alone as the intended beneficiaries of a business has been questioned considerably from many perspectives, which argue that it is either not the way in which a business is actually run or that it is a view which does not meet the needs of society in general.

Conversely stakeholder theory argues that there are a whole variety of stakeholders involved in the organisation and each deserves some return for their involvement. According to stakeholder theory therefore benefit is maximised if the business is operated by its management on behalf of all stakeholders and returns are divided appropriately amongst those stakeholders, in some way which is acceptable to all. Unfortunately a mechanism for dividing returns amongst all stakeholders which has universal acceptance does not exist, and stakeholder theory is significantly lacking in suggestions in this respect. Nevertheless this theory has some acceptance and is based upon the premise that operating a business in this manner achieves as one of its outcomes the maximisation of returns to shareholders, as part of the process of maximising returns to all other stakeholders.

These two theories can be regarded as competing explanations of the operations of a firm, which lead to different operational foci and to different implications for the measurement, and reporting of performance. It is significant however that both theories have one feature in common. This is that the management of the firm is believed to be acting on behalf of others, either shareholders or stakeholders more generally. They do so, not because they are the kind of people who behave altruistically, but because they are rewarded appropriately and much effort is therefore devoted to the creation of reward schemes which motivate these managers to achieve the desired ends. This is the subject of Agency Theory.

8.5 Agency Theory

It is important to recognise that the firm is assumed to exist for the benefit of its owners who are assumed to be solely interested in the maximisation of their wealth. Managers, on the other hand, are the decision-makers in an organisation and they are implicitly assumed to automatically act in the best interests of owners, either because they are also the owners, or because they share the same interests. In other words, managers are assumed to make the same decisions that owners would make, irrespective of the effect on their personal interests.

Managers are, therefore, assumed to assess objectively alternative actions, and always select the option favoured by the owners of the firm. The management accountant, therefore, is then concerned with providing the 'right' information combined with the 'right' decision-model which will help the manager make the 'right' decision. An obvious criticism of this approach, however, is that it fails to recognise that managers may not share the same interests as owners, and that this is likely to impact upon real-world decision-making. Agency theory attempts to address this problem, by providing a more realistic representation of decision-making.

Agency theory therefore recognises that people are unlikely to ignore their own self interest in making decisions; in other words people do not behave altruistically. It is a relatively new approach to analysing decision-making which provides a framework within which the political and behavioural aspects of decision-making can be considered as part of the decision making process. The theory is therefore positive rather than normative as it seeks to understand and explain what happens in practice rather than seeking to prescribe what ought to happen. It recognises that the manager is an agent of the owners of the firm, whose actions the management accounting system seeks to influence.

Under Agency Theory both principal and agent are assumed to be rational economic persons: in other words they know what they are doing and they act consistently and rationally. They are both assumed to be motivated by self-interest alone, although the theory recognises that they possess different preferences, beliefs and information. Agency Theory provides a means of establishing a contract between the principal and the agent which will lead to optimal performance by the agent on behalf of the principal. The most important aspect is that information is not evenly distributed between managers and owners. This problem is known as 'information asymmetry' and has two separate, though related elements: moral hazard and adverse selection.

8.5.1 Moral hazard

Moral hazard arises where it is difficult or costly for owners to observe or infer the amount of effort exerted by managers. In such a situation, there is an inevitable temptation for managers to avoid working to the terms of the agreed employment contract, since owners are unable to assess the 'true picture'. Managers may also have the incentive as well as the means to conceal the 'true picture' by misrepresenting the actual outcomes reported to the owners. Accounting provides one such means for misrepresentation through its ability to represent outcomes from any course of action in more than one way.

8.5.2 Adverse selection

Whereas moral hazard relates to the 'post-decision' consequences of information asymmetry, adverse selection is concerned with the 'pre-decision' situation. Since all the information that is available to the manager at the time a decision is made is not also available to the owner, then the owner cannot be sure that the manager made the right decision in the circumstances. In addition, the manager has no incentive to reveal what he knows since this will then make it easier for the principal to properly assess his actions in the future. This is known as 'information impactedness'.

The existence of 'information asymmetry' means that for owners to obtain relevant information concerning the manager's effort, they must either rely on the communications received from the managers themselves, or must incur monitoring costs. An example of monitoring costs would include the annual audit of the firm's financial statements; indeed such auditing of financial statements was instituted as a means of safeguarding such investments in firms made by those who had no part in the operational activity of the firm. In the context of the agency relationship between top management and divisional management, such monitoring costs would include the cost of employing head office staff to monitor the performance of divisions.

8.6 Conclusions concerning the theory

The theory devises many ways to overcome these problems but these are specialist and beyond the scope of this book. Agency Theory has been developed from the Organisational Failure Framework of Williamson. It seems to offer some pointers as to how firms can be managed better but has problems as far as practical application is concerned. It is based upon one key assumption – that every party to a transaction acts in a rational manner in order to maximise his / her utility. This assumes of course that the evaluation of utility undertaken by every individual can be precisely calculated and thus that the same decision would always be made by the same individual in exactly the same set of circumstances. Nevertheless it helps us to understand corporate behaviour.

8.7 Rating Agencies

A rating agency is a company that devises credit rating – assessments of the risk involved – for various financial instruments and their issuers. In some cases, the servicers of the underlying debt are also given ratings. In most cases, the issuers of such securities are companies, state and local governments, not-for-profit organisations and NGOs or national governments issuing debt-like securities (eg bonds) that can be traded on a secondary market. A credit rating for an issuer takes into consideration the issuer's credit worthiness (i.e., its ability to pay back the loan), and affects the rate of interest applied to the particular security being issued. In theory the role of the rating agency is to provide an impartial assessment – based upon their expertise and research – to potential lenders in order to compensate for the inevitable information asymmetry between borrower and lender.

