CSR, Sustainability, Ethics & Governance

*Series Editors:* Samuel O. Idowu · René Schmidpeter

Maria Aluchna
Samuel O. Idowu *Editors*

# Responsible Corporate Governance

## Towards Sustainable and Effective Governance Structures

# CSR, Sustainability, Ethics & Governance

**Series editors**

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Maria Aluchna • Samuel O. Idowu
Editors

# Responsible Corporate Governance

## Towards Sustainable and Effective Governance Structures

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# Foreword

Governance is an essential element of organization process for a number of entities such as public administration, NGOs, small and medium business, privately held firms and large corporations listed on the stock exchange. Governance formulates the goals to be achieved, determines the direction for the organization development and sets the evaluation criteria. Corporate governance is defined as a set of mechanisms and institutions both inside the company and in its external environment which are shaped in order to assure for the achievement of formulated goals and expressed expectations. As classics put it "with great power comes great responsibility".

Existing studies clearly indicate that responsible corporate governance adds to economic growth and social development, enhances transparency, enables stakeholder empowerment and engages them in the decision process and supports the adoption of modern and prospectus concepts. However, with the lack of the adequate guidance, accountability, responsibility and transparency, governance may evolve in the wrong direction, favouring one group at the cost of other groups, abusing the existing rights, focusing excessively on short-term goals and benefits, disclosing insufficiently or non-complying with the recognized standards. The recent financial crisis of 2008–2010 indicates that the costs of irresponsible governance and unethical operation of companies generate severe costs which are incurred not only by the direct shareholders but as a matter of fact are significant systemic burden for various stakeholders, communities and general public.

Larcker and Tayan (2013) note that corporate governance remains a very complex issue as it involves organizational decisions made at the senior level that directly influence the incentives, motivations and behaviour of all employees. These decisions need to be undertaken in a given organizational and institutional context. It is crucial how the strategic changes cascade throughout an organization taking into account all structural and cultural determinants in which these decisions are embedded in. Although in its traditional view corporate governance has predominantly referred to public listed companies, nowadays the know-how and evidence is adopted in other organizations such as family firms, NGOs and public

administration. This transfer of corporate governance experience into a different context also requires understanding and careful implementation.

Sound corporate governance may help structure the decision process and direct the organization to strategically incorporate expectations of various stakeholder groups. Responsible governance based on solid fundamentals, values and integrity can provide positive spillovers and synergistically influence practices, structures and behaviour of individual and institutional actors. The growing awareness of social challenges and environmental damage pressures responsible governance to shift to address the issues societies and economies call for. Thus, in reaction governance needs to incorporate the concepts of corporate social responsibility, stakeholder management and sustainable business. The experience of corporate governance with the identification of its dynamics and recent improvements offers knowledge which may add to the development of different organization and may be effectively adopted in various contexts. I truly believe this is the underlying assumption and the main message of the book "Responsible Corporate Governance".

Vice Rector for Research and Management Piotr Wachowiak
Warsaw School of Economics
Warsaw, Poland
Fall 2016

# Preface

In recent years, boards of directors have faced acute criticism for poor corporate governance, the blame for which arguably lies in an excessive focus on shareholder value and the inefficient incentive mechanisms and excessive risk taking it involves. The traditional neoclassical view of the firm, with its focus on shareholder value, ignores the company's broader role in society and can be argued to have led to increased instability in the global economy and its stock markets, ultimately to the detriment of shareholders. Recent reforms and recommendations call for a broader approach to corporate governance where shareholder primacy is balanced with an approach that incorporates multiple stakeholder expectations. Moreover, neglecting the interests of other stakeholders can reduce financial performance and thrust the company into the spotlight of social criticism and stakeholder rejection. The changing role of corporate governance raises a series of questions about the development of the concept, its integration with corporate social responsibility (CSR) and sustainability as well as its practical implementation at the company level.

This book addresses tasks and functions of corporate governance in the light of current challenges and the dynamics that arise from a broader approach to company management and the integration of corporate governance with CSR and sustainability. Addressing corporate governance shortcomings that are believed to have contributed to the recent financial crisis, the book will identify the integration of corporate governance and CSR and will include examples of company practice. Such changes affect the practices of shareholders, boards of directors and regulators. For shareholders, the integration of corporate governance and CSR translates into their activism, different investment strategies, specific reporting expectations and the submission of proposals to the annual meeting. Boards of directors need to revise their tasks with respect to the criteria for executive appointments, their corporate strategy, performance measures and diversity recommendations.

Directors should reconsider the structure of executive pay and performance incentives. Finally, regulators introduce new laws addressing for instance the need for integrated reporting (combined reports on financial, social and environmental performance), limiting the voice of short-term oriented shareholders and providing guidelines for executive compensation.

London, UK Samuel O. Idowu
Warsaw, Poland Maria Aluchna
November 2016

# Acknowledgements

This book evolved during hours of discussions we held with our colleagues, inspirations during meetings and events and in the process of confrontation with business practice. By initiating the book, we are hoping to show the critical development of corporate governance in—what we believe—responsible and sustainable direction. We hope this book adds to the discussion on the necessities of continuous improvements in corporate governance.

We would both like to thank Professor David Crowther, formerly of London Metropolitan University, UK, and now Professor of Corporate Social Responsibility, De Montfort University, UK, whose motivation and inspiration initiated the sparkle of interests for CSR and opened the opportunities for joint projects during numerous CSR conferences organized by Professor Crowther's Research Network. We also would like to acknowledge the excellent cooperation of all our contributors for their valuable input, discipline and understanding during the process of preparing the book and for their friendship and support throughout the various stages that culminated into the production of the book.

Samuel O Idowu would like to express his gratitude to a number of people who have continued to support his research activities: Emeritus Professor Malcolm Gillies, former Vice Chancellor London Metropolitan University; Professor Stephen J Perkins, Dean Guildhall Faculty of Business & Law; Professor Nicholas Capaldi, Emeritus Professor Richard Ennals; Professor Stephen Vertigans; and Professor John O Okpara. I am grateful to many of my long-time friends and my family who have continued to support me. I am particularly grateful to my wife and children for providing the atmosphere to do all these things—Mrs Olufunmilola O Idowu and Josiah O Idowu and Hannah A Idowu.

Maria would like to thank Professor Piotr Płoszajski, the head of the Department of Management Theory, Warsaw School of Economics (SGH), Poland, for the years of guidance and support as well as all the Department co-workers for creating a creative and friendly atmosphere. I would also like to express my thanks to Professor Ryszard Bartkowiak, the Dean of Management and Finance Collegium of Warsaw School of Economics (SGH) who facilitates my research and continuous

professional development. I would also like to express my gratitude to Samuel O Idowu for his friendship, the opportunity to work on this project and fantastic cooperation. I would also like to thank my family for their understanding and patience.

We would also like to thank our publishing team at Springer headed by the Senior Editor Christian Rauscher, Barbara Bethke and other members of the publishing team who have supported this project.

Finally, we would like to apologize for any errors or omissions that may appear anywhere in this book; please be assured that no harm was intended to anybody. Causing harm or discomfort to others is simply not the spirit of corporate social responsibility.

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Tkachenko Irina has won many grants on corporate governance issues, including international: The Fundamental Research Fund in the sphere of economic science by the Russian Ministry of Education (1999–2000, 2003–2004); RGNF Grant

(2001, 2011–2012); The Russian Foundation for Basic Research (2013–2015); Grant of Bridge partnership with Ashcroft International Business School of Anglia Ruskin University, UK (2006–2010, 2012); ACTR-RSEP fellowship, George Washington University, Washington, DC (USA, 1995); Canada-Russia Program in Corporate Governance, Schulich School of Business, Toronto, Ontario, Canada; Grant of CIDA, June–July, 2003; Erasmus Mundus Action 3: (SCEE project)—The Warsaw School of Economics (Szkoła Główna Handlowa w Warszawie, SGH) (2013). Tkachenko I. was a visiting lecturer in Karaganda State University, Kazakhstan (2012), in Poland (SGH, 2013) and in Italy (Luiss Guido Carli University and Link Campus University (Rome, 2014) and Florence University (2014).

# Responsible Corporate Governance: An Introduction

**Maria Aluchna and Samuel O. Idowu**

Corporate governance is understood as a set of mechanisms and institutions which are intended to provide efficient monitoring and control over a firm's strategy and operation. As offered in the definition G20/by OECD (2015: 3) "good corporate governance is not an end in itself. It is a means to create market confidence and business integrity, which in turn is essential for companies that need access to equity capital for long term investment". Hence, corporate governance provides structural and procedural fundaments "intended to make sure that the right questions get asked and that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term sustainable value" (Monks & Minow, 2004: 2). It also however encompasses the less formal aspects of norms and values for accountability, transparency and legitimacy (Monks, 2002) which are the underlying for responsible business conduct.

Corporate governance derives from the historical dynamics and politics of ownership structure and shareholder activism (Cheffins, 2013; Soederberg, 2010) and is embedded in the institutional and regulatory framework (Bruno & Claessens, 2010). In its current version corporate governance has been primarily developing to address shortcomings of public listed company characterized with dispersed ownership structure found predominantly in the Anglo-Saxon economies with the aim to mitigate conflicts of interests between principals and agents. More precisely, corporate governance assures to provide monitoring and control over the firm's executives particularly referring to decision making procedures, profit redistribution and investment policy. The monitoring task is exemplified both in the operation

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of internal institutions such as the board packed with experienced, educated and independent directors as well as in the functioning of external mechanisms including stock and debt markets, market for corporate control or labor market for executives (Tricker, 2011). Corporate governance also guides procedures for appointment and succession of top managers and recommends the structure of incentive executive compensation (Larcker & Tayan, 2011). With the transfer of corporate governance know-how to other countries stimulated by globalization of stock market, its tasks and functions expanded into mitigating principal-principal conflict identified in companies characterized by ownership concentration in continental Europe, Asia and Latin America. In emerging and developing countries a greater emphasis is put on transparency, protection of shareholder rights and constrains for realization of private benefits by majority owners. In light of increasing social issues related to inequalities, migration and globalization as well as environmental challenges resulting from declining natural resources (Idowu & Mermod, 2014) corporate governance has redeveloped its recommendations calling for extending the responsibility of business towards environment and society and integrating stakeholder interest into the firm's strategy.

Corporate governance is empirical in nature and is required to address currently emerging tasks which relate both to efficiently implement classic structural and procedural guidelines and responsibility values as well as to incorporate social and environmental objectives into the process of assessing corporate performance. Corporate governance in its recommendations and reforms needs to react to inefficiencies identified by Larcker and Tayan (2013) who show that while 8% of publicly traded companies each year have to restate their financial results due to previous manipulation or error, 10% of chapter "Integrated Reporting: State of the Art and Future Perspectives" cases involve allegations of fraud and 5% of publicly traded companies have been accused of retroactively changing the grant date of stock options to increase their compensation value to executives (stock option backdating).

In addition, Labaton Sucharow (2012: 4–5) indicate the severe integrity and responsibility crisis. On a sample of US and UK financial services professionals they reveal that:

- 24% of respondents believed that the rules may have to be broken in order to be successful
- 25% of UK and 22% of US respondents believed financial services professionals may need to engage in unethical or illegal activity to succeed
- 26% respondents claimed to have observed unethical or illegal behavior first-hand
- 16% of respondents would engage in insider trading to make $10 million trading if they believed they could get away with it
  - 55% of respondents could say definitively that they would not

- 39% of total respondents believed that most likely their competitors have engaged in illegal or unethical activity while doing business (with 36% of UK respondents and 40% of US respondents)

Addressing the above mentioned challenges this book is a reflecting the momentum of today's business dynamics. The idea behind this publication is to capture changes in corporate governance, CSR, the responsibility of a company in economy and society as well as the role of stakeholders. This book in its three main parts offers an insight into the development of corporate governance in response to economic, social and environmental challenges in the context of the after-crisis reality. More precisely, Part I highlights efforts of reforming corporate governance towards best practice presenting initiatives and practice with reference to shareholder activism, company social investment, board structure and functioning, committees, compensation policy, anti-takeover-devices, shareholder rights and compliance. In Part II the dynamics of corporate governance is situated within the process of balancing stakeholders and shareholders exploring legitimacy issues of multi-stakeholder initiatives, addressing the issue of "unity in multiplicity" and identifying the relationship between corporate social responsibility and corporate governance. Part III offers new tools and instruments which are intended to facilitate the introduction of the responsible practice of executive compensation, the implementation of integrated reporting and the methodology to measure ownership and liability decision.

Part I "Reforming towards best practice" starts with chapter by Mark Camilleri who discusses "Responsible Corporate Governance in Europe" in the framework of European Union's (EU) policies encouraging large corporations and state owned enterprises to report on environmental, social and governance (ESG) performance. Specifically, Mark Camilleri presents the EU directive 2014/95/EU on non-financial reporting and identifies areas for improvement in corporate governance issues using the case studies of three major European banks (ING, Deutsche Bank and UniCredit).

Mikkel Skougaard in chapter entitled "Perspectives on the Integration of Corporate Governance in Equity Investments: From the Periphery to the Core, from Passive to Active" demonstrates the integration of corporate governance in equity investments. He discusses the process of incorporation of governance factors into financial goals and the increase of investors stewardship and activism who actively engage in reforming corporate governance in portfolio companies. Mikkel Skougaard provides the wide range of methods adopted by investors in order to integrate the dimension of corporate governance into equity investments.

Chapter entitled "Company Social Investments: Growth of Capitalization or Burden of Risk?" is written by Irina Tkachenko, Ludmila Ramenskaya who in their contribution present the results of the empirical study of 15 largest Russian public companies which operate in different sectors and have developed models of corporate social responsibility. Irina Tkachenko, Ludmila Ramenskaya document positive links between social investments and the valuation of Russian firms'. They

also show that better working conditions, occupational health and safety, environment-related activities significantly lower company risks.

In chapter written by Belén Díaz Díaz; Rebeca García Ramos and Elisa Baraibar Díez address the issues of "Corporate Governance in Spain: Has the Crisis Changed Corporate Governance Policies?". They explore the evolution of corporate governance over the last three decades focusing on the emergence of numerous voluntary-compliance good governance codes. Taking into account the differences across Europe measured by 33 variables. They present results of the analysis based on a sample of 206 enterprises from Stock Indexes of Spain (IBEX 35), France (DAX), Germany (CAC-40) and the United Kingdom (FTSE-100) and reveal country-based CG differences in 25 variables, and pre- and post-crisis differences in 11 variables for Spain, 10 for Germany, 17 for the United Kingdom, and 18 for France.