The recent failures of such agencies has been well documented. Too often they gave high ratings to bonds that subsequently defaulted. Their investment grade ratings of many sub-prime mortgage-backed securities were a primary cause of the recent crisis. Such faulty assessments have allowed companies to raise capital that they later wasted while denying more deserving companies capital they could have used to create jobs. The losses borne by bond investors have been huge and the government has absorbed many of these losses to prevent the total collapse of the financial system. More recently they have been overcompensating for their rash assessments by downgrading – to an extreme extent – their assessed creditworthiness of governments and causing yet more financial chaos.

A credit rating is a statement about the future. An investment grade rating should indicate that a bond is unlikely to default. Since the future is unpredictable, some investment grade bonds will default. However, defaults should be uncommon. Rating agencies have been criticised for having too close a relationship with company management, possibly opening themselves to undue influence or the vulnerability of being misled. Also information about ratings changes from the larger agencies spreads quickly so they charge debt issuers, rather than investors, for their ratings. This has led to accusations that these agencies are plagued by conflicts of interest that might inhibit them from providing accurate and honest ratings.

At the same time, the largest agencies (Moody's and Standard & Poor's) are often seen as agents of market forces, that drive companies to consider how a proposed activity might affect their credit rating, possibly at the expense of employees, the environment, or long-term research and development. The lowering of a credit score by an agency can create a vicious cycle, as not only interest rates for that company would go up, but other contracts with financial institutions may be affected adversely, causing an increase in expenses and ensuing decrease in credit worthiness. This happens to countries also which is another cause of economic crisis, or prevention of economic recovery. Sadly these agencies have a track record of not just over rating securities and their lenders in the first instance but overcompensating in downgrading as a reaction. So their actual role in compensating for information asymmetry has been shown to be somewhat questionable.

8.8 Regulation

Economic theory has suggested that competition and free market forces are the preferable environment within which economic entities and industries should operate. The reason for this is that competitive forces provide incentives for economic efficiency and equitable distribution. If market forces are expected not to be capable of providing the correct incentives to the companies there is a need for government intervention. This is known as regulation which is used as a substitute for the missing market forces. The purpose of such regulation is to ensure that no party is able to exploit their unequal position for gain and to ensure that efficiency incentives and equitable distribution are achieved.

Often the method of regulation which has been accepted is that of self regulation – with an industry effectively policing its members. Sometimes, as with the auditing industry, this has proved to be ineffective and external regulators have been appointed. Each regulator has the role of addressing and balancing up the needs of the various stakeholders of their respective industry. The stakeholders of regulated industries or markets include the press, customers and their pressure groups, shareholders, City analysts, and the government. Each of the stakeholders is interested in a different aspect of performance and so views the performance of the industry from a different perspective (Crowther 1996) in order to reach different conclusions. From this list of stakeholders the prime concern has been with addressing the needs of the two dominant stakeholders: shareholders and customers.

Within Western capitalist societies the emphasis is very much on companies providing returns to the shareholders and therefore they are a dominant stakeholder. In the case of the regulated industries the regulators have also been given the task of protecting the customers who would otherwise be 'gouged' by monopoly abuses (Veljanovski, 1991). In terms of customers the prime focus is upon domestic customers, possibly because these are the most numerous and in the weakest bargaining position, or possibly because these are the people who will vote for a government (which appoints the regulator) in the next election. 'Sliding scale' regulation is more specifically oriented to the idea of ensuring consumers are not abused at the expense of shareholders. It allows greater returns to shareholders only if consumer prices are reduced (National Consumer Council, 1989). This form of regulation was popular in the UK at the start of this century and has attracted interest recently as it has been suggested that other forms of regulation fail to deliver an equitable distribution.

8.9 The 2008 financial crisis

The recent financial crisis, much as previous ones, has highlighted failures in governance and failures in regulation. Indeed some writers, in their desire for scapegoating, have argued that the regulators are more guilty even than the perpetrators and should be sanctioned accordingly. There is of course one flaw in this argument and one problem with managing the prevention of future financial crisis (Grabel 2003) and this is concerned with the recognition of and regulation of a truly global market for finance. The liberalisation of financial markets instigated by the Washington consensus has made the free movement of funds a fact of financial life and has encouraged the parcelling together of doubtful debts into mystery parcels to be sold around the world[24]. And of course the operators in all financial markets, always ready to accept a gamble in the hope of ever larger profits and bonuses have been quick to respond.

Regulators inevitably, according to their founders, must focus upon a local market while finance escapes them through its ability to migrate around the world. Effectively this means that any realistic form of regulation does not and cannot exist (Becker & Westbrook 1998). One consequence of this regulatory failure of course is that contamination spreads and the dubious practices developed in one financial market become the norm in other markets. When the inevitable crisis appears this too spreads from one country to another as all economies are affected by both the consequences of dubious lending practices and by the ensuing crisis of confidence. This calls attention to the fact – recognised but mostly ignored in the financial models used to legitimate financial activity – that the financial market is a global market and a corollary of this is that any regulatory regime must also be global. Therefore we highlight the problems with the current regime and argue that perhaps a global regulatory authority capable of sanctioning even the most powerful actors in the market, including national and transnational governments, is necessary in the current global environment (see Chapter 10).

8.10 Failures in regulation

One thing which is apparent is that the current financial crisis, much as previous ones, has highlighted failures in regulation just as much as failures in governance. Indeed this has been a focus of much attention and some have argued that the regulators are more culpable even than the perpetrators and should be sanctioned accordingly. Equally of course it is the function of government, in Lockean (1690) tradition to implement the Social Contract (Rousseau 1762) and introduce regulation to curb the exercise of power and to protect the less powerful for a better operation of the markets. Clearly this has not worked – not because the principle is flawed but because economic reality has changed, encouraged by the Washington consensus and fostered by such people as Gordon Brown, former Prime Minister of the UK.[25] Indeed many people hold the policies of Brown, in relaxing regulation to impotence in order to encourage banks into the UK as being a prime cause of the ensuing financial crisis regarded as inevitable by many. The situation could be regarded as a house of cards ready to collapse at the slightest breeze. Inevitably this breeze did arrive in the form of the sub-prime lending scandal in the US! From this the contamination spread from one country to another as all economies are affected by both the consequences of dubious lending practices and by the ensuing crisis of confidence.

So it is wrong to single out regulators for blame. Their overseers must accept responsibility for encouraging profligacy. The crisis is of course made much worse by bank lending policy and financial profligacy,[26] with bank lenders being secure in the expectation that there was no risk because governments would step in to rescue them[27] from dire consequences of their irresponsibility. Indeed the government bodies – with press complicity – have sought to disguise the fact that such lending has been completely irresponsible by falling back on semiotics to create the term toxic debt to disguise the reality of complete irresponsibility bordering on lunacy. The language being used from these people tends therefore to be used as a device for corrupting thought (Orwell 1970) by being used as an instrument to prevent thought about the various alternative realities of bank lending policy.

The role of regulation is essentially to compensate for the inefficiencies and inequities of the market place. In other words it is to ensure that everyone gets a more fair chance in transacting with each other while seeking to minimise the costs of doing so. Unfortunately the transaction cost minimisation imperative has assumed superordinacy at the expense of fairness. This is a part of the problem. The main part of the problem however is one which no-one seems to be addressing – or even recognising. This is that the market based model of economic activity is a combative one – one in which the winner takes all is the basis for behaviour. This has led to the kind of recklessness which we have witnessed and which has led directly to the crisis.

8.11 Conclusions

The issues we have discussed in this chapter are important for the governance of companies. They are also controversial as there is a general agreement about some of the problems but no general agreement about possible solutions. Nevertheless these issues affect many aspects of governance which are referred to in other chapters of this book.

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8.14 Self-test questions

1. What is meant by information asymmetry?
2. What is the main purpose of audit and how does the Audit Committee help this purpose?
3. How do rating agencies help to solve information asymmetry?
4. What is the purpose of regulation?
5. What is the difference between moral hazard and adverse selection?

9 Corporate Governance in non-commercial organisations

9.1 Introduction

It is important to consider the nature of the sector. The not for profit (NFP) sector is one which is growing in importance all over the world. Moreover it is much bigger than people generally realise. In Europe for example it is estimated that the sector comprises around 40% of GDP. In this chapter we will explore the distinctive nature of the sector and consider the implications for governance.

There is a growing movement within the "non"-profit and "non"-government sector to define itself in a more constructive, accurate way. Instead of being defined by "non" words, organisations are suggesting new terminology to describe the sector. The term "civil society organization" (CSO) has been used by a growing number of organisations, such as the Center for the Study of Global Governance. The term "citizen sector organisation" (CSO) has also been advocated to describe the sector — as one of citizens, for citizens. This labels and positions the sector as its own entity, without relying on language used for the government or business sectors. However some have argued that this is not particularly helpful given that most NGOs are in fact funded by governments and business.

9.2 Definitions

First we need to start with some definitions:

A not for profit organisation is one whose objective is to support or engage in activities of public or private interest without any commercial or monetary profit. In many countries some will be charities but there will also be many which are not. Their distinguishng feature is not that they seek to provide benefits to less advanteged 9although many do) but rather that they do not seek to make a profit to return to investors. They tend therefore to have a different ownership structure.

A non-governmental organisation (NGO) is a legally constituted organisation which operates without any participation or representation of any government. In the cases in which NGOs are funded totally or partially by governments, the NGO maintains its non-governmental status insofar as it excludes government representatives from membership in the organisation.

9.3 The role of NGOs

Non-governmental organisations (NGOs) fulfil a vital role in society, filling the gap often left between civic responsibility undertaken through an agency of the government and personal responsibility often undertaken through the family. Indeed the modern streamlined and reduced state very often deliberately relies upon such NGOs to undertake responsibilities previously undertaken by the state, such as health, welfare and educational roles, which can no longer be undertaken due to the twisted logic of privatisation. To fill the gap states often rely upon NGOs and provide funding accordingly – a state obligation undertaken by proxy. The role and significance of NGOs has therefore risen accordingly; commensurate with this we have seen an explosion in the number of NGOs and a concomitant explosion in the spheres of influence of such organisations and in the roles which they claim for themselves.

In many ways this has been brought about by the retreat of the state which has caused the number of NGOs to increase to fill the gap left by this retreat (Kajimbwa 2006). This retreat means that the current situation is reminiscent of the situation in the middle of the nineteenth century with the rich being expected to donate some surplus to the poor but with a clear distinction between the deserving poor and the undeserving poor, with the distinction of course being dependent upon the acceptance by the receivers of the norms of the givers. Any further retreat would take us back to the medieval world of charity being inseparable from religion, but at least such charity was available to everyone as religious organisations tend not to discriminate in this manner! Thus the role of NGOs has increased very significantly in recent years.

It is uncertain how many NGOs exist in the world but there are many millions. It is estimated for example that in India alone there are 2 million such organisations. Some are very large international organisations and there are a few thousand[28] of these while many are national organisations or even very local organisations. Some of these are very small indeed and not all are active at a particular point in time. One thing which is certain however is that the number continues to grow as new ones are established for new purposes and this provided us with a rationale for our analysis, which is concerned with the growth in the number of NGOs existing and the ensuing problems.