Part I is completed by chapter "Responsible Corporate Governance. The Case of Best Practice" by Maria Aluchna on which addresses shortcomings corporate governance codes of best practice. Discussing the internationally recognized recommendations of the codes which include on board work, transparency, investor protection and empowerment, various stakeholders, Maria Aluchan raises the question on the adoption and factual compliance with these guidelines in practice. She provides an attempt to address these limitations presenting insights collected during 20 interviews with board directors, corporate governance experts, auditors, lawyers and funds representatives.

Part II explores the development of corporate governance over the process of balancing stakeholder and shareholder interests. In chapter by Lars Moratis discusses "Extending the Frontiers of Responsible Corporate Governance: Exploring Legitimacy Issues of Multi-Stakeholder Initiatives". He investigates and elaborates on the criteria for assessing the legitimacy of multi-stakeholder initiatives (MSIs) represented by collaborative governance governments, non-governmental organizations and companies. Referring to Mena and Palazzo framework Lars Moratis argues for the inclusion of the dimension of throughput legitimacy and proposes an adjusted set of MSI legitimacy criteria based on the ISO 26000 regime.

Developing from the theoretical and empirical view Maria-Gabriella Baldarelli and Mara Del Baldo in chapter entitled "New categories for responsible corporate governance starting from the 'unity in multiplicity'" explore the logic of reciprocity as the "engine" of socially responsible governance. The concept of reciprocity in business and enterprises is viewed as a form of interaction based on the experience of giving and receiving based on the notion of importance of the good life and integrity in managerial decision-making. Using the case study of Economy of Communion Spa (EoC Spa) Maria-Gabriella Baldarelli and Mara Del Baldo identify mechanisms which enable responsible governance being linked to the company's mission and accountability. They document that reciprocity in the Economy of Communion of industrial parks increases creativity and sensitivity towards poverty as well as stimulate intrinsic motivation to implement responsible and effective governance.

Chapter written by George K. Amoako delivers insights on the “Relationship between Corporate Social Responsibility (CSR) and Corporate Governance (CG) Activities in Africa. The Case of Some Selected Companies in Ghana”. He investigate factors that influence CSR and corporate governance issues in Africa, specifically focusing on Ghana, recognizing the necessity that good corporate governance is both introduced by regulation and driven by underlying assumption on enhancing performance, competitiveness and sustainability. Based on a series of interviews with employees from MTN Ghana, Glico Life Insurance, Latex Foam, Quality Insurance Co. Ltd. and Akan Printing Press George K. Amoako explores the rotation of board directors as the result of the government change in Ghana. He also documents how different international and domestic companies in Ghana perceive CSR and corporate governance contribution to company strategy and development.

The final contribution of Part II is provided with chapter by Adebimpe Lincoln and Oluwatofunmi Adedoyin who discuss “A review of the Effectiveness and Potential Shortcomings of Corporate Governance Frameworks in the Nigerian Banking Industry”. Adebimpe Lincoln and Oluwatofunmi Adedoyin draw upon the stakeholder view on the importance of corporate governance in the Nigerian banking sector. Adopting a mixed method approach including the use of a quantitative questionnaire survey and qualitative semi-structured interviews with various stakeholders, they reveal the shift of corporate governance perception from a shareholder-centric to a more stakeholder-centric model. Recognizing the role of international guidelines they document interviewees’ reservations about transposing these recommendations into the Nigerian banking sector without the adaption to the local environment.

Chapter “Responsible Executive Compensation” by Ihar Sahakiants opens Part III dedicated to the exploiration of tools and instruments supporting the implementation of new tasks of corporate governance**.** Ihar Sahakiants in his contribution on “Responsible Executive Compensation” draws upon the concept of socially responsible executive pay. He identifies the link between the compensation of top managers and corporate social responsibility (CSR). With the adoption of the influential principal-agent framework and recognition of variations in legal contexts and corporate governance configurations across the globe he examines possible ways to design respective remuneration schemes.

The chapter by Maria Roszkowska-Menkes explores “Integrated Reporting: State of the Art and Future Perspectives”. Identifying two competing research streams on business-case and sustainability Maria Roszkowska-Menkes discuses limits in the understanding of the integrated reporting concept. She conducts her analysis according to four main questions on what integrated reporting is, why companies should report according to the integrated framework, to whom integrated reporting is addressed and finally how it’s implemented should be put in action.

The discussion on integrated reporting is continued in chapter by Sunday Okaro and Gloria Okafor in their contribution entitled “Integrated Reporting in Nigeria: The Present and Future”. Sunday Okaro and Gloria Okafor view the emergence of

the integrated reporting concept as a reaction to identified shortcomings of the narrow perspective of shareholder value maximization paradigm. They emphasize the need to incorporate stakeholder value orientation and search for links between social responsibility and accounting to encompass social and environmental issues in the financial statements. With the essential principles including strategic focus and orientation, connectivity of informal stakeholder relationships, materiality, conciseness, reliability and completeness, consistency and comparability, they capture the economic, social and environmental effects of integrated reporting within the mainstream of sustainability accounting. Sunday Okaro and Gloria Okafor refer their discussion to the regulatory, environmental and infrastructural context integrated reporting framework in Nigeria implemented on the voluntary basis and facing a number of measurement and subjectivity issues.

Part III and the whole book is completed with chapter by Rute Abreu, Liliane Cristina Segura, Marco Milani' Fátima David entitled "Ownership and Liability Decision". Authors argue that traditional accounting concentrates in actions of the firm, while it neglects the effects of the firm upon its external environment. With growing awareness of the business impact on society and environment, the modern accounting is expected to be able to measure and report the firm's influence on its stakeholders. Rute Abreu, Liliane Cristina Segura, Marco Milani' Fátima David offer the methodology to analyze the effect of ownership on the liability decision. Using the context of non-family versus family owned firms and adopting Benford law-based analysis they conduct the empirical longitudinal study based on sample of 281 firms listed on Bovespa Stock Exchange. The results reveal the understanding of the liability decision in the context of family owned and non-family owned firms as well as firm's significant effect upon its external image that lead to changes the liability decision through its activities.

Good corporate governance based on fundaments of responsibility, accountability is viewed as an essential element for development both at the company and a country level contribution to social and economic growth. Corporate governance at the micro spheres of companies adds to integrity and efficiency in operation gaining legitimacy from stakeholders, retaining skilled human capital and attracting investors. This naturally contributes to the sustained long-term development at the country and region levels. With the need to transform business into low-emission and resource-efficient economy required the implementation of new paradigms such as stakeholder management or shared value supported by instruments including sustainable business models and integrated reporting. All these will influence mechanisms, institutions and norms and values corporate governance is directed by. Thus, the quest for efficient and at the same time responsible corporate governance remains still on the "to do" list for regulators, investors, executives and stakeholders. These 13 chapters aim at contributing to the process of understanding and developing of responsible corporate governance.

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# Part I
# Reforming Towards Best Practice

# Responsible Corporate Governance in Europe

**Mark Anthony Camilleri**

## 1 Introduction

The corporate social responsibility (CSR) practices of huge multinationals affect millions, perhaps billions of people across the world, whether through the products they supply, the people they employ, the communities they locate in or the natural environments they affect. Over the last few decades, the resurgence of corporate governance could have been triggered by corporate irresponsibility and scandals. Debatably, corporations are not only strategically-rational; they are also morally-obliged to uphold their stakeholders' interests, at all times. While corporate scandals have given considerable mileage to business ethics and CSR issues; businesses ought to focus their energies on their core economic functions of producing goods and services, whilst maximising returns for their primary legitimate interest groups, namely shareholders (Donaldson & Preston, 1995; Friedman, 1970; Harford, Mansi, & Maxwell, 2012; Shleifer & Vishny, 1997). In this light, responsible corporate governance determines the systems, principles, and processes by which large firms or state-owned entities are governed.

The corporate governance principles and codes have been developed to guide large organisations (with more than 500 employees) to balance the distribution of rights and responsibilities of all stakeholders. During these last decades the big entities were constantly reminded that they had obligations towards; shareholders, employees, investors, creditors, suppliers, local communities, customers, and policy makers. Moreover, organisational leaders were instructed on their duties and responsibilities pertaining to the composition of the board of directors as they had to respect their shareholders' rights. Notwithstanding, sound corporate governance demanded corporate officers and board members to give life to an organisation's

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guiding values, to create an environment that supports ethically sound behaviours, and to instil a sense of shared accountability among employees (Paine, 1994). Therefore, the driving force of corporate governance ought to be characterised by integrity, honesty and organisational ethics. Ethical values shape the search for opportunities, the design of organisational systems, and the decision-making process. These responsible principles help to define what a company is and what it stands for. They provide a common frame of reference and serve as a unifying force across different functions, lines of business, and employee groups (Paine, 1994). Stakeholders expect accountability and transparency from large organisations. Hence, organisations are expected to clarify and make publicly known the roles and responsibilities of the board and management. Corporate entities are encouraged to implement procedures to independently verify and safeguard the integrity of the company's financial reporting. Such disclosures of material matters concerning the organisation should be timely and balanced in order to ensure that all investors have access to clear and factual information.

This contribution explains how corporate governance is not an end in itself. It is a means to create market confidence and business integrity. Responsible corporate governance is essential for companies that need access to equity capital for long term investment. Access to equity capital is particularly important for future oriented growth companies, particularly in the financial services industry. This chapter presents a review of some of the international corporate governance principles as it reports about the voluntary guidelines on non-financial reporting in the EU. This is followed by a content analysis of the corporate governance practices of three major European banks hailing from different contexts. More specifically, this research evaluates formal and informal structures, as well as the processes and disclosures procedures that exist in oversight roles and responsibilities within the financial services sector. The underlying objective of this analysis is to scrutinise the banks' corporate governance micro/macro dimensions as they need to respond to regulatory pressures and stakeholder demands. The discussion of the three banks provides a useful illustration of how corporate governance practices can be implemented, and it does provide an indication of how some practices may differ from institution to institution (and by country). Yet, there are also certain practices that remain similar across the EU countries. Therefore, this chapter sheds light on principles and good practices of corporate governance in three major European banks, namely; ING Bank, Deutsche Bank and UniCredit. It addresses the rights of directors, managers, shareholders and employees among other interested parties. This research critically evaluates how these stakeholders are engaging in corporate decision making, in the light of the latest developments in corporate governance policy.

## 2 Corporate Governance Regulatory Principles and Codes

The corporate governance principles have initially been articulated in the "Cadbury Report" (Jones & Pollitt, 2004) and have also been formalised in the "Principles of Corporate Governance" by the Organisation for Economic Cooperation and Development (Camilleri, 2015a; Lazonick & O'sullivan, 2000). Both reports have presented general principles that help large organisations in corporate governance decisions. Subsequently, the federal government in the United States enacted most of these principles that were reported in the Sarbanes-Oxley Act in 2002 (Abbott, Parker, Peters, & Rama, 2007). Different governments and jurisdictions have put forward their very own governance recommendations to stock exchanges, corporations, institutional investors, or associations (institutes) of directors and managers, sometimes with the support of intergovernmental organisations. With regards to social and employee related matters, large organisations could implement the International Labour Organisation (ILO) conventions that promote fair working conditions for employees (Fuentes-García, Núñez-Tabales, & Veroz-Herradón, 2008). The corporate disclosure of non-financial information includes topics such as; social dialogue with stakeholders, information and consultation rights, trade union rights, health and safety and gender equality among other issues (EU, 2014). The compliance with such governance recommendations is usually not mandated by law. Table 1 presents a selection of corporate governance principles:

Most of these principles have provided reasonable recommendations on sound governance structures and processes. In the main, these guidelines outlined the duties, responsibilities and rights of different stakeholders. In the pre-globalisation era, non-shareholding stakeholders of business firms were in many cases sufficiently protected by law and regulation (Schneider & Scherer, 2015). In the past, the corporate decisions were normally taken in the highest echelons of the organisation. The board of directors had the authority and power to influence shareholders, employees and customers, among others. This board consists of executive and non-executive directors. The organisations' ownership structure, and the composition of the top management team could influence corporate social performance (Lau, Lu, & Liang, 2014). Notwithstanding, the non-executive directors could also

**Table 1** A non-exhaustive list of corporate governance principles

| |
|---|
| The Cadbury Report (1992) |
| International Corporate Governance network (1995) |
| OECD's Principles of Corporate Governance 1999 (revised in 2004) |
| Sarbanes-Oxley Act (2002) |
| World Business Council for Sustainable Development (2004) |
| The International Finance Corporation and the UN Global Compact (2009) |
| Equator principles (2010) |
| EU's Directive on Disclosure of Transparency 2013/50/EU (2013) |
| EU's Directive on Non-Financial Disclosures 2014/95/EU (2014) |

(Compiled by the author)

have a positive impact on CSR reporting (Sharif & Rashid, 2014). However, these assumptions have become partly untenable with the diminution of public steering power and the widening of regulation gaps (Lau et al., 2014). In many cases, stakeholders of business firms lack protection by nation state legislation. Notwithstanding, with the inclusion of stakeholders, corporate governance may compensate for lacking governmental and regulatory protection and could contribute to the legitimacy of business firms (Miller & del Carmen Triana, 2009). Schneider and Scherer (2015) argued that the inclusion of stakeholders in organisational decision processes on a regular basis can be regarded as the attempt of business firms to address the shortcomings of a shareholder-centred approach to corporate governance. This casual consultation with stakeholders could often be characterised by unequal power relations (Banerjee, 2008).

Previous research may have often treated the board as a homogeneous unit. However, at times there could be power differentials within boards (Hambrick, Werder, & Zajac, 2008). Boards are often compared to other social entities, in that they possess status and power gradations. Obviously, the chief executive will have a great deal of power within any organisation. In addition, the directors may include current executives of other firms, retired executives, representatives of major shareholders, representatives of employees and academics. Who has the most say? Is it the directors who hold (or represent) the most shares or does it reflect the directors' tenures? It could be those who hold the most prestigious jobs elsewhere, or the ones who have the closest social ties with the chairman or chief executive. These power differentials within the echelons of top management teams could help to explain the firms' outcomes. Ultimately, the board of directors will affect processes and outcomes.