9.4 Inflation and NGOs

It is very easy to establish an NGO; almost no regulatory requirements exist and almost no control is exercised. In many countries the establishment of an NGO is completely free of regulation.[29] All that is necessary is to decide a purpose for the NGO. This can be very broad and general such as the Worldwide Fund for Nature (WWF) or Medicine Sans Frontieres. Or it can be very narrow and specific such as Brinsley Animal Rescue[30], UK or the Temple Trust[31], Sri Lanka. All that is necessary is that the NGO has a purpose and does not seek to make a profit. Indeed it is easier to set up a new NGO than it is to close one down. One consequence of this is that the number of NGOs is increasing all the time, arguably at an exponential rate. We can describe this as an inflationary situation and therefore have coined the term NGO inflation. In many respects this is laudable as the need is almost infinite for organisations serving charitable purposes or even serving PR or lobbying purposes. In other respects however there are, or can be, problems associated with this inflation. It is these problems which are the focus of this chapter.

It is important to start by considering the nature of the sector. The not for profit (NFP) sector is one which is growing in importance all over the world. Moreover it is much bigger than people generally realise. In Europe for example it is estimated that the sector comprises around 40% of GDP. As the state reduces its activity this sector can be expected to grow in compensation – indeed some would argue that governments are relying on this happening in order to satisfy their ideological requirements.

9.5 Distinguishing features of sector

The first thing we must remember about this sector is that there is no profit motive and decisions must be taken according to different criteria. Instead the emphasis is upon the provision of a service, which is the essential reason for the existence of such an organisation. Additionally there is normally a disconnection between the acquisition of resources and their use – in other words the money to provide the services normally does not come from the recipient of those services. Moreover the need for those services frequently outstrips the ability of the organisation to satisfy those needs and it is forever operating under a situation of resource constraint.

This means that there are different motivations operating in the NFP. It also means that the stakeholders are different – something which we will return to as it is important for our consideration of governance in such organisations.

9.6 Types of NFP organisation

We can classify NFPs into various types, each with different purposes:

9.6.1 Public bodies

These are related to government in some way and include such things as a local authority and a health authority. These all have the function of providing services to members of society and receive their funding and powers directly from the national government.

9.6.2 Quasi public body

These are also often known as Quangos (quasi autonomous non-governmental organisations) and serve a public or civic purpose without having any direct relationship with the government. Many civic societies are like this and other examples include such things as housing associations. These too often get some funding directly from the government.

9.6.3 Educational institution

As the name suggests these serve an educational function and include such organisations as schools, further education colleges and universities. These may be publicly owned organisations or privately owned and the norm differs between countries.

9.6.4 Charity

We will consider these in detail later but here we need to recognise that a charity exists to fulfil a particular function which involves providing a service.

9.7 Motivation for NFPs

The motivation for the existence of NFPs is important to consider as it tends to be different to profit seeking organisations and this has implications for governance. Firstly a NFP organisation is motivated by some kind of societal concern. Normally this involves the provision of a service to some part of that society and this service provision is normally unrelated to payment for that service.

One motivation for an NFP therefore is the acquisition of resources in order to undertake the provision of those services. Thus there is a concern with the optimising of the utilisation and allocation of what is inevitable scarce and restricted resources. Similarly there is a concern with transaction cost minimisation. These issues are similar to those of profit seeking organisations but the way in which they are decided and the way in which effectiveness is measured tends to be quite different.

Because there is no profit motive then this way of providing motivation to managers and rewarding them for their performance does not exist and alternatives must be sought. Another factors which must be borne in mind is the matter of who decides what is good performance. For a profit seeking organisation the customer will ultimately decide by choosing to buy or not buy. In a NFO there is no customer and the service beneficiaries do not pay (or at least not full cost) for the service received.

Thus the determining of measures of performance is important for these organisations. So too is the setting of standards and the reporting of performance. This is normally done through the development of performance indicators. Often a variety of measures are used including:

- Budgetary control / cash flow
- Performance indicators
- Non-financial measures
- Qualitative factors

For the evaluation of performance then there is less relevance of accounting measures and a correspondingly greater importance of non-financial measures. This inevitable involves problems of quantification and a necessity for deciding between alternatives. One technique which is particular to this environment is that of cost benefit analysis. And one concern of such organisations is to demonstrate efficiency by minimising the proprtion of costs which are used as administration – indeed this can lead to manipulations of accounting information as efficiency has consequences for attracting new funds.

9.8 Implications for managers

It will be apparent that there are a number of issues facing managers of these organisations. The first is concerned with the acquisition and utilisation of resources. There is considerable uncertainty regarding the acquisition of resources and this makes planning particularly difficult. The planning horizon therefore tends to be short even though the projects which some NFPs are involved in are inevitably long term in duration.

Other issues which concern managers include the setting of objectives and the measuring of performance. Finance, budgeting & control of course are particularly important in this environment. Another factor is concerned with the influence of stakeholders. Without customers and without shareholders and investors there are a range of other stakeholders who are important and have a great deal of influence. These will include such stakeholders as donors, recipients and society at large.

As far as the external environment is concerned then there are a number of issues which are important and distinctive. The first is the question of market identification; this is essential for planning but is not necessarily obvious. Then, as we have implied already there is the fact that service delivery is not evaluated by its beneficiaries who do not pay for its receipt. There are a lot of different stakeholders who all have a view about performance and some influence on its evaluation – a complex situation.

NFPs are – in theory at least – not in competition with each other: this is true as far as helping beneficiaries is concerned but there is an element of competition in the acquisition of resources. For the provision of services there are generally several organisations involved in providing the same services and it might be thought that collaboration – rather than competition – might be an effective way of providing such services. Certainly high profile disasters always attract assistance from several large charities which often collaborate and pool resources.

One of the factors in this sector however is that the largest NFPs are most able to acquire additional resources. Thus there is competition for market share because this leads to easier resource acquisition. In theory also NFPs exist to fulfil a particular purpose. Once that purpose has been satisfied there is no purpose to their continued existence. For both of these factors however the egos of the people managing the NFPs become a factor as each strives to extend its life, extend its purpose and extend its size and market share.

9.9 Available resources

For many NFPs the main source of funding comes from the government. This is certainly true for public bodies and for quasi public bodies. In most countries it is also true for educational institutions. For the largest charities it is also true as governments tend to use these charities to distribute their aid programmes.

Other sources of funding include borrowing but this is only really an option for capital projects when some security can be provided. So for many NFPs the other main source of funding is from fund raising. This can take the form of seeking donations or legacies or trusts. For the larger organisations then raising funds through trading is also a viable possibility and in the UK, for example, the shopping centres have a considerable number of charities represented.

9.10 Structure of a charity

As charities are a significant number of the organisations in the NFP sector then we need to consider their structure in some detail. The first point to make is concerning the legal environment in which they operate. This can be described intra vires rather than ultra vires. The difference is as follows:

9.10.1 Ultra vires

An ultra vires organisation has the power to do anything which it is not specifically prevented to do according to either the law or its founding legal articles of association. All commercial organisations are founded like this and can therefore extend and change their operations according to market needs and circumstances.

9.10.2 Intra vires

An intra vires organisation can only undertake those activities which it is specifically empowered to undertake. It is therefore much more difficult for such an organisation to extend or change its activities. All charities are established as intra vires organisations. This can be defined as its charitable purpose.

A charity has many tax and regulation advantages but in return there are certain restrictions on what it can do. Thus a charity is not able to act as a pressure group – at least not overtly. Politics are excluded from its sphere of operation. It can engage in fund raising of course but it is prevented from trading as a means of raising funds. This might seem surprising given how many charities are visibly engaged in trading. This is done either through a third party or by means of a trading subsidiary which then gifts the proceeds to the charity.

Thus these restrictions are legal restrictions to ensure that the benefits of being a charity can only accrue to an organisation with a genuine charitable purpose but they are interpreted fairly liberally for organisations which are recognised to be charities. The ultimate sanction of course it the removal of charitable status from such an organisation.

The final point to make about charities is that they make extensive use of volunteers as well as of paid employees. This keeps their operating costs down of course but also adds another stakeholder group with an interest in and concern for how the charity operates, manages its performance and services its beneficiaries. Moreover the relationship between volunteers and paid employees is sometimes a source of conflict.

9.11 Accounting issues

We have dealt with a number of accounting issues already in our consideration of planning and budgeting; of the measurement and reporting of performance; and of the evaluation of results. Another important point to make though is concerning the time horizon adopted by these organisations. Many projects are long term in nature but sources of funds are often short term in nature. So there is a long term horizon for expenditure but a short term horizon for income, this is problematic and a source of difficulty in planning for many of these organisations.

Many of these NFP organisation engage in fund raising, as we have seen. This itself causes complications for the accounting iof such organisations and can affect its operational procedures. Money can be given to one of these organisations either for its general activities or for a specific purpose. For example the larger charities frequently have appeals for a specific disaster relief operation. When money is given for a specific purpose then it can only be used for that purpose. Thus these organisations tend to have a number of funds for specific purposes.

This can be problematic when the need for such money has been completed and there is a surplus – it is difficult to use this for another purpose. A further difficulty is caused by the fact that some funding is needed for general administration. People are willing to give for a specific cause but not for general administration. Thus the accounting for these organisations is geared towards making as much expenditure as possible direct expenditure rather than indirect.

9.12 Governance issues in NFPs

All of these factors have implications as far as governance is concerned. It is often thought that if an organisation exists for a public or charitable purpose then it must be a socially responsible organisation demonstrating good governance. Our consideration of issues throughout this book should have enabled you to understand that this is not necessarily the case. Governance is about how an organisation conducts its operations and deals with its stakeholders. For NFPs we can see that there is a different focus and we need to consider this in terms of governance implications. We can consider this according to these criteria:

9.12.1 Stakeholders

There are different stakeholders for a not for profit organisation and the different stakeholder groups have different amounts of power to a profit seeking organisation. It is inevitable therefore that dealing with these stakeholders will be a much more important function for a NFP. Moreover the sources of conflict might be different and the actions taken in resolution of this might also be different. Inevitable also the decision making process is likely to be different.

9.12.2 Sustainability

In terms of doing more with fewer resources (see Aras & Crowther 2009) then this is always an objective for this kind of organisation. In terms of affecting the choices available to future generations then an NFP actually seeks to do this and to redistribute resources more equitably. In terms of seeking a continual existence then really an NFP should strive to make its purpose of existence no longer relevant and should not seek sustainability.

Thus sustainability is an equally important issue for these organisations but its implications are very different in terms of both motivation and decision making.

9.12.3 Accountability

Accountability is an even more important issue for this kind of organisation and who it is accountable to can be very different. Without either shareholders or customers then accountability is to donors, beneficiaries and a wide range of other stakeholders. Moreover it needs to address this accountability – which can be different for different stakeholders – in order to be able to continue with its operations.

9.12.4 Transparency

With this diverse set of stakeholders groupings who all have considerable interest in the organisation and its activity then there is obviously a great need for transparency and all such organisations will strive for this. This is particularly exacerbated by the need to keep fund for specified restricted purposes. On the other hand it is in the interest of the NFP to seek to use its accounting system and procedures to classify indirect costs as direct and thereby to minimise the apparent administrative costs incurred. This is contrary to the principle of disclosure but completely understandable!