A more macro perspective on informal structures opens up new questions regarding the roles of key institutional actors in influencing the public corporation (Hambrick et al., 2008). Although researchers have long been aware of different shareholder types, there has been little consideration of the implications of shareholder heterogeneity for the design and implementation of governance practices. Managers and shareholders, as well as other stakeholders, have wide variations of preferences within their presumed categories. For instance, there are long-term and short-term-oriented shareholders, majority and minority shareholders, and active and passive shareholders (Hambrick et al., 2008). In addition, the rise of private equity funds may have created a whole new shareholder category. This group is becoming more and more influential. The idea of heterogeneity within stakeholder categories, including diversity among equity shareholders, will become a popular topic in future governance research (Miller & del Carmen Triana, 2009). Growing shareholder activism raises questions that could have been overlooked in the past. Who runs, and who should run the company? Corporate governance does not begin and end with principals, agents, and contracts. Beyond the obvious roles of regulatory authorities and stock exchanges, we are witnessing an increasing influence from the media, regulatory authorities, creditors and institutional investors, among others. These various entities may have a substantial effect on the behaviours of

executives and boards of public companies. Arora and Dharwadkar (2011) had suggested that effective corporate governance could discourage violation of regulations and standards. Jizi, Salama, Dixon, and Stratling (2014) examined the impact of corporate governance, with particular reference to the role of board of directors, on the quality of CSR disclosure in US listed banks' annual reports after the US sub-prime mortgage crisis. Jizi et al. (2014) implied that the larger boards of directors and the more independent ones are in a position to help to promote both shareholders' and other stakeholders' interests. They found that powerful CEOs may promote transparency about banks' CSR activities for reputational concerns. Alternatively, the authors also pointed out that this could be a sign of managerial risk aversion. Recently, many businesses have linked executive pay to non-financial performance. They tied executive compensation to sustainability metrics such as greenhouse gas (GHG) reduction targets, energy efficiency goals and water stewardship; in order to improve their financial and non-financial performance (CERES, 2012). In a similar vein, Jo and Harjoto (2011) have found that CSR is correlated with governance characteristics, including board independence and institutional ownership. They posited that this finding supports the conflict-resolution hypothesis as opposed to the over-investment and strategic-choice arguments as CSR engagement positively influences operating performance and firm value. Jizi et al. (2014) also indicated that the two board characteristics usually associated with the protection of shareholder interests (board independence and board size) are positively related to CSR disclosure. Manasakis, Mitrokostas, and Petrakis (2013) suggested that businesses should recruit socially-responsible CEOs and delegate them to instil their CSR ethos on the organisations' stakeholders. They contended that these individuals could act as a commitment device for the firms' owners and toward consumers.

Moreover, Lau et al. (2014) have examined the effects of corporate governance mechanisms on CSR performance to gain legitimacy in a changing institutional context. They maintained that Chinese firms had to adopt global CSR practices in order to remain competitive. Adaptive governance ought to incorporate strategic and monitoring activities that determine the way companies enact their responsibilities toward shareholders and other stakeholders (Young & Thyil 2014). Relevant contextual factors including; the economic environment, national governance system, regulation and soft law, shareholders, national culture, behavioural norms and industry impacts could affect corporate governance. In their philosophical stance, Lau and Young (2013) held that there are different realities that affect corporate governance. They went on to suggest that it is important to explore hybrid solutions into an integrated framework to lessen the possibility of bottlenecks and any emerging incongruities. Rahim and Alam (2014) also argued that corporate self-regulation in less vigilant environments could be incentivised by regulators and other stakeholders. Notwithstanding, the firms who voluntarily disclose more CSR information had better corporate governance ratings (Chan, Watson, & Woodliff, 2014). Such businesses are usually larger; belong to higher profile industries; and are highly leveraged. Mason and Simmons (2014) suggested a holistic approach to corporate governance and social responsibility that integrate companies,

shareholders and wider stakeholder concerns. They argued that this is attainable if companies delineate key stages of the governance process and align their profit-centres and social responsibility concerns to produce a business-based rationale for minimising risk and mainstreaming CSR.

Interestingly, the latest European Union (EU) Directive 2014/95/EU on non-financial disclosures has encouraged large undertakings to use relevant non-financial key performance indicators on environmental, social and governance matters (Camilleri, 2015b).

## 3 European Corporate Governance Guidelines

On the 29th September 2014, the European Council has introduced amendments to its previous Accounting Directive (2013/34/EU). The EU Commission has been mandated by the European Parliament to develop non-binding guidelines on the details of what non-financial information ought to be disclosed by large "public interest entities" operating within EU countries. It is hoped that non-financial reporting will cover social and environmental issues, including; human rights, anti-corruption and bribery matters as expressed in the UN Guiding Principles on Business and Human Rights (the "Ruggie Principles") and OECD's Guidelines for Multinational Enterprises (ECCJ, 2014). This recent, directive has marked a step forward towards the hardening of human rights obligations for large organisations with a staff count of more than 500 employees. At the moment there are approximately 6000 large undertakings and groups across the EU. Public interest entities include all the undertakings that are listed on an EU stock exchange, as well as some credit institutions, insurance undertakings and other businesses so designated by the EU's member states. Their disclosures are expected to feature a brief description of the entities' business models, including their due diligence processes resulting from their impact of their operations. Corporations (or state owned organisations) should also explain how they are preventing human rights abuses and/or fighting corruption and bribery. This EU directive has emphasised materiality and transparency in non-financial reporting. It also brought up the subject of diversity at the corporate board levels. It has outlined specific reference criteria that may foster wider diversity in the composition of boards (e.g. age, gender, educational and professional background). The EU Commission has even suggested that this transparency requirement complements the draft directive about women on boards. Of course, this new directive will still allow a certain degree of flexibility in the disclosures' requirements. As a matter of fact, at the moment it does not require undertakings to have policies covering all CSR matters. Yet, businesses need to provide a clear and reasoned explanation for not complying with the EU's directive. Therefore, non-financial disclosures do not necessarily require comprehensive reporting on CSR matters, but it encourages the disclosure of information on policies, outcomes and risks (ECCJ, 2014). Moreover, this directive gives undertakings the option to rely on international, European or national frameworks (eg. the

UN Global Compact, ISO 26000) in the light of the undertaking's characteristics and business environment. It is envisaged that these revised non-financial reporting requirements will be published as from financial year 2017. However, many European corporations, including multi-national banks are already following these voluntary corporate governance principles.

## 4 Methodology

This empirical investigation presents case studies of large multinational firms within the financial services industry. It represented a "strategy of research that is concentrated on the comprehension of the dynamics that characterise specific contexts (Eisenhardt, 1989: 532) of corporate governance reporting in Europe. It involved an inquiry of data that is context-dependent (Yin, 2015). Therefore, the research design considered the observational conditions before setting a framework for analysis. The first phase of this research defined the identifying units of analysis in the volume of available data. The researcher drew a representative purposive sample of the largest European financial services organisations in different EU contexts. In fact, this study described, explained and shed light on the dynamics of corporate governance reporting of three major banks, namely; ING Bank (2014), Deutsche Bank (2015) and UniCredit's (2015). Together these banks's total assets amounted to more than USD3800 billion (Relbanks, 2015).

The researcher conducted an open analysis of these banks' hypertexts as he identified the dominant messages and subject matters within their disclosures. A dictionary-based approach set up a list of categories that were derived from a frequency list of words. The researcher controlled the distribution of words and their respective categories (of their chosen analytical constructs) over the texts. The coding process often involved the interpretation of semantic text, including technical terms and industry jargon. Such a fieldwork approach involved the analysis of organisational processes and practices of social accounting (Adams, 2002; Del Baldo, 2012).

This inferential step uncovered the coded data as it extracted relevant and material information on the European banks' internal factors (organisational structures, internal micro-processes, their corporate characteristics and the general contextual factors. It explained how European corporations in the financial services industry were disclosing their governance procedures and processes following the EU directive 2014/95/EU on non-financial disclosures. In general terms, the analysis of the European banks' governance disclosures involved a meaningful, comprehensive view of the position and performance on issues relating to the diversity in boards, the shareholders' rights, as reported on the duties and responsibilities of internal and external auditors. Specifically, the three case studies scrutinised the organisations' management and supervisory structures in corporate boardrooms; in order to analyse the firms' accountability and transparency toward their stakeholders.

The content analysis methodological stance describes what is being disclosed by the respective entity; but may not necessarily reveal the underlying motives for the observed pattern (i.e. 'what' is reported, but not 'why'). This qualitative approach possesses its inherent limitations. For this reason, the researcher has taken preventative steps to ensure the reliability and validity of his findings. The researcher annotated the "underlying themes" and interpreted them through a standardised content analysis grid that has facilitated the coding process. This grid was consistently used across all cases during the data gathering process. This stratagem has helped the researcher to identify the general themes of the corporate governance reports of the three bank and to make comparisons and generalisations of their disclosures.

# 5 Analysis of the Non-financial Disclosures of Corporations in Financial Services

## *5.1 ING Bank*

ING Groep N.V. (that is being referred to as ING) is a global financial institution with its base in Amsterdam, Netherlands. At the time of this study, the company had more than 52,000 employees in over 40 countries. Every year, ING reports about its corporate governance policies and practices to the Monitoring Committee (also known as the 'Frijns Committee'). For the record, the Monitoring Committee's "Dutch Corporate Governance Code" became effective as of the 1st January 2004. This "Code" consists of the principles and related best-practice provisions that are intended for all companies whose registered offices are in the Netherlands and whose shares or depositary receipts for shares have been admitted to a listing on a stock exchange, or more specifically to trading on a regulated market or a comparable system. This Code is intended for all large undertakings (with a balance sheet value >500 million €) and whose shares or depositary receipts for shares have been admitted to trading on a multilateral trading facility or a comparable system (DCGC, 2016).

The Code contains principles and best practice provisions that regulate relations between the management board, the supervisory board and the shareholders (i.e. the general meeting of shareholders). Compliance with the Code's principles is in accordance with the 'apply or explain' principle. In other words, the principles and best practice provisions of the Code must be applied unconditionally or an explanation ought to be given for any departure from them. The Code is divided into five chapters: compliance with and enforcement of the Code; the management board; the supervisory board; the shareholders and the general meeting of shareholders; the audit of the financial reporting and the position of the internal audit function and the external auditor.

ING Group complies with these provisions on an annual basis. In its General Meeting, ING expressly indicates to what extent it has applied the best-practices in this code. If it did not do so, the company is bound to explain why and to what extent it has not applied these provisions. ING has a two-tier board structure consisting of the Executive Board and the Supervisory Board. ING's Executive Board (Management Board) is responsible for day-to-day management of the business as well as its long-term strategy. ING's management board is accountable to the supervisory board and to the general meeting, whilst taking into consideration the interests of the company's stakeholders (ING, 2014). It is responsible for managing the risks associated with the company activities, for financing the company, and to control systems (for monitoring and reporting) in liaison with the supervisory board and the audit committee.

The Supervisory Board is responsible for controlling management performance and advising the Executive Board. It comprises outside directors who are involved in five permanent committees: the Audit Committee, the Risk Committee, the Remuneration Committee, the Nomination Committee and the Corporate Governance Committee. All committees are totally independent of ING as each committee has its own charter which describes the powers and duties that have to comply with applicable regulation, such as the US Sarbanes-Oxley Act. For example, one of the remits of the supervisory board is to determine the level and structure of the remuneration of the members in the management board. This board also takes into account; the results, the share price performance and non-financial indicators that are relevant to the long-term objectives of the company, with due regard to relevant risks.

The shareholders are not only interested in getting their return on investment, but they also have a say in the decision-making of ING bank. In fact, they are entitled to voting rights. Each share in the capital of ING Groep N.V. gives entitlement to cast one vote. Shareholders and depositary-receipt holders may exercise their voting rights even if they do not attend a shareholders' meeting. They can enable a proxy to a third party to do so on their behalf. The shareholders have the right to appoint and dismiss members in the executive and supervisory boards during ING's general meeting. According to the Dutch Financial Supervision Act, the shareholders and holders of depositary receipts of ING Groep N.V. are required to provide updated information on their holdings once they cross threshold levels of 3%, 5%, 10%, 15%, 20%, 25%, 30%, 40%, 50%, 60%, 75% and 95%. The shares granted to the members in the management board members shall be retained for a period of at least 5 years or until at least the end of their employment (if this period is shorter). The number of shares to be granted is dependent on the achievement of their previously set targets.

The corporate audit services (CAS) is ING's internal audit group that services ING Bank and the ING Group. It reports to the Executive Board and the Audit Committee and is present at the meetings of the Audit Committee. CAS's mission, its scope of work, its authority and responsibilities are laid down in the Internal Audit Charter that is endorsed by the CEO or Executive Board. Finally, it is also approved by the Audit Committee. CAS's mission is to provide an independent

assessment of the design and effectiveness of internal controls over the risks to ING's business performance. In carrying out this work CAS provides specific recommendations toward improving the governance, risk management, internal control systems and regulatory compliance processes. The budget for CAS operations is approved by the Audit Committee on an annual basis. CAS's annual risk-based audit plans for ING Bank and ING Group are reviewed by the Executive (Management) Board and approved by the Audit Committee. CAS also initiates a periodic exchange of its risk analysis and audit planning results with the external auditor. It submits periodic reports, with key performance indicators (including audit plan realisation and implementation of recommendations) to the Audit Committee and Executive (Management) Board. This includes an annual report on the adequacy and effectiveness of ING's systems of control, which comprise a summary of internal audit activity results and key issues. CAS is subject to an independent quality review at least every 5 years.

The Dutch law requires that the company's external auditors should be appointed at the general meeting and not by the audit committee. The external auditor performs the audit on the consolidated financial statements of ING Groep N.V., ING Bank N.V. and the statutory financial statements of their subsidiaries. In this role, the external auditor attends meetings of the Audit Committee and is present during the annual General Meeting of Shareholders (AGM). As part of the audit engagement, the external auditor issues a management letter to the Executive (Management) Board and the Audit Committee, which identifies (potential) issues pertaining to the adequacy and effectiveness of the governance, risk and control framework. ING's Supervisory Board will make recommendations to the AGM once every 4 years for the appointment of a prospective external auditor. ING's policy requires the auditor to provide the Audit Committee with a full overview of all services provided to ING Group, including related fees that should be supported by detailed information. This overview is evaluated on a quarterly basis by the Audit Committee.

In contrast to the Sarbanes-Oxley Act of 2002, the Dutch Corporate Governance Code contains a 'comply-or-explain' principle. This is consistent with the latest EU (2014) directive. Therefore, any deviations to the code are permissible as long as they are reasonably explained. When these deviations are approved by the general meeting, the company is deemed to be in full compliance with the Code.