9.12.5 Disclosure

Increasing disclosure is a feature of corporate reporting as they seek to satisfy stakeholders through increased accountability and transparency. Disclosure has of course always been a feature of NFP activity as such disclosure is necessary to seek additional funds as well as to satisfy the diverse but powerful and vociferous stakeholder groupings. In this respect therefore it might be considered that profit seeking organisations are becoming more like not for profit organisations.

9.13 Conclusions

The environment in which not for profit organisations operate is somewhat different but there are still governance implications which are mostly concerned with sustainability and with accountability. Particular features of this environment are:

- Uncertain resource availability and its effect on long term planning
- Stakeholder power and involvement
- Conflicting priorities
- Legal environment
- Managing ambiguity

9.14 References

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9.16 Self-test questions

1. What is ultra vires?
2. What types of NFP exist?
3. What governance issues exist for NFPs?
4. What measures of performance are typically used by these organisations?
5. How can we define a NGO?

10 Globalisation and corporate governance

10.1 Introduction

Globalisation is a leading concept which has become the main factor in business life during the last few decades. This phenomenon affects the economy, business life, society and environment in different ways, and almost all corporations have been affected by these changes. We can see these changes mostly related with increasing competition and the rapid changing of technology and information transfer. This issue makes corporations more profit oriented than a long term and sustainable company. However, corporations are a vital part of society which needs to be organised properly. Therefore we need some social norms, rules and principles in society and business life; this is the role of governance.

10.2 Globalisation

Globalisation can be defined as the free movement of goods, services and capital. This definition does not cover all the aspects of globalisation or global changing. Globalisation also should be a process which integrates world economies, culture, technology and governance. This is because globalisation also involves the transfer of information, skilled employee mobility, the exchange of technology, financial funds flow and geographic arbitrage between developed countries and developing countries. Moreover globalisation has religious, environmental and social dimensions. In order to encompass this broad impact area globalisation covers all dimensions of the world economy, environment and society. Moreover it is apparent all over the world and the world is changing dramatically. Every government has a responsibility to protect all of their economy and domestic market from this rapid changing.

The question is how a company will adapt to this changing. First of all companies have to know different effects of globalisation. Globalisation has some opportunities and threats. A company might have learnt how to protect itself from some negative effects and how to get opportunities from this situation.

Globalisation affects the economy, business life, society and environment in different ways:

- Increasing competition,
- Technological development,
- Knowledge/Information transfer,
- Portfolio investment (fund transfer between developed countries and emerging markets),
- Regulation/deregulation, International standards,
- Market integration,
- Intellectual capital mobility,
- Financial crisis-contagion effect-global crisis.

10.2.1 Competition

Globalisation leads to increased competition and therefore increased competition is a consequence of globalisation. This competition can be related to product and service cost and price, target market, technological adaptation, quick response and quick production by companies, in addition to such things as quality and customer satisfaction. When a company produces with less cost and sells cheaper, it will be able to increase its market share.

Customers have too much choice in the market and they want to acquire goods and services quickly and in a more efficient way. And also they are expecting high quality and a cheap price which they are willing to pay. All these expectations need a response from the company, otherwise the sales of the company will decrease and they will lose profit and market share. A company must be always ready for price competitions for product and service and for changes in customer preferences because all of these are global market requirements.

10.2.2 Exchange of Technology

One of the most striking manifestations of globalization is the use of new technologies by entrepreneurial and internationally oriented firms to exploit new business opportunities. Internet and e-commerce procedures hold particular potential for SMEs seeking to broaden their involvement into new international markets (Wrighta & Etemad, 2001). Technology is also one of the main tools of competition and for enhancing the quality of goods and services. On the other hand it necessitates quite a lot of cost for the company. The company has to use the latest technology for increasing their sales and product quality. Globalisation has increased the speed of technology transfer and technological improvement. Customer expectations are directing markets. Mostly companies in capital intensive markets are at risk and that is why they need rapid adapting concerning customer and market expectations. These companies have to have efficient technology management and efficient R&D management.

10.2.3 Knowledge/Information transfer

Information is a most expensive and valuable production factor in the current environment. Information can be easily transferred and exchanged from one country to another. If a company has a chance to use knowledge and information then it means that it can adapt to this global changing. This issue is similar with the technology transfer issue in global markets. The rapid changing of the market requires also quick transfer of knowledge and efficient using of that knowledge and information.

10.2.4 Portfolio investment (Financial fund flows)

Globalisation encourages increased international portfolio investment. Additionally, financial markets have become increasingly open to international capital flows. For this reason, portfolio investment is one of the major problems of developing economies. It is almost the only way to increase liquidity of the markets and economies for emerging countries through attracting foreign funds. Significantly, this short term investment can dramatically impact on the financial markets. When the emerging economies have some problem in their country or investors make enough profit from their investment then these investors might leave the market. This would mean that market liquidity decreased and financial markets indicators plummet immediately.

10.2.5 Regulation/deregulation and international standards

Globalisation needs more regulation of the markets and economy. There are many new and complicated financial instruments and methods in the market and such instruments easily transfer and trade in other countries because of the globalisation effect. Every new system, instrument or tool requires new rules and regulations to determine its impact area. These regulations are also necessary to protect countries against global risks and crises. When the crisis comes out of one country then it influences other countries with trade channels and fund transfers, which we call the contagion effect. On the other hand, during globalisation the shares of big companies are trading in international stock markets and these companies have shareholders and stakeholders in many different countries. International rules and regulations offer protection particularly to small investors against the big scandals and other problems in companies, examples of which we have seen during the recent finacial crisis.

International standards also regulate markets and economies by means of international principles and rules such as international accounting standards, international auditing standards. These aim to make corporate reporting standardised and comparable. So that is why the globalised world has more rules and more regulations and international standards than before.