## *5.2 Deutsche Bank*

Deutsche Bank AG is a global financial services corporation that has its headquarters in Frankfurt, Germany. It is a listed company and has more than 100,000 employees in over 70 countries. Therefore, Deutsche Bank is subject to the essential statutory regulations of the German Corporate Governance Code. This Code describes the legal regulations for management and the supervision of German listed companies, as per Aktiengesetz (German Stock Corporation Act). Other

elements of the Code are derived from international and national-acknowledged standards for good and responsible corporate governance. These are presented as principles in the form of recommendations and suggestions that are not mandatory. For instance, the Deutsche Corporate Governance Kodex recommends that the amount of compensation for the Management Board members is to be capped, both overall and with regard to variable compensation components. In 2014, Deutsche Bank AG did not set a cap (limit) for the pay-out amount of the deferred equity-based compensation, so it has not complied with the Code's recommendation in No. 4.2.3 (2) sentence 6. Any deviations from the recommendations ought to be explained and disclosed with the annual declaration of conformity (as per the EU's Comply or Explain principle). Besides giving reasonable recommendations and suggestions that reflect the best practice of corporate governance, the Code aims at enhancing the German corporate governance system's transparency and comprehensibility, in order to strengthen the confidence of international and national investors, clients, employees and the general public in the management and supervision of German listed companies (DCGK, 2016).

Deutsche Bank complies with the German Corporate Governance Code as per section 161 of the German Stock Corporation Act. The Code clarifies the obligation of the Management Board and the Supervisory Board to ensure the continued existence of the enterprise and its sustainable creation of value in conformity with the principles of the social market economy (interest of the enterprise). The Supervisory Board appoints, supervises and advises the members of the Management Board and is directly involved in decisions of fundamental importance to the enterprise. The members of the Supervisory Board are elected by the shareholders at the General Meeting. The Supervisory Board of Deutsche Bank must be composed in such a way that its members as a group possess the knowledge, ability and expert experience to properly complete its tasks. In particular, the Supervisory Board members should have sufficient time to perform their mandates. The composition of the Supervisory Board shall have an adequate number of independent members and shall not have more than two former members of the Management Board of Deutsche Bank AG. The Supervisory Board has established the following seven standing committees, including; a Chairman's Committee; a Nomination Committee: an Audit Committee; a Risk Committee, an Integrity Committee; a Compensation Control Committee and a Mediation Committee (Deutsche Bank, 2015).

The Management Board submits to the General Meeting the Annual Financial Statements, the Management Report, the Consolidated Financial Statements and the Group Management Report. The General Meeting resolves on the appropriation of net income and the discharge of the acts of the Management Board and of the Supervisory Board and, as a rule, elects the shareholders' representatives to the Supervisory Board and the auditors. Furthermore, the General Meeting resolves on the content of the Articles of Association, including: the purpose of the company; inter-company agreements and transformations; the issuance of new shares, convertible bonds and bonds with warrants; as well as the authorisation to purchase

own shares. It also authorises the remuneration system for the members of the Management Board.

The shareholders exercise their rights before or during the General Meeting. In principle, each share carries one vote. There are no shares with multiple voting rights, preferential voting rights (golden shares) or maximum voting rights (Deutsche Bank, 2015). When new shares are issued, shareholders, in principle, have pre-emptive rights corresponding to their share of the equity capital. Each shareholder is entitled to participate in the General Meeting to take the floor on matters on the agenda and to submit materially relevant questions and proposals. At least once a year the General Meeting is to be convened by the Management Board giving details of the agenda. The convening of the meeting, as well as the reports and documents, including the Annual Report, required by law for the General Meeting are to be made easily accessible to the shareholders on the company's internet site together with the agenda. If a postal vote is offered, the same applies to the necessary forms. Deutsch Bank facilitates the personal exercising of shareholders' voting rights and the use of proxies. The Management Board could arrange for the appointment of a representative to exercise the shareholders' voting rights in accordance with relevant instructions. This representative should also be reachable during the General Meeting. The company also makes it possible for shareholders to follow the General Meeting using modern communication media (e.g. through the Internet). Beyond Deutsche Bank's statutory obligations to report and disclose dealings in shares of the company without delay, the ownership of shares in the company or related financial instruments by the Management Board and Supervisory Board members shall be reported if they exceed 1% of the shares issued by the company. If the entire holdings of all members of the Management Board and Supervisory Board exceed 1% of the shares issued by the company, these shall be reported separately to the Management Board and Supervisory Board in the Corporate Governance Report.

Prior to submitting a proposal for election, the Supervisory Board or, respectively, the Audit Committee shall obtain a statement from the proposed auditor stating whether, and where applicable; which business, financial, personal and other relationships exist between the auditor and its executive bodies and head auditors on the one hand, and the enterprise and the members of its executive bodies on the other hand, that could call its independence into question. This statement shall include the extent to which other services were performed for the enterprise in the past year, especially in the field of consultancy, or which are contracted for the following year. The Supervisory Board shall agree with the auditor that the Chairman of the Supervisory Board or, respectively, the Audit Committee will be informed immediately of any grounds for disqualification or partiality occurring during the audit, unless such grounds are eliminated immediately. The Supervisory Board commissions the auditor to carry out the audit and concludes an agreement on the latter's fee. The Supervisory Board shall arrange for the auditor to report without delay on all facts and events of importance for the tasks of the Supervisory Board; which arise during the performance of the audit. Deutsche Bank's Supervisory Board shall arrange for the auditor to inform it if during the performance of the

audit, the auditor comes across facts which show a misstatement by the Management Board and Supervisory Board on the Code. The auditor takes part in the Supervisory Board's deliberations on the Annual Financial Statements and Consolidated Financial Statements and reports on the essential results of its audit (Deutsche Bank, 2015).

### *5.3 UniCredit*

UniCredit S.p.A is an Italian commercial bank operating in 17 countries with over 144,000 employees, in an international network that spans 50 markets. Its joint stock company adopts the so-called traditional management and control system. This system is based on the existence of two corporate bodies; the Board of Directors and the Board of Statutory Auditors. The Board of Directors supervise and manage the company, whereas the Board of Statutory Auditors oversees the management. Moreover, the accounting supervision is entrusted to an external auditing firm. UniCredit's overall corporate governance framework has been defined in its current provisions that reflect the recommendations of the Corporate Governance Code for listed companies (Borsa Italiana, 2015). Each Italian company with listed shares (the "issuer") follows this "Code". They are expected to disclose their corporate governance report and proprietary shareholdings with accurate, concise, exhaustive and easily understandable information. This is synonymous with the EU's (2014) comply or explain directive as each single recommendation contained within the principles and criteria ought to be implemented during the period covered by the report. The corporate governance disclosures should; (a) explain in what manner the company has departed from the recommendation; (b) describe the reasons for the departure, whilst avoiding vague and formalistic expressions; (c) describe how the decision to depart from the recommendation was taken within the company; (d) where the departure is limited in time, explain when the company envisages complying with a particular recommendation; (e) if it is the case, describe the measure taken as an alternative to the relevant non-complied recommendations and explain how such alternative measure achieves the underlying objective of the recommendation or clarify how it contributes to their good corporate governance (Unicredit, 2015).

The main principles of the Italian code specify the rights, duties and responsibilities of various stakeholders, including; the directors, statutory auditors and shareholders among others. All the members of the Board of Directors and the Board of Statutory Auditors are appointed by the Shareholders' Meetings on the basis of a proportional representation mechanism (*voto di lista*). This voting system features lists of candidates competing against one another in order to ensure the election of minority shareholders representatives. UniCredit's boards have to comply with specific rules concerning the appointment of their members in accordance with the gender composition criteria provided for by law (see Clauses 20 and 30 of the Articles of Association). They also cover professional experience, integrity and

independence requirements. As regards the appointment and the requirements of the Board of Statutory Auditors members, it must be pointed out, *inter alia*, that: UniCredit's Articles of Association stipulate that two permanent auditors as well as two stand-in ones are reserved to the minorities and that the Chairman is appointed by the Shareholders' Meeting among the auditors elected by the minorities. In addition, at least two permanent auditors and one stand-in auditor must be listed in the national Rolls of Auditors; which must have carried out the legal auditing of accounts for a period of no less than 3 years (Unicredit, 2015).

The Directors' term of office spans three operating years, except where a shorter term is established at the time they are appointed, and ends on the date of the Shareholders' Meeting that is convened for the approval of the accounts (relating to the last operating year in which they were in office). The Executive Management Committee has been set up to ensure the effective steering, coordination and control of the group's undertakings. The Ordinary Shareholders' Meeting appoints five permanent Statutory Auditors, from whom it also elects the Chairman and four substitute Auditors. The permanent and substitute Auditors may be re-elected. The Chairman of the Board of Statutory Auditors is appointed by the Shareholders' Meeting from among the permanent Auditors that are elected by the minority shareholders. The Supervisory Body pursuant to Legislative Decree 231/2001 prescribes the establishment of an internal Supervisory Body. Its duty is to supervise the organisation's compliance with responsible corporate governance. The Supervisory Body of UniCredit consists of five members, including two external members and three executives in "apical" positions with guidance, support and control functions.

The Internal Control System (ICS) involves a set of rules, procedures and organisational structures. ICS aims to ensure that corporate strategy is implemented through effective corporate processes. It strives to ensure the reliability and integrity of accounting and management data. UniCredit's Group Risk Management (GRM) function ensures that there is regulatory compliance as it manages risk, including; credit risk, market risk, liquidity risk and operational and reputational risk. UniCredit's Internal Audit Department verifies the conformity of the group companies' conduct with the Parent Company's guidelines as it monitors the effectiveness of internal control systems.

The shareholders' meetings are called on to pass resolutions pursuant to the terms and conditions that are laid down in the bank's Articles of Association. In Ordinary Sessions, the shareholders' meetings are convened at least once per year, within 180 days of the end of the financial year, to pass resolutions on topics over which they have jurisdiction. Specifically, in an ordinary session, the shareholders' meetings are called upon to approve the balance sheet and to resolve on the allocation of the profit, appoint directors and statutory auditors, and appoint external auditors for statutory certification of the accounts. Additionally, the shareholders' meetings are called upon to pass resolutions on any early termination of the directors or auditors, or on the termination of the appointment of external auditors for the statutory certification of the accounts. Moreover, ordinary session shareholders' meetings also approve: (i) the remuneration policies for supervisory,

management and control bodies as well as for employees; (ii) equity-based compensation schemes. Shareholders' meetings are convened in extraordinary sessions as and when required to pass resolutions on any of the issues over which they are empowered (pursuant to applicable law). Specifically, in extraordinary sessions, the shareholders' meetings pass resolutions on amendments to the Articles of Association and on transactions of an extraordinary nature such as capital increases, mergers and demergers.

Both ordinary and extraordinary shareholders' meetings are convened, according to law, via a notice published on the company's website and through the other methods envisaged by both legal and regulatory provisions. The Board of Directors shall publish a report at the Company's registered office, on its website, and through the other channels on each item on the agenda and make the said report publicly available. The Chairman of the Shareholders' Meeting is fully empowered to moderate the meeting proceedings in compliance with the principles, terms and conditions established by the provisions in force, as per the General Meeting Regulations. All those who hold voting rights are eligible to attend the shareholders' meetings. Any person that is entitled to vote may choose to be represented in a shareholders' meeting by proxy. These shareholders have to indicate the name of one or more possible representative's substitutes.

Shareholders who, even jointly, represent at least 0.50% of the UniCredit share capital, may ask for the shareholders' meeting agenda to be integrated and/or to submit resolution proposals on items already on the agenda (according to the cases, methods, terms and conditions outlined in Section 126-bis of the Legislative Decree no. 58/98 and in the Articles of Association). The requests, together with the documentation certifying the ownership of the shareholding, must be submitted in writing. Shareholders requesting additions to the agenda must prepare a report stating the reasons for their resolution proposals on the new matters they propose for discussion; such report shall be forwarded to the Board of Directors by the final deadline for the submission of the request for addition. Questions received by the Company prior to the Meeting shall be answered—subject to the right thereto being ascertained—during the Meeting itself at the latest. The Company is entitled to provide a single answer to questions on the same subject matter (UniCredit, 2015).

## 6 Discussion

This contribution has reported that the European banks are following specific national provisions that have introduced industry codes of conduct. Notwithstanding, these financial institutions are also complying with the EU's directive 2014/95/EU. The comply or explain directives can be seen as providing market-based solutions that may suit both the company and its shareholders without the need for regulatory intervention. This voluntary instrument is based on shared beliefs and institutional arrangements with stakeholders. The corporations that do not comply

with the codes are expected to explain how their actual practices are consistent with responsible corporate governance and the achievement of their business objectives.

In a similar vein, institutional arrangements need to ensure that explanations are credible to the regulatory authorities. These arrangements may relate to different corporate governance matters, including; ownership issues, the role of intermediaries, shareholder rights and engagement, stock markets and the incentives that all these arrangements create. Institutional arrangements will determine whether shareholders will play the stewardship role expected of them in a comply-or-explain scenario. They are expected to challenge companies' explanations and engage with boards if they are unconvincing to them. For example, there are provisions (pertaining to the comply-or-explain methodology) which suggest that the roles of the chairman and chief executive should not be exercised by the same individual; the board should appoint a senior independent director; at least half the board, excluding the chairman should comprise independent non-executive directors; there should be nomination, audit and remuneration committees and separate sections of the annual report to describe the work of the nomination and audit committees; and the directors should have access to independent professional advice and the services of the company secretary, among other issues.

Therefore, the comply or explain is an approach that positively recognises that an alternative to a provision is justified if it achieves good governance. At the same time, companies are prepared to be as accountable and transparent as possible. Departures from a code provision are not presumed to be breaches because accompanying explanations should provide insight into how companies think about improving their corporate governance. Reportedly, the three European banks did not specify the details on certain matters, including; the remuneration benchmarking exercise, data collection regarding high earners, assessment of the suitability of members of the management body and key function holders, and their internal governance matters.

In this light, the European Banking Authorities (EBA) will shortly collect data on remuneration benchmarking, as it shall gather relevant information on the number of natural persons earning EUR 1 million or more per financial year (EBA, 2014a, 2014b). This data collection aims at ensuring a high level of transparency regarding the remuneration practices within the EU. These guidelines will be used to benchmark trends and practices. In addition, there are other guiding principles that set out the process, criteria and minimum requirements for assessing the suitability of members of the management body and key function holders (EBA, 2015). These recommendations followed EBA's (2011) guidelines on internal governance of institutions and the banking systems, as a whole. This document was primarily aimed at enhancing and consolidating supervisory expectations, and to ultimately improve the sound implementation of internal governance arrangements. In this case, this research reported how the three banks have thoroughly explained their organisational structure with well defined, transparent disclosures about their board members' lines of responsibility. They also demonstrated that they had set effective processes to identify, manage, monitor and report the potential risks that they might be exposed to. Notwithstanding they all described

their internal control mechanisms to a certain extent. Perhaps, there were minor reporting deficiencies in terms of oversight of the supervisory function, risk management and internal control frameworks coupled with the riskiness of the products and services they offer. Nevertheless, the three banks have provided details on their sound administrative and accounting procedures. They also shed light on how they determine and structure their remuneration policies.