10.2.6 Market integration

In fact globalisation leads to the conversion of many markets and economies into one market and economy. The aim of international standards and regulations is also to deregulate all these markets. The economy needs financial structures capable of handling the higher level of risk in the new economy. For this reason financial markets must be broad, deep, and liquid and at present only the U.S. financial markets are large enough to provide this financial structure in the world market. Global stock market projection and Pan-European stock market projection are part of this changing. There are many similar examples in the current situation for market integration which are also the result of increasing competition in the economy. Integration examples are prominent in company mergers and acquisitions as well.

10.2.7 Qualitative Intellectual capital mobility

Another effect of globalisation is human capital mobility through knowledge and information transfers. One of the reasons is that international/multinational companies have subsidiaries, partners and agencies in different countries. They need skilled and experienced international employees and rotation from country to country to provide appropriate international business practice. This changing also requires more skilled, well educated and movable employees who can adapt quickly to different market conditions.

10.2.8 Financial crisis-contagion effect-global crisis

Financial crises are mostly determined through globalisation and as a result of the globalisation impact. In fact, this is quite a true explanation. The financial world has witnessed a number of crises in recent years. Generally financial crises come out from international funds/capital flows (portfolio investments), lack of proper regulations and standards, complex financial instruments, rapid development of financial markets, asymmetric information and information transfers. One country crisis can turn into a global crisis with systemic risk effect. Systemic risk refers to a spreading financial crisis from one country to another country. In some cases, crises spread even between countries which do not appear to have any common economic fundamentals/problems. Previous global crises have also shown that one of the reasons for the crisis is unregulated markets.

10.3 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 any 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 is 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 organizations, 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[32] – described as the world's largest voluntary corporate responsibility initiative[33] – 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.

10.4 Global perspectives

As stated previously, good governance is of course essential for good corporate performance and one view of good corporate performance is that of stewardship. 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. 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 eventually 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.

10.5 How Globalisation Affects Governance

The question might be how globalisation affects governance. But the answer to this question is not only related to the last quarter of the 20th century but also related to previous centuries. John Maynard Keynes calculated that the standard of living had increased 100 percent over four thousand years. Adam Smith had a seminal idea about the wealth of communities and in 1776 he described conditions which would lead to increasing income and prosperity. Similarly there is much evidence from economic history to demonstrate the benefit of moral behaviour; for example, Robert Owen in New Lanark, and Jedediah Strutt in Derbyshire – both in the UK – showed the economic benefits of caring for stakeholders. More recently Friedman has paid attention to the moral impact of the economic growth and development of society.

It is clear that there is nothing new about economic growth, development and globalisation. Economic growth generally brings out some consequences for the community. This is becoming a world phenomenon. One of the most important reasons is that we are not taking into account the moral, ethical and social aspects of this process. Some theorists indicated the effect of this rapid changing more than a hundred years ago. Economic growth and economic development might not be without social and moral consequences and implications.

Another question is who is responsible for this ongoing process and for ensuring the wellbeing of people and safeguarding their prosperity. Is this the responsibility of governments, the business world, consumers, shareholders, or of all people? Government is part of the system and the regulator of markets and lawmakers. Managers, businessmen and the business world take actions concerning the market structure, consumer behaviour or commercial conditions. Moreover, they are responsible to the shareholders for making more profit to keep their interest long term in the company. Therefore they are taking risk for their benefit/profit. This risk is not opposed to the social or moral/ethical principles which they have to apply in the company. There are many reasons for ethical and socially responsible behaviour of the company. However, there are many cases of misbehaviour and some illegal operations of some companies. Increasing competition makes business more difficult than before in the globalised world.

The good news and our expectations are that competition will not have any longer bad influence on company behaviour. According to international norms, (practice) and expectations, companies have to take into account social, ethical and environmental issues more than during the last two decades. One of the reasons is more competition and not always more profit; another reason is consumer expectation is not only related to the cost of products but also related to quality, proper production process and environmental sensitivity.

Moreover shareholders are more interested in long term benefit and profit from the company. The key word of this concept is long termism which represents also a sustainable company. Shareholders want to get long term benefit with a sustainable company instead of only short term profit. This is not only related to the company profit but also related to the social and environmental performance of the company. Thus, managers have to make strategic plans for the company concerning all stakeholder expectations which are sustainable and provide long term benefit for the companies with their investments. However, Sustainability can be seen as including the requirement that whatever justice is about – fair distribution of goods, fair procedures, respect for rights and social justice – and is capable of being sustained into the future indefinitely.

Thus sustainability requires that the values of justice are capable of being continued into the future: if current practices for instance were just from the present point of view but would prevent the same practices from occurring in the future, that would be rejected from the point of view of sustainability (Dower, 2004)…. So investor or shareholder expectations and all other stakeholders approaches are supporting a socially responsible and ethical company more than other companies. Globalisation has had a very sharp effect on company behaviour and still we can see many problems particularly in developing countries. This is one of the realities of the globalisation process. However we are hoping to see some different approaches and improvements to this process with some of them naturally related to some international principles, rules and norms. But most of them are related to the end of this flawed system and the problems of capitalisation.

The challenge of governance in a globalizing world is to engage in a process of political deliberation which aims at setting and resetting the standards of global business behaviour. While stakeholder management deals with the idea of internalising the demands, values and interests of those actors that affect or are affected by corporate decision-making, we argue that political CSR can be understood as a movement of the corporation into environmental and social challenges such as human rights, global warming, or deforestation (Scherer & Palazzo, 2008).

10.6 Globalisation, Corporate Failures and Corporate Governance

Enron, WorldCom, Parmalat, and various other failures of global corporations bring out some governance issues and have increased attention to the role of business ethics. Managers and CEOs of these companies must be considered responsible for all of these failures and these are cases of "corporate irresponsibility". Many people have the opinion that if corporations were to behave responsibly, most probably corporate scandals would stop.