Arguably, further reforms may help to strengthen the oversight and management of European banks. For instance, the potential conflicts of interest of directors and controlling shareholders in governing bodies as well as the cross-appointments within financial institutions could be deterred and prevented with clearly laid-out policies in this regard. Responsible corporate governance necessitates due diligence at all times, particularly on controlling shareholders. These case studies have shown that at the moment there are stringent regulations on lending parties among other issues. There was mention of certain requirements for board qualification and composition. Interestingly, the latest EU directive has also brought up the subject of diversity at the corporate board levels. It has recommended specific criteria that were aimed at fostering wider diversity in the composition of boards (e.g. age, gender, educational and professional background). The EU Commission has even suggested that this transparency requirement complements the draft directive about the presence of women on boards.

Debatably, most of the recent provisions could be perceived as 'over-prescriptive' by certain European entities; as large undertakings are expected to incorporate externalities to enhance activism toward responsible corporate governance (Acharya & Volpin, 2010). Of course, any restrictions on ownership and voting rights (one member-one vote) could possibly weaken market diligence and the bank's capacity to raise capital from outside sources. For this reason, many jurisdictions are increasingly protecting their minority shareholders. For example, in the Netherlands, the minority shareholders are entitled to present lists of Board candidates when they own a minimum amount of share capital. In the Italian context, the banks' by-laws will establish relevant mechanisms according to how the board seats are distributed among slates (Borsa Italiana, 2015). Generally, the slate receiving the highest number of votes takes all the board seats, but the quota reserves at least one seat for the minority shareholders. In this case, the representative of the minority shareholders chairs the internal control body in Italy. There are instances where corporations could decide to get around responsible corporate governance requirements relating to fiduciary duties, executive salaries, and the divulgation of the entities shareholders' identity and their voting rights, tax incentives, loyalty dividends, among other issues. Notwithstanding, there are other contentious matters including; preventing human rights abuses and/or fighting corruption and bribery (EU, 2014).

## 7 Conclusions and Implications

The past EU directives and recommendations on corporate governance disclosure requirements; shareholder rights and non-financial accounting for the listed companies were implemented across all European states. Moreover, many states, including Germany, Italy and the Netherlands have recently transposed the latest EU (2014) directive. The underlying rationale behind such a European directive was that corporate governance policies have an important role to play in achieving the broader economic objectives with respect to investor confidence, capital formation and allocation. Responsible corporate governance affects the cost for corporations to access finance for their growth prospects. Notwithstanding, the responsible principles could safeguard the stakeholders' rights (particularly shareholders' rights). Ideally, all stakeholders ought to be treated in fair, transparent and equitable terms. The EU's corporate governance principles are providing a comprehensive framework that reassures shareholders that their rights are protected. This is of significant importance in today's globalised capital markets. International flows of capital enable companies to access financing from a much larger pool of investors. If companies and countries are to reap the full benefits of the global capital market, and if they are to attract long-term "patient" capital, corporate governance arrangements must be trustworthy, well understood across borders and adhere to internationally accepted principles. Even if corporations do not rely on foreign sources of capital, a credible corporate governance framework, supported by effective supervision and enforcement mechanisms; will help foster confidence in domestic investors, reduce the cost of capital, strengthen the good functioning of financial markets, and ultimately induce more stable sources of financing.

There is no single model of good corporate governance. However, the guiding principles including the EU's Directive on Disclosure of Transparency 2013/50/EU and the EU's Directive on Non-Financial Disclosures 2014/95/EU (2014) underpin responsible corporate governance in Europe. However, responsible corporate governance principles are non-binding and are not intended as prescriptions for national legislation. These principles seek to identify objectives as they suggest various means for achieving them. The European corporate governance principles aim to provide a robust, yet flexible reference for policy makers and market participants to develop their own frameworks for corporate governance. To remain competitive in a changing world, corporations must innovate and adapt their corporate governance practices. This way, they can meet new demands and grasp new opportunities. The European governments have an important responsibility for shaping an effective regulatory framework that provide sufficient guidelines and flexibility that allow markets to respond to new stakeholders' expectations. The EU directives are widely used as a benchmark by individual European states. The principles themselves are evolutionary in nature and are reviewed in the light of significant circumstantial changes that may arise in corporate governance. This contribution suggests that effective corporate governance frameworks are critical to

the proper functioning of the banking sector and the respective macro economy as a whole. It reported how the three major European banks and their supervisors are operating to achieve robust and transparent risk management as they promote public confidence in their board committees. This way they uphold the safety and soundness of the European financial services industry.

## 8 Limitations and Future Research Avenues

There are many factors that could influence the companies' active engagement in corporate governance behaviours and their adequate disclosure in annual reports. The composition of the decision-making bodies and the way how they define their activities could be considered as challenging in terms of both accountability and transparency toward stakeholders.

Although, all member states are transposing new EU directives; to date, there are no specific, obligatory requirements in relation to the type of non-financial indicators and metrics that should be used as a yardstick for corporate governance disclosures. Moreover, there is a need for further empirical evidence that should analyse how the European principles may (or may not) affect other large undertakings, including state-owned organisations or non-governmental organisations. For instance, IMF (2013) reported a challenging issue facing many financial services firms. It reported that foundations constitute one of the major shareholders in banks. Apparently, they hold 20% or more of bank capital in Italy. Therefore, these foundations can control boards with a small share of ownership, often through shareholders' agreements. On the other hand, in Anglo-Saxon countries, foundations are increasingly investing in a broadly diversified range of sectors and are not inextricably linked to the ownership of the banks' shares (IMF, 2014). Their board members typically include investment experts, professors, researchers, and professionals, thereby allowing for a wide range of specific knowledge. They often mandate an Investment Committee that is made up of investment professionals, that are supervised by the Boards; to draft investment policies as they set investment targets (IMF, 2014).

In conclusion, this exploratory research shed light on the corporate governance policies of three major international banks, operating in the European context. Hence, further research may use other methodologies and sampling frames. Future research avenues exist on corporate governance disclosures in different industry sectors. This research has analysed three corporate governance codes out of twenty-eight member countries within the European Union. A wider selection of countries could have probably given a better understanding of how different contexts could have transposed the EU's (2014) directive. This contribution has clearly indicated that there are external forces, including institutional factors that can influence and shape responsible corporate governance and their disclosures. Future research could also explain how internal pressures such as shareholder activism could restrain or alter the organisations' actions.

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# Perspectives on the Integration of Corporate Governance in Equity Investments: From the Periphery to the Core, from Passive to Active

**Mikkel Skougaard**

## 1 Introduction

Historically, non-financial data, including corporate governance, was not considered in mainstream equity valuation methodologies, analysis and investments. However, past as well as recent corporate scandals have led to a rising acknowledgement within the investor community that governance factors may have the potential to affect corporate performance and by extension corporate valuation. And although far from universally accepted, an increasing number of mainstream investors are gradually incorporating corporate governance factors (agency risk) into their equity investment processes. However, different approaches with very different purposes remain among the investor community to corporate governance integration.

Two main activities demonstrate, more than any other the integration of corporate governance in equity investments. On the one hand, the increasing incorporation of governance factors alongside financial ones at the onset of an investment process and subsequent stock selection in actively managed portfolios as investors seek valuable sources of risk-related information and/or excess returns: From the Periphery to the Core. Whilst on the other hand, the increasing number of investor engagements with portfolio companies on a wide range corporate governance matters, partially explained by the rise of index tracking investments, as investors seek to fulfill their stewardship responsibilities with the purpose of realizing change through dialogue, confrontation, voting, or a combination of these: From Passive to Active.

This short paper aims to provide perspectives on the wide spectrum of different methods applied by investors when seeking to integrate corporate governance in

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their equity investments, highlighting the pitfalls and benefits attached to each approach.

## 2 Misunderstandings in Sustainable and Responsible Investments

The emergence of sustainable and responsible investments, and more recently, the rise of the integration of non-financial information in the investment process (including corporate governance) have led to the rise of a wide number of industry names and acronyms, which for an outsider, can often be confusing. Responsible Investment (RI), Socially Responsible Investment (SRI), Impact Investing, Environmental, Social and Governance (ESG) investing or integration, and even Corporate Social Responsibility (CSR) are some of the names that are often used interchangeably, and wrongly. Although they may all sound similar, there are fundamental differences between them as they represent markedly different approaches to investment and clearly need to be distinguished.

The primary differentiator between the SRI or RI type of investments and ESG is purpose (Hawley, Kamath, & Williams, 2011). SRI is in essence driven by ethical and moral imperatives, as the investor aims to match his or her believes with his or hers investment decisions, which means that the investor will consider both future returns and the social good when investing, and may be willing to sacrifice returns to meet those goals (although there is evidence to suggest that SRI related investing at times yield higher returns). SRI types of investments can both be positive through investment that targets and favours corporations that have strong records in a particular area such as labour relations or low emissions (a.k.a. inclusionary or positive screening), but can also be negative through the exclusion of certain industries like tobacco or weapon manufacturers (a.k.a. exclusionary or negative screening). On the other side of the spectrum, ESG integration is driven solely by economic imperatives. ESG integration aims at determining the potential impact of environmental, social and governance factors (risks) on the future performance of the company and by extension its valuation.

**Separating the G from the E and S**

From a very early stage, the integration of non-financial with the means of assessing and more accurately pricing risk has been bundled together in what is commonly known as ESG. However, a blanket, non-differentiated approach to ESG integration across multiple equities is flawed for two reasons. First because E, S and G represent different risks, as the Environment represents an externality risk, the Social aspect represents a reputational risk, whereas Governance represents an agency risk for the investor. The second reason why bundling ESG integration across equities might be flawed is because E and S tend to be, to a large extent, sector specific, whereas G is sector neutral, or sector agnostic. Good governance, or for that matter, bad governance, tends not to discriminate between sectors, nor do

specific sectors need better governance than others. The point being that any sector needs good governance, just as any company, regardless of the sector, will be affected by poor corporate governance.

This short paper will only deal with the integration of Governance into equity investing, and will neither deal with any SRI type investments nor the integration of E or S.

## 3 The Integration of Corporate Governance into Equity Investing

Fund managers, and analysts supporting them, are aware of factors that can *affect* a security's *value*. *O*perational, financial, industrial and macroeconomic are all familiar factors that impact the future value of an investment and are at the core of fundamental analysis. However, factors that are challenging, not only to measure, but ultimately to quantify, and that do not form part of traditional financial metrics, such as corporate governance (or agency risk), have likewise the capacity to affect the risk and return of investments. Non-financial measures, incl. corporate governance, have historically, for most investors, belonged to the periphery of fundamental analysis, if included in any analysis at all.

However, past as well as recent corporate scandals have led an increasing number of institutional investors, fund managers and analysts to incorporate corporate governance factors alongside financial ones in their equity investments. Motivated by economic imperatives, portfolio managers and analysts as well as governance specialists working closely with these two are attempting to capture the effects of corporate governance and the impact that it may have on the financial performance of the company they are analyzing, the impact it may have on the value of the security and the overall risk to the portfolio.

The process of integrating agency risk basically attempts to determine, to the extent that is possible, the impact that a firm's corporate governance may have on performance and by extension on asset pricing. Although quantifying in monetary terms the potential impact of agency risk may be difficult, such integration may, everything else being equal, achieve a much more comprehensive risk assessment and valuation of the underlying security. Although an increasing body of evidence suggests that better governance results in better performance (Bebchuk, Cohen, & Ferrell, 2009; Deutsche Bank, 2004; Gompers, Ishii, & Metrick, 2003; La Porta et al. 1999), the evidence linking good corporate governance to performance still remains inconclusive (Bebchuk et al. 2012; Bhagat and Black 1998; Bhagat and Bolton 2009), but there is ample real evidence that poor governance is value destructive, hence why the increasing interest in the matter.

### *3.1 Governance Set-Up Within Institutional Investors*

The increasing interest in the integration of non-financial criteria into the investment process has led to the build-up of resources within institutional investment houses solely dedicated to the purpose and execution of this integration task. The teams responsible for such as task are often given different names within each institutional investor, being labelled anything from ESG Team, Responsible Investment Team, Proxy Team, Stewardship Division, to Corporate Governance Department etc. Yet however different their names may be, these teams have been built to fulfill a largely similar aim, which is ultimately, to integrate, to one extent or another, corporate governance in the investment process. Although their functions can be long and varied, two main activities demonstrate, more than any other the functions of such a team and the subsequent integration of corporate governance in equity investments: before the investment is made (ex-ante) and after the investment has been made (ex-post) (Fig. 1).

1. Ex-ante: Measuring corporate governance risk at the onset of an investment decision (i.e. before deciding whether and/or where to invest), and only applicable to actively managed portfolios. Governance specialist teams will provide a corporate governance risk measurement to the fund manager in the form of a score (more of that later), who in turn will incorporate these corporate governance factors alongside financial ones at the onset of an investment process and subsequent stock selection in their actively managed portfolios (risk identification). Alternatively, integrating corporate governance at the onset may provide the investor with the possibility to build a portfolio containing only those companies with the highest scores in the pursuit of excess returns (alpha generation), or alternatively to build a portfolio that excludes those companies with poor governance scores as the risk is deemed too high (risk minimization).
2. Ex-post: For the purposes of active ownership (engagement and voting) after the investment has been made, which is possible for securities held through both index tracking and actively managed funds, and/or for the purposes of potentially exiting their investment (selling their shares), only possible for actively managed ones. For index tracking funds (passive funds) as well as for actively managed portfolios, governance specialist teams will seek out companies held in

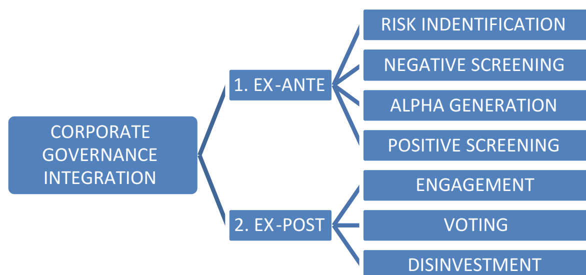


**Fig. 1** Ex-ante vs. ex-post integration. Source: Own compilation

a portfolio and engage the target, with the purpose to understand a potential governance risk, expressing their views to encourage, and in some cases, demand change (engagement), complementing these engagement efforts with voting at shareholder meetings (force through change). Furthermore, continually scoring companies, not only at the onset of an investment, but also once the investment has been made allows for the continuous review of the rise of potential agency risks that may prompt a fund manager to either sell its shares (disinvestment) or to engage on the matter, the latter an alternative option to selling shares, although the choice of either will ultimately depend on the circumstances and the fund manager.

These corporate governance teams will usually be positioned within the equities investment department and are placed physically close to portfolio managers. There will always be some degree of separation between the fund managers and the governance specialists, either down to potential conflicts of interests, or the ability to shield fund managers from insider information. But the separation comes down mostly to the fact that corporate governance integration is a specialist function in and by itself, and therefore considered best left to governance analysts, especially when it comes to proxy voting. However a level of cooperation and integration between the two camps does exist, although the strength of this varies very much from investor to investor.

One common aspect among large institutional investors is that governance integration tasks have been handed over to governance specialists as opposed to the fund manager themselves. Although the ideal situation would be for fund managers themselves integrated governance risk, meaning that corporate governance would be fully integrated into the investment process, but the reality is that such a scenario, whilst ideal, is still a distant reality.

## 4 From the Periphery to the Core

The active integration of corporate governance risk into the investment decision making process (ex-ante) is only possible for those fund managers who hold actively managed portfolios, as the integration of corporate governance risk alongside traditional metrics is only possible for those of actively considering alternative investment targets. Furthermore, corporate governance integration is especially motivating for those active investors who invest in the long-term, as long term investors tend to be more exposed to the effects of poor corporate governance on performance over time, as the build-up and the potential negative eruption of these effects tend to take place over time.

**Quantifying the Unquantifiable?**

However, the process of integrating corporate governance into an investment decision before such a decision is made is inherently complicated. When trying to estimate the value of the security, the portfolio manager will usually apply a range

of traditional, quantitative, measureable, standardized, industry-recognized and accepted metrics and benchmarks, providing him or her with the capacity to track financial and operational performance and, ultimately, returns. However, when it comes to integrating corporate governance alongside these metrics, the undertaking of trying to quantify agency risk becomes rather challenging.

Driven by a desire for measurability, the portfolio manager, the corporate governance specialist team, or both, will attempt to reach a quantified output (numerical score), but will be doing so by applying mostly qualitative input. The difficulty faced by those attempting such integration is twofold. On the one hand, there is the difficulty of having to assign an economic value to mostly qualitative factors (board independence, incentive schemes, auditor independence etc.). On the other hand, the varying levels of disclosure and often very limited disclosure of governance factors, especially for companies in emerging markets, makes the process even more challenging.

Corporate governance, the effect it has on decision making within a firm, the associated risk, and its effect on performance and valuation is ultimately the outcome of a complex web of relationships between the shareholders, the board and the management, all under the influence of a set of national and increasingly supranational laws, regulations, codes and cultural norms, making it even more complex to understand, let alone quantify. Furthermore, the ultimate corporate governance risk, the one that is simply impossible to quantify ex-ante relates to human behavior. According to the Principal-Agent (Investor-Executive) theory (Berle & Means, 1932; Jensen & Meckling, 1976) that has historically served as the basis for research, debate, law making and shareholder understanding of governance risks, the interests between the two sides may, and often do, diverge as the principal (the executive) is driven by self-interest with little regard for what is best for the agent (the shareholders). The principal, so the theory goes, will pursue his or her own interests ahead of those of the agent, and given the opportunity, the management will maximize their own individual wealth at the expense of the shareholders. Although arguably this is a minority phenomenon, the tail risk (the risk or probability of rare events) in corporate governance will arguably always lie in human behavior and decision making, and therefore outliers and other large scandals will not be possible to capture through any form of integration either ex-ante or ex-post.

Yet despite the challenges faced in quantifying corporate governance risk, some level of quantification, along with subjective interpretation of the governance risk of a specific corporation is necessary in order to achieve at least some measure of risk, as all things equal, a better understanding of corporate governance risk should lead to a more comprehensive investment analysis and subsequently a more informed investment decision.

### 4.1 The Ratings Game

During the last years, in light of the number of corporate scandals, the subsequent destruction of value created by poor governance and the increasing attention that this has created, it is not surprising the considerable the attention and significant resources that have been devoted by investors in seeking to develop a method that will aid with the analysis, measurement and capturing of agency risk. The quest for such measurement has led a number of corporate governance services providers to create corporate governance ratings (or indexes) using a wide number of corporate governance factors by which to measure agency risk. These ratings, whose final risk measure (or score) fusions into a single number, are offered to institutional investors as aid to their corporate governance integration efforts, either at the onset of an investment (ex-ante), or after the investment has been made (ex-post). Although the factors applied by such rating agencies vary, there are a number of typical KPIs that are usually applied in the rating irrespective of the provider. Some of these KPIs are as follows (Table 1):

As highlighted above, there is a variety of KPIs that are usually included and typically applied as measure of how well the investor is protected through various channels such as equal treatment of shareholders, accountability, transparency, overall alignment etc. A wider range of measures allows the fund manager and the corporate governance team to highlight potential risks that might otherwise go undetected (not analyzed), and which could lead to investing in alternative securities with lower risk, lead to potential disinvestment and/or lead to engagement action.

However, a prevalent criticism of these ratings has been based on the generally understood and acknowledged view in corporate governance circles that there is no one-size-fits-all approach. Criticism has been based on the argument that trying to create a uniform set of governance standards to measure and compare agency risk across very different companies is flawed. The main risk is that such a rating approach without any differentiation of the companies that are being analyzed

**Table 1** Governance rating items

| Board structure | Executive remuneration | Audit | Shareholder rights |
|---|---|---|---|
| • Composition<br>• Independence<br>• Diversity<br>• Director election<br>• Policies<br>• Committee composition and independence | • Design<br>• Long vs short term<br>• Use of equity<br>• Transparency of performance metrics and targets | • Auditor fees<br>• Auditor independence<br>• Non-audit fees<br>• Audit rotation<br>• Audit controversies | • Restriction in voting<br>• Dual class shares<br>• Anti-takeover devices<br>• Related party transactions<br>• Bylaws |

Source: Own compilation

can lead to misclassification in the scores, and at worst, making portfolio investment decisions based on a misunderstanding of the risk.

It is often the case that these rating agencies apply a blanket approach to ratings without differentiating. However, this is understandably done so as rating an entire universe of companies on an individual basis often numbering in the thousands cannot be reasonably be done without applying such an approach, especially not if investors are looking for comparability. Another problem lies in the fact that these rating omit, for some reason or other, to look at a key factor. As the list of commonly used KPIs illustrates, none of these rating agencies factor in the ownership structure of the listed corporation they are analyzing, yet they often claim that their ratings models, data and scores help investors to identify governance risk.

For an investor, a main determining corporate governance risk factor is the ownership structure, as this largely determines the risk that investors run when investing in a listed corporation (Bebchuk & Hamdani, 2009). There are fundamental differences in the nature of the agency risk that investors run in controlled and full free float firms, as it is not the same risks that an investor faces when investing in a controlled company (where more than half the issued shares, or votes are controlled by a single shareholder) or a listed company with a full free float where the largest shareholder may hold no more than five percent. In a controlled company with an owner holding more than half the shares, half the votes, or both, the nature of the agency risk is usually concentrated in specific matters often relating to the abuse of minority shareholders, related party transactions, minority shareholder rights, financial tunneling etc. Whereas in a company with a full free float, risks are usually found in matters concerning rent-seeking though executive remuneration, anti-takeover devices, entrenched management etc. The fact that there are fundamental differences in the nature of the agency risk, and the fact that none of these key differences are reflected in either the design or the use of ratings is a systemic weakness leading to incorrect measurement of risk and misranking, and at worst, erroneous investment decisions.

There are however certain governance factors risks that remain neutral to differences in ownership structure, and this correctly includes some of the KPIs used by rating agencies. Items like audit related risk, board composition (independence) and overall transparency are key governance risks irrespective of ownership. However, assigning the same weight to certain KPIs regardless of ownership structure means the investor ends up underweighting the importance of measures that protect them, say in a full free float company, whilst potentially overweighting irrelevant ones in a controlled company (Bebchuk & Hamdani, 2009), anti-takeover devices being an illustrative example.

However, despite the reasonable criticism, despite the agreed view that governance risk is ultimately contextual and dependent on firm specific circumstances, and despite the fact that the degree of predictability of these ratings is at best inconclusive (Bhagat, Bolton, & Romano, 2008; Renders et al. 2010), some level of measurement and comparability of governance risk in a standardized and quantified manner across multiple securities is needed. If anything because the absence of such measurement would make fundamental analysis incomplete, omitting the analysis of certain risks.

### 4.2 *Rating Usage*

Despite the imbedded weakness, the widespread acceptance and use of these corporate governance ratings among institutional investors suggests that there is a general perception of their perceived usefulness, and rightfully so. Very few investors produce their own scores or measurements of governance risk given the resources that such an undertaking would require, especially for those whose investment universe numbers the thousands, as even applying a differentiated analysis (and score) to each corporation would be excessively time consuming and would potentially hinder comparability efforts. Therefore, corporate governance teams, and by extension, fund managers, are heavily reliant on these rating agencies for corporate governance integration, either for the purpose of making portfolio investment decisions (buying or selling), for their active ownership activities (engagement and proxy voting), or both.

## 5 From Passive to Active

As earlier mentioned, according to corporate governance theory the agent (the executive) remains intrinsically opportunistic, in that there is an ever-present possibility of opportunism to the detriment of the principal (the shareholder) unless it is curbed through controls and continuous monitoring (Davis, Schoorman, & Donaldson, 1997). Energy from investors is therefore spent, among other things, controlling for assumed human weaknesses inside those who control the corporation in the form of mismanagement, shirking, rent-seeking etc, and correcting it if necessary. A mechanism that serves to overcome these problems is active ownership through engagement between shareholders and companies. Engagement being understood as direct communication between the investors and the board/ management.

The increasing number of investor engagements with portfolio companies on a wide range corporate governance matters is partially explained by the rise of index tracking investments. But the rise in engagement is likewise explained by the gradual rise of stewardship codes around the globe, encouraging investors to responsibly make use of the rights provided to them. Furthermore, investors are aware that there is an ever greater scrutiny within society and among their client base (asset owners) in how they ensure that the companies that they are invested in on their behalf, act in the best interest of shareholders over time.

Index tracking investors, or colloquially also known as “passive investors”, are invested across the market, and unlike investors pursuing an active strategy (i.e. buying and selling securities on the basis of fundamental analysis), they are not in a position to sell their shares. Passive investors are therefore exposed to every single issue affecting every single company every single day in perpetuity, including management self-interest.

Non-experienced observers to the industry tend to confuse and often misunderstand institutional investors when these invest via index tracking funds, and the role that they play in active ownership (or the lack of it). A surprisingly large number of observers tie passive investment with passive behavior. Such observers argue that since investors are invested in the company it is because the securities they hold belong to a particular index in which the investor owns every security regardless of their view on that specific share, and in the absence of the ultimate sanction possibility (to sell the shares), the shareholder is, as Berle and Means argued although in a somewhat different context, "practically powerless through his own efforts to affect the underlying property" (Berle & Means, 1932).

However, passive investments have nothing to do with passive behavior (Scott, 2014). For passive investors invested through indexed strategies, active ownership through engagement and voting represents the only option for signaling concern to the management of the companies whose securities they hold, and they have arguably therefore the highest incentive to pursue an active ownership strategy with the companies in their portfolios, as they need to ensure that their investments perform, or at least that they do not destroy value. Ultimately however, there are also ownership responsibilities as investors seek to fulfill their stewardship duties towards the asset owners (their clients).

For index tracking investors, it is common for corporate governance teams to be responsible for the active ownership, that is, to carry out the engagements and exercise the voting, as effectively no fund manager is behind the investment, but rather the holding of such a security is the result of an index tracking product. One of the key engagements topics among passive investors are corporate governance related matters. This is especially so as although better corporate governance, however understood, may not necessarily mean better performance, investors are painfully aware that poor governance can be, and usually is, value destructive over time.

Despite the inability to divest their shares, "passive" investors, contrary to popular belief, have the power to yield a considerable amount of influence on the board and the management of the index constituents whose securities they hold. Engagement with the board and the management represents a material process by which passive investors can positively impact the corporate governance structures and practices of the individual companies they own, as they seek for the company to adopt policies and implement mechanisms which align more closely the interest of management with those of shareholders, by either expressing their views with the intention to encourage change (engagement), and/or ultimately forcing through the change (voting).

The value proposition inherited in engagement will largely depend on the investment mandate and the investment strategy pursued by the investor. Not all index tracking investors engage with their investee companies (the reasons vary), the same way not all fund managers running actively managed portfolios automatically sell out if they are concerned with the risk a company is running. Some active managers, especially those taking a long-term view, will prefer to engage with the board and the management to address the issues over the long term, weighting the

potential benefits attached to such an engagement as opposed to selling. When engaging with a corporation's board, being a passive investor can arguably be an advantage, as participants on both sides of the engagement table are aware that a passive investor's investment is likely outlive both the board and the management, providing the shareholder not only influence, but a strong and genuine argument for long-term fundamental change. But just as was the case with corporate governance integration before the investment is made, the main challenge for governance specialists and fund managers is to precisely quantify the value created by their engagement efforts, a highly complex task, as it is impossible to quantify what may have happened if changes had not been implemented as a result of engagement efforts.

## 5.1 *Engagement Through Proxy Voting:* Speak Softly and Carry a Big Stick

Although engagement is a useful tool, it is often not enough in and by itself. The option of exercising voting rights in addition to engagement provides a more complete approach to active ownership. Furthermore, voting, in addition to engagement, provides a higher degree of leverage to ensure that the views of the investor, and by extension that of its clients whose interest they represent, are given appropriate consideration by the board and the management. What is often unappreciated by outsiders is that engagement and voting (the core of active ownership) requires constant efforts across the year, especially since many of the engagements undertaken will only yield results two to three years down the line. And often, the changes proposed by the company, as a result of engagement (revised incentive schemes, appointment of non-executive director etc.) will be slow and gradual.