Corporate governance protects firms against some long term loss. When corporations have social responsibilities, they calculate their risk and the cost of failure. Firstly, a company has to have responsibility to shareholders and also all stakeholders which means that it has responsibility to all society. Corporate failures have an important impact on all society also. In particular, big scandals such as Enron have sharply affected the market and the economy. Various stakeholders (e.g. employee, customer, consumer, suppliers etc) as well as shareholders and regulators of the firm have a responsibility to ensure good performance. Therefore, corporate governance is not only related to firms but also related to all society. So changing the role of corporate responsibility shifts the focus from the real problem that society needs to address.

One of the reasons for this result is increasing competition between the company and the market. Managers tend to become much more ambitious than before in their behaviour and status in the globalised world. Thus we have to focus on corporate and managerial behaviour. The question is how to behave as a socially responsible manager and how to solve this vital problem in business life and in society. In the business world there are always some rules, principles and norms as well as regulations and some legal requirements.

However, to be socially responsible one must be more than simply being a law abiding person who has to be capable of acting and being held accountable for decisions and actions. The problem is the implication for all of these directions for company and managerial behaviour. On the other hand, one perspective is that a corporation is a “legal person” and has the rights and duties that go with that status—including social responsibility. In the case of Enron, managers were aware of all regulations, even though they have known all irresponsible and unethical problems in the company management, they did not change their approach and behaviour.

The conclusion is that it is not always possible to control behaviour and corporate activity with regulations, rules and norms. So another question arises in this situation, that if people do not know their responsibility and socially responsible things to do and if they do not behave socially responsibly then, who will control this problem in business life and in the market. The concern is that the social responsibility implication of the company cannot be controlled through legal means. This is the only social contract between mangers and society and stakeholders of the company and for responsible and accountable behaviour.

Firms will consciously need to focus on creating value not only in financial terms, but also in ecological and social terms. The challenge facing the business sector is how to set about meeting these expectations. Firms will need to change not only in themselves, but also in the way they interact with their environment (Cramer,2002).

10.7 Conclusion

As we can see, globalisation has an enormous effect on society and business life which can be manifest in a number of different ways. So business life needs more regulation and proper and socially responsible behaviour than before. In this chapter we have shown the relationship between corporate governance and globalisation. We pointed out that the relationship between business failure/ scandals increased after globalisation, and good governance is required to address this problem.

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10.10 Self-test Questions

1. What is the main indicator of Globalisation?
2. How does globalisation affect corporate governance?
3. Why is global governance an issue and what form might it take?
4. Is the reason for the big corporate scandals irresponsible management?
5. What is the relationship between crises and regulation?

Endnotes

[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.

[5] An example is the Cadbury Report.

[6] It is also known as the Anglo American model.

[7] For example the recent financial crisis has been brought about – as far as many people are concerned – by failures in the governance systems of the UK and the USA – the two principal exponents of this system of governance.

[8] This is also known as the Continental model.

[9] Such as, for example, the UK Combined Code referred to earlier.

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

[11] 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.

[12] 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.

[13] Interestingly Sir Adrian Cadbury who led the committee which established the first code of corporate governance is a member of this family – perhaps concern can be inherited.

[14] It needs a very careful reading of the annual report to discover this.

[15] We base our assertion regarding all businesses upon our study of the FTSE100 businesses, and so recognize that our claim may not have universal truth.

[16] In actual fact Lovelock claimed in his hypothesis that the earth and all its constituent parts were interdependent. It is merely an extension of this hypothesis to claim the interrelationship of human activity, whether enacted through organisations or not.

[17] See for example Davila Gomez & Crowther (2007).

[18] This is of course the basis upon which financial management is based.

[19] Consider for example the financial consequences for Barings Bank of their focus upon short term financial success. Nick Leeson was able to gamble so much that he destroyed the bank. See the film Rogue Trader for details.

[20] The consequences of the use of asbestos, for example, were not known about in the 1960s when this material was considered beneficial for commercial use.

[21] NPV = net present value. It is a mechanism for translating future costs and revenues to present day value. Its calculation is outside the scope of this book.

[22] Diversification in this context means to increase the number of shares in different companies which are held

[23] Such owners are of course the legal owners of the business, that is the shareholders.

[24] Even the current US regime has acknowledged that there has been a laxness in regulation which has made a significant contribution to the current situation.

[25] He was previously Chancellor of the Exchequor and therefore architect of the very relaxed regime operating in the UK.

[26] Of course in the UK the scandal over parliamentary expenses and the misuse – even sometimes criminal fraud – of public money has shown that governments are often not fit to act as overseers and are unable to behave any better – or even as well as – than the managers of financial institutions.

[27] Consider for example the British governments nationalisation of Northern Rock before the crisis had really started. Consider also the even more surprising volte face of the US government in acquiring stakes in struggling financial institutions – lots of evidence of the risk free environment in which banks have been operating…

[28] Wikepedia suggests that there are around 40,000 such international NGOs although different classifications lead to different numbers. Nevertheless the number of such large international NGOs is a very small proportion of the total number of NGOs.

[29] There are exceptions. For example, In Turkey there are some general regulation about NGOs. If you want to establish a new association then you have to complete all the necessary paperwork and get permission from the Association board of Turkey. And you have to give a report every year after a general board meeting about managerial and financial aspects. As a sanction it is necessary to pay very small amount kind of tax every year if you do not do this but this is a fairly small penalty.

[30] Brinsley in a small town in the centre of England and Brinsley Animal Rescue has the purpose of rehoming unwanted pets in the area.

[31] The Temple Trust operates from the UK but has the purpose of looking after orphans in a region of Sri Lanka.

[32] See www.unglobalcompact.org

[33] Possibly the newly introduced ISO 26000 will become bigger and more important in this respect