Although shareholding sizes vary among institutional investors, some can amass relatively large positions (3–10%) which means that their voices at the engagement table, combined with their votes at the shareholder meeting carry considerable weight, especially since not all shareholders exercise their voting rights. Companies will try by all means to avoid large investors voting against management as it is an embarrassment for the board if a large vote turns out unsupportive, or worst case scenario risking one or more items on the shareholder meeting not begin voted through, which in essence means that investors send the Board back to the drawing board having to start all over again.

Exercising the right to vote, although a key element in an active ownership strategy, is not by itself enough as a vote on its own does not provide sufficient information to the recipient (the company) if there has been no interaction with the investor explaining the reason, either prior or after the vote has been casted. One often heard critique from the corporate world is the lack of feedback of a vote, in particular of a negative vote against management. Companies and their board depend on the feedback from the investor when they have voted against.

Specifically, they depend on exact information as to what led the investor to vote against. If the investor remains silent after a vote, that vote, although counted, can be labelled as semi-wasted.

Corporates and the board can, provided they take their time to read it, stay well informed in advance of a shareholder meeting on how investors might vote. Most of institutional investors have established a set of corporate governance policies and principles as well as proxy voting guidelines, which have been made publicly available. These corporate governance principles have often been formulated on the basis internationally recognized governance best practices, as well as empirical studies and observed experiences in other markets. Furthermore, the proxy voting guidelines usually cover items that are typically presented for shareholder votes at shareholder meetings, incl. director elections, executive remuneration, share issuances and/or buybacks etc. Whilst the corporate governance principles will usually provide a frame of reference for engagements, the proxy voting guidelines ensure that investors vote their holdings consistently across all portfolios and markets.

Although the widespread use of these guidelines is common, the content varies considerably from investor to investor. Some investors prepare very detailed guidelines, the key advantage being that it aids and speeds their voting, and provides clarity (for better or worse) to the company before the vote, but can often feel too prescriptive, leaving no room for deviation. Some investors on the other end tend to be less specific, often formulating vague statements on key issues, whilst being fully silent on others. Whilst not prescriptive at all, these guidelines provide little reference for boards, although are often an indication that the investor will provide a higher degree of deference to companies and allow deviations to best practice provided there is a proper rationale for doing so.

One common element among investors, despite potentially different proxy voting guidelines, is a general agreement that any issue or proposal by the board that tries to limit shareholder rights, maintain or increase management entrenchment, decrease transparency, or decrease management accountability will usually receive a negative vote.

**When Does Engagement Take Place, How Does It Take Place, With Whom and on What Topics?**

Most of the votes take place between February and May when most companies hold their AGMs, which is to say that most votes casted are annual shareholder meeting related. As has been the case, most of the engagements have historically followed the shareholder meeting, meaning that companies mostly sought to engage their shareholders around the time of the shareholder meeting. Which for the most part meant that engagements were reactive and often initiated by the company on the back of a negative voting recommendation issued by a proxy advisor.

Although largely still the case, engagements have increasingly started to touch on much wider issues affecting the corporation outside their annual general meeting. Now investors are actively engaging with their portfolio companies on governance issues as part of their fiduciary duty and also with the objective to protect the long-term value of their assets by seeking changes to their policies and structures,

ensuring that corporations are managed for the interest of all shareholders, making sure that the board and policies in place act against executive or board mismanagement. Furthermore, companies themselves have started to gradually approach investors well ahead of their annual general meetings to understand potential shareholder concerns over governance risks, as they seek to pre-empt potential points of disagreement.

Although engagement tactics may vary, the person to whom these engagements are directed to does not. A common desire among investors is to express their views and concerns to those who can do something to address them. Corporate governance matters are a board responsibility, hence why it is common for non-executives to lead the company's engagement efforts on behalf of the board. The usual person would the company chairman, or if it is a specific issue, it will be the chairman of one of the committees. And although the topics discuss during engagements will be varied, there are a number of topics that are often discussed, which include, but are not limited to (Table 2):

The wide range of topics that are usually discussed during engagements with the board and investors intends to shed light on how the corporation is being governed and for the interest of whom. However, the nature of any engagement undertaken will inevitably be influenced by the scope and urgency of the perceived problem and by the responsiveness of the board.

### *5.2 Differences in Approach to Ownership*

Although the typical topics covered in engagements on corporate governance matters are relatively similar (executive pay, board composition, strategy, capital allocation etc.) the way in which engagement is undertaken is far from similar. Different approaches remain, however the two main camps, which are often confused by outsiders are shareholder activism on the one side vs active ownership on the other.

Shareholder activists, often led by smaller hedge funds, typically possess a small holding in the company they target, and can by themselves not do much. However, their main aim does not necessarily lie in trying to influence the board, but rather in trying to persuade other shareholders, preferably a majority of shareholders (Foley, 2016). The strategy is to convince other shareholders that the activist has worked out a better strategy for the company (whatever that may be) than the board. In such a pursuit, they will try every conceivable tactic, from direct public battle with the board, placing an agenda for vote at the shareholder meeting, speaking with other investors, using the press etc. This approach is arguably more confrontational in its aim, not shying away from a head collision with the board if deemed necessary. Activist shareholders will usually achieve their goal when the board believes that a majority of shareholders supports the activist.

Active ownership on the other hand plays a more discreet role, with behind the scenes discussions, with a more patient, yet an equally demanding approach. This

**Table 2** Engagement topics

| Ownership structure |
|---|
| • Potential negative efefcts on decision making |
| • Management/board entrenchment as a result of ownership |
| • Dual class shares |
| • Voting limitations and restrictions |
| • Shares with special rights |
| • Interference of shareholder(s) in the day to day operations |
| • Overall transparency, especiall concerning ultimate beneficary ownership |
| Board and board comittees |
| • Composition |
| • Independence |
| • Chairman/CEO separation |
| • Presence and role Senior Independent Director |
| • Appointment process and reasoning for recent appointments |
| • Board evaluation (internal or externally conducted) |
| • Remuneration of non-executives |
| Management |
| • Quality and experience |
| • Responsiveness to shareholder concerns |
| • General availability |
| Executive remuneration |
| • Design (complexity, split between fixed, short term and long term remuneration) |
| • Aligment with strategy |
| • Types of performance criteria , targets and their transparency and vesting periods |
| • Use of equity as a percentage of total pay |
| • Clawback mechanisms |
| • Accelerated vesting |
| • Maximum pay |
| Bylaws and strategy |
| • Bylaw protection against issuances without pre-emptive rights |
| • Anti-takeover devices |
| • Related Party Transactions |
| • Financial Tunneling |
| • Diversion into non-core and M&A decisions/track record |
| • Allocation of capital and returns |
| • Overall Strategy and performance |
| • Accouting and audit matters |

Source: Own compilation

method is often employed by larger asset managers who wish to keep their conversations confidential. The main advantage of this approach is that it yields a higher level of trust between the investor and the board, especially on sensitive matters (of which corporate governance tends to be), and therefore increases ability of the investor to influence fundamental change over time. Furthermore, corporates

will often approach these investors when planning to make changes, providing the investors with an ideal opportunity to shape the outcome of the discussion. A proactive approach to consistent engagement with its shareholders behind the scenes and over time not only allows the board to understand shareholder concerns over governance risks, but allows building relationships that may help fend-off potential activists, should such one arise. The main disadvantage is that asset managers do not get the credit they deserve for their efforts as no information is being provided to the public.

Even within active ownership, there are different camps with different approaches to engagement. There are those that allow the board to manage the corporation without excessive interference, as they do not attempt to impose highly prescriptive actions, providing a higher degree of deference to the board. This approach rests on the belief that the board is best positioned to make decisions and should retain a considerable degree of flexibility. On the other side, there are those that engage and vote out of set of rigid policies, allowing no deviation to the board to explain how the board's own approach to corporate governance may address some of the shareholder concerns over governance risks.

Two forms for engagement that are often overlooked by the market are collective engagements and engagement between shareholders. Often, and especially in companies with a widely held ownership, some investors will promote collective engagements, which takes the form of a group of shareholders coming together under one roof to engage with the company. Although a conceptually interesting idea, where most shareholders will agree on the problem, the main challenge is to agree on a solution. Furthermore, the level of intimacy and the willingness of discussing more confidential information during such collective meetings will inevitably decrease. However, a key advantage is that it allows smaller investors to have a direct say through such forums, which might not otherwise be possible in a one-to-one meeting given their size. Engagement among shareholders is a relatively new phenomenon, which in some markets is widely used to discuss issues of concerns among companies. Ensuring that no laws on concert parties are being trespassed, investors regularly use this tool to share concerns, whilst ensuring that boards (knowing that such communication between shareholders exists) do not attempt at divide and conquer shareholders by giving different messages.

## *5.3 A Rising Tide Lifts All Boats*

Finally, because index tracking investors are by definition invested across the entire market, they have a logical interest in raising standards across the entire market, not just in individual corporations. As a result, institutional investors spend a considerable amount of time and resources devoted to addressing concerns at a market level by entering into dialogue with any institution, private or public, that yields any sort of influence over corporate governance standards and shareholder rights in any given market. Institutional investors are keen participators in and contributors to the

debate on how to raise governance standards. Speaking to regulators, listing authorities, institute of directors and stock exchanges offers the investor the advantage of narrowing (or expanding it, depending on how it is viewed) its engagement efforts to a smaller set of market players seeking to ensure a wider raise in governance standards across the entire market. Engagement with the objective of raising governance standards at individual companies and the market as a whole are not mutually exclusive, and are more of a complement to each other, in that both activities ultimately seek to enhance governance standards for the benefit of all shareholders, thereby reducing risk and enhancing the value of their investments over time.

## 6 Conclusion

Driven by experience, client pressure and increasing social expectations, investors are increasingly seeking to understand how corporate governance (agency risk) can affect their investments, and what actions can be taken to mitigate these risks. And although far from complete, and although far from mainstream, the increasing attention and commitment of resources into the integration of corporate governance both before and after the investment is made is a positive development in the continued improvement of fundamental analysis. Furthermore, a more active ownership approach among investors seeking to ensure that boards work in the interest of all shareholders is likewise a positive development.

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# Company Social Investments: Growth of Capitalization and Risks (The Case of Russia)

**Irina Tkachenko and Ludmila Ramenskaya**

## 1 Introduction

The aim of the study is to determine the impact of social investments on Russian company capitalization and to identify whether Russian companies consider investments in CSR positively significant or they perceive a sustainable, ethical, and socially-oriented development as a burden, coupled with additional costs and risks.

The chapter can be roughly divided into two parts. The first part synthesizes the context in which the empirical analysis is found and develops the theme of the Russian CSR model and business ethics measured against internationally accepted criteria for sustainable development. This part also addresses the stakeholder approach, whose application will enable to look at the problem of increasing business effectiveness through the prism of attaining social orientation of companies by satisfying stakeholders' interests.

The remainder of the chapter describes the empirical sample and empirical results. We evaluate the evidence concerning relationship between company capitalization and social investments, business ethics and risk governance, reputational risk in particular. Risk governance has become a challenging area of Russian CG after the 2008–2009 economic crisis which showed inability of large Russian corporations to adequately respond to a changing economic environment.

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## 2 CSR in Russian Business: Comparison of Russian Research and Global Indices

The development of CSR in leading Russian companies is in line with global trends in moving towards the ideology of social investments that benefit company stakeholders. Since 2004, the Russian Institute of Directors has regularly conducted the survey of CG best practices in Russia, which covers the most important components of CG, including the CSR aspect. The 2012 survey showed that practices of Russian companies in the field of CSR continued to be at a low level. For the 5-year period from 2004 to 2008, in the total sample, compliance with CSR recommendations increased by 14%, from 32% to 46% (an average increase is 3.5% per year). In the consecutive 4 years (2008– 2011), this figure remained the same. In the 2011 sample, companies followed on average 49% of the recommendations pertaining to the CSR component.

The companies, whose shares are listed on Moscow Exchange, demonstrate a higher level of CG practices. The 2008 figures for state-owned companies were comparable with the level in the total sample and accounted for 45%. However, the following years showed a downward trend: in 2009 this figure decreased by 6% as compared with the previous year, and 2011 witnessed a fall to 34%. In 2011 CG best practices in 74 listed companies accounted for 56% vs. an average 49% in the total sample of 150 firms. Among the most developed aspects of CG practices are CSR projects for employees and their families (82% of listed companies); and local community projects (76% of listed companies).

The analytical review of corporate non-financial reports, published by the Russian Union of Industrialists and Entrepreneurs (RSPP), summarizes 15 years of experience in the development of non-financial reporting in Russia (2015). The number of companies sending their non-financial reports to the Register of corporate non-financial reports, rocketed from one company in 2001 to 65 companies in 2014, with the peak reached in 2013, when 77 companies presented their financial reports. Along with traditional Russian CSR areas, such as labor relations, health and safety, environmental issues, management, charity, and product quality, new CSR initiatives have emerged: responsibility in the supply chain, human rights and entrepreneurship, business ethics, and prevention of corrupt actions.

Nevertheless, some Russian experts in the field of CG (Blagov, 2011; Verbitsky, 2015) think that the issue of CSR is still considered by Russian companies as an undesirable and wearisome burden, imposed from above. Companies lack the comprehensive understanding of CSR and consequently are not willing to implement these policies in their practice. A majority of Russian companies consider CSR as a prerogative of the 'elite club' of wealthy and successful companies.

Unfortunately, the global business community does not assess the Russian business as ethical. This attitude was marked in our earlier studies (Tkachenko, 2015). *The Global Competitiveness Report 2013–2014* ranked Russian companies 101 out of 148 for ethical behaviour (with a score of 3.7) (Schwab, 2013). In 2014

Russia slightly improved its position and moved to 72nd place (out of 144), scored 3.9 (Schwab, 2014).

In 1999 the global business community initiated the launch of the Dow Jones Sustainability Indices (DJSI), the leading global benchmark for corporate sustainability, which represents the top 10% of the largest 2500 companies in the S&P Global BMI based on long-term economic, environmental and social criteria. According to the 2015 Corporate Sustainability Assessment, the leading group includes 47 countries, none of which is from Russia. Among the leaders are the companies from Germany, Great Britain, Switzerland, France, Korea and other developed countries.

Thus, we see that Russian businesses (and not only listed companies) are facing emerging challenges to introduce standards of CSR into practices, and to integrate CSR principles into company long-term strategy.

## 3 Stakeholder Approach to Measuring CSR Value Creation for Internal and External Stakeholders

A stakeholder approach to business emerged in the mid-1980s as a response to the changes that were occurring in the business environment. A focal point in that movement was the publication of R. Edward Freeman's *Strategic Management—A Stakeholder Approach* in 1984. He defined stakeholders as any group or individual (e.g. customers, suppliers, communities, employees) who is affected by or can affect the achievement of an organization's objectives (Freeman, 1984: 5). In their later work, Freeman and Velamuri (2008) further developed the concepts of the stakeholder approach and CSR and proposed to replace 'corporate social responsibility' with 'company stakeholder responsibility'. This idea implies that all businesses—large, medium-sized and small—need to be involved in value creation for stakeholders and that business cannot be separated from ethics.

The questions "How do CSR practices impact on employees?", "How do stakeholders benefit tangibly from businesses pursuing CSR?" and "What is the relationship between a company's social performance and its financial performance?" have been addressed in several recent international publications (Aguinis & Glavas, 2012; Aluchna, 2010; Matthiesen & Salzmann, 2015). Nevertheless, Russia has been given relatively little attention, despite its being a major natural resource player. Although some publications do analyze the Russian experience (Belyaeva, 2013; Glebova, Rodnyansky, Sadyrtdinov, Khabibrakhmanova, & Yasnitskaya, 2013; Kuznetsov & Kuznetsova, 2008; Tkachenko, 2011), there is still a shortage of analytical research similar to what is available in the West. To bridge the gap in the literature and to continue up a line of research, this paper is making an attempt to explore how CSR pursued by largest Russian companies affects the development of human capital and stock market capitalization through the lens of a stakeholder approach.

The role of the stakeholder approach in the company implementation of CSR activities is backed up by *IQNet SR 10 Social Responsibility Management Systems. Requirements* (2011). This standard establishes the requirements for a socially responsible management system for organizations that are committed to existing social responsibility principles (IQNET, 2011: 7). By engaging in CSR, companies pursue pragmatic goals: through the development of human capital, they create conditions for effective interaction between the corporation and the stakeholder, which can be expected to enhance company's value for the latter.

# 4 Empirical Study

## *4.1 Methods*

The empirical study includes the performance analysis of 15 largest public limited companies over the 5-year period from 2010 to 2014. These are the companies that have embedded CSR policies in the overall strategy and actively implement them. Data related to financing CSR projects and programs were taken from non-financial reports that are placed on companies' websites and available in the public domain.

The research methodology is based on theory and management tools and includes comparative analysis, economic and mathematical modeling, and methods of value-based management. The correlation-regression model is used to prove the impact of different types of social investments on company financial performance and capitalization.

## *4.2 Sample Profile*

Figure 1 illustrates the total number of non-financial reports across industries for the 5-year sample period from 2010 to 2014. It is apparent that starting 2012, the overall number of company non-financial reports published regularly was decreasing significantly, particularly, in gas and oil, metallurgical and mining industries. This fact may be attributed to a worsening market situation along with limited access to international capital markets and companies' attempts to reduce costs.

The review of the types of non-financial reporting has identified certain industry group preferences. Thus, in the oil and gas industry the most popular form of reporting is sustainability reports; in the energy and chemical industries integrated reports that do not detail CSR costs are common; while metallurgical, mining, telecommunication and financial companies provide social reports.

The exact process of sampling was as follows. The initial sample size involved 45 public companies that published their non-financial reports in 2014. Then, two financial and insurance companies (as their performance is measured by the Central

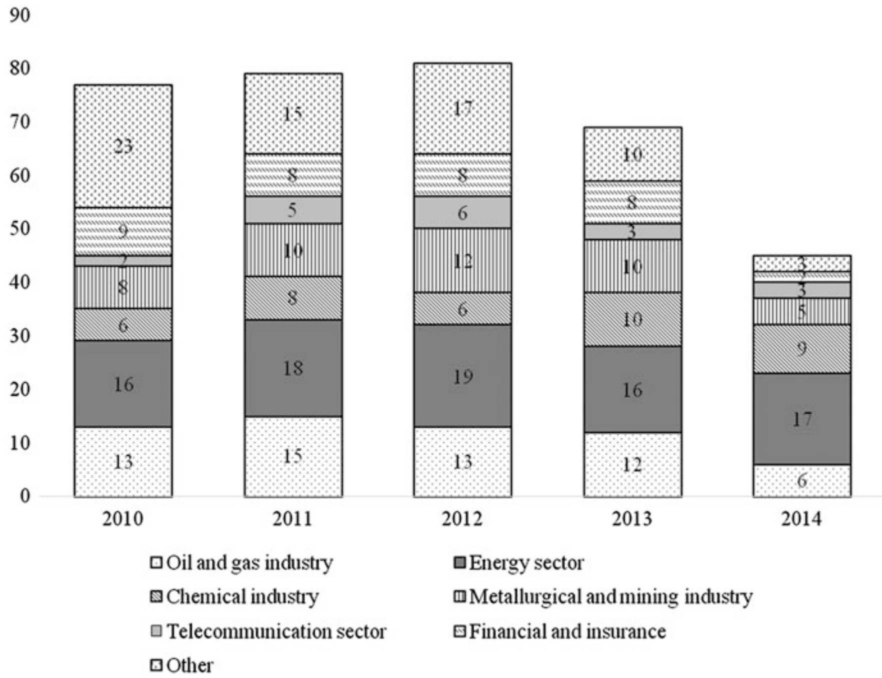


**Fig. 1** Publication of Russian company non-financial reports across industries. Source: The national RSPP register of non-financial reports, 2010–2014

Bank regulations) and three firms in the 'Other' group (Fig. 1) were excluded from the sample, as well as *Gazprom* Environmental Report. Another 17 firms did not meet the securities criterion: they were not quoted on the Russian trading floor within the period under review. Non-financial reporting of the 22 companies was analyzed in terms of available information about the amount of CSR funding. Only 15 firms met this criterion, thus they constituted the sample size.

The sampled companies are active in various industries: gas and oil—22%; energy—36%; chemicals—14%; metallurgy and mining—21%; telecommunication—7% (Fig. 2). The descriptive variables such as market capitalization, total assets, number of employees as well as performance variables such as return on assets (ROA) and return on equity (ROE) for the exampled sample are given in Table 1. Though the sample size is not big, it may be considered representative as it reflects the overall distribution of non-financial reporting in Russian companies.

The research conducted by the Russian Union of Industrialists and Entrepreneurs (2015) identified the corporations with the highest Transparency and Disclosure Indicator in 2013. Of the total 15 firms, nine companies are included in out sample: *MMC Norilsk Nickel, Alrosa, Severstal, Lukoil, Tatneft, Nizhnekamskneftekhim, RusHydro, Inter RAO, Federal Grid Company of United Energy Systems*.

The analysis is based on annual data collection, however, for some companies the data were not available as the consequence of irregular non-financial reporting

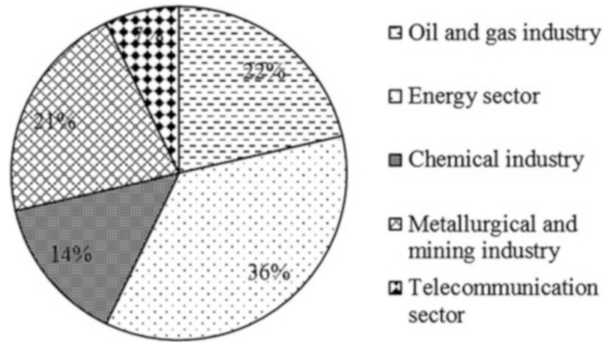


**Fig. 2** Distribution of sample companies by industries

and differences in the areas of company investments. Since not all figures were available for 8% of the sample companies, the received data are not balanced. Nevertheless, an econometric model may be considered accurate, as absence of the figures does not depend on a variable.

Despite challenging economic conditions in 2014, 13 companies reported profits, while *Rosseti* and *Severstal* made a loss. However, it is worth noting that though *Severstal* posted losses, it increased its social investments (Table 2). The data also point to the decline in capitalization of 40% of the sampled companies; 26% halved their value. The most devastating impact on share prices were witnessed at the telecommunication services and energy companies: *MTS, Rosseti, and Federal Grid Company of United Energy Systems.*

This decline could be attributed to both external and internal factors. Geopolitical tensions, exchange rates coming under pressure, and constrained access to international financial markets were major conditions weakening Russian economy. The uncertainty surrounding billionaire Vladimir Evtushenkov's arrest on suspicion of money laundering could have a long-term impact on share prices at all of the companies he controls. Evtushenkov's AFK *Sistema* had major stakes in two biggest holdings, *Bashneft* and *MTS*, which contributed to a significant drop in the companies' market value—51.5% and 47.6% respectively (Table 1).

## 5 Social Investments: Non-financial Reporting of Russian Companies

The stakeholder model enables to conform and balance a variety of expectations from stakeholders. It also demands a system of measuring CSR value creation recognized by stakeholders. Such value within the framework of CSR may result not only in a significant financial payback (or a company increased capitalization), but also in recognized public benefits for stakeholders. The business must have a firm CSR orientation, create key stakeholder value, and strive for ethical leadership. The present empirical study investigates the impact of company social investments

**Table 1** Descriptive and performance variables for the sampled companies, 2014

| Industry/company | Market capitalization (million RUB) | Capitalization ratio, 2014/2013 (%) | Total assets (million RUB) | Net profit/loss (million RUB) | Number of employees | ROA (%) | ROE (%) |
|---|---|---|---|---|---|---|---|
| *Telecommunication* | | | | | | | |
| MTS | 354,803 | −47.6 | 492,369 | 51,822 | 68,549 | 6.14 | 28.45 |
| *Chemicals* | | | | | | | |
| Nizhnekamskneftekhim | 33,756 | −20.2 | 87,191 | 9269 | 16,772 | 11.03 | 14.46 |
| Kazanorgsintez | 25,081 | +99.8 | 45,415 | 6112 | 8258 | 14.87 | 40.65 |
| *Metallurgy and mining* | | | | | | | |
| MMC Norilsk Nickel | 1,291,599 | +51.2 | 700,269 | 34,057 | 81,855 | 4.93 | 10.32 |
| Alrosa | 458,027 | +77.8 | 500,992 | 23,469 | 30,043 | 9.16 | 9.63 |
| Severstal | 416,639 | +56.6 | 459,955 | −13,101 | 53,200 | −3.05 | −8.29 |
| *Oil and gas* | | | | | | | |
| Lukoil | 1,886,039 | +9.4 | 1,755,496 | 371,881 | 110,300 | 24.37 | 37.22 |
| Bashneft | 182,642 | −51.5 | 421,991 | 65,272 | 33,300 | 16.46 | 42.79 |
| Gazprom Neft | 668,049 | −4.6 | 1,172,326 | 14,131 | 57,722 | 1.40 | 5.25 |
| Tatneft | 505,674 | +12.1 | 579,354 | 82,061 | 20,502 | 14.75 | 18.10 |
| *Energy* | | | | | | | |
| Rosseti (Russian grids) | 68,201 | −45.5 | 144,383 | −52,346 | 217,971 | −36.20 | −36.70 |
| RusHydro | 202,977 | +12.5 | 855,580 | 30,729 | 21,213 | 3.68 | 4.58 |
| Interregional distribution grid company of Siberia | 8676 | +31.0 | 65,077 | 107 | 19,994 | 0.30 | 0.36 |
| Inter RAO group | 8676 | +7.0 | 353,417 | 434 | 58,479 | 0.12 | 0.13 |
| Federal grid company of United Energy Systems | 56,111 | −51.4 | 1,231,217 | 5137 | 24,362 | 0.42 | 0.61 |

**Table 2** Changes in the volume of internal social investments by companies, 2010–2014 (in million RUB)

| Industry/company | 2010 | 2011 | 2012 | 2013 | 2014 | 2014/2010 (%) | 2014/2013 (%) |
|---|---|---|---|---|---|---|---|
| *Telecommunication* | | | | | | | |
| MTS | 407.70 | 408.70 | 438.30 | 440.80 | 824.38 | +102.20 | +87.02 |
| *Chemicals* | | | | | | | |
| Nizhnekamskneftekhim | 588.57 | 778.30 | 953.40 | 1008.90 | 986.48 | +67.61 | –2.23 |
| Kazanorgsintez | – | – | – | 747.03 | 796.74 | – | +6.65 |
| *Metallurgy and Mining* | | | | | | | |
| MMC Norilsk Nickel | 11,701.22 | 7717.00 | 12,978.34 | 10,477.70 | 14,196.80 | +21.33 | +35.50 |
| Alrosa | 2446.60 | 2836.10 | 2863.60 | 3013.80 | 3324.00 | +35.86 | +10.29 |
| Severstal | 1381.62 | 1459.74 | 1920.70 | 2586.88 | 4449.79 | +222.00 | +72.01 |
| *Oil and gas* | | | | | | | |
| Lukoil | 15,305.42 | 16,797.85 | 17,810.12 | 44,867.50 | 49,870.12 | +225.83 | +11.15 |
| Bashneft | 3391.02 | 3652.10 | 4167.192 | 4004.36 | 3172.70 | −6.44 | −20.77 |
| Gazprom Neft | 9807.42 | 9267.27 | 11,442.94 | 14,085.03 | 10,141.80 | +3.41 | −28.00 |
| Tatneft | 776.70 | 770.15 | 729.53 | 4853.10 | 4249.50 | +447.12 | +12.44 |
| *Energy* | | | | | | | |
| Rosseti (Russian grids) | – | – | 3427.00 | 4157.20 | 1039.30 | – | −75.00 |
| RusHydro | 271.10 | 273.96 | 343.60 | 479.60 | 453.88 | +67.42 | −5.36 |
| Interregional distribution grid company of Siberia | 372.90 | 445.40 | 527.70 | 508.24 | 522.24 | +40.05 | +2.75 |
| Inter RAO group | 1877.42 | 2445.86 | 4100.00 | 4139.80 | 5727.12 | +205.05 | +38.34 |
| Federal grid company of United Energy systems | – | 468.40 | 991.21 | 1022.00 | 1121.40 | – | +9.73 |

Dashes indicate data not available

on their capitalization in two dimensions: financially relevant for (i) internal and (ii) external stakeholders.

On the one hand, company social investments financially relevant for *external stakeholders* aim at the development of local communities and may take the form of charity events, sponsorship, environmental improvement, region's infrastructure enhancement, etc.

Since most of the companies in the sample are manufacturing, they spend a significant amount of money on environmental investments. It seems reasonable then to analyze investments in environmental initiatives as a separate category.

On the other hand, company social investments financially relevant for *internal stakeholders* aim at the development and social support of company employees.

The conducted research on company internal and external investments in CSR (Fig. 3) indicates the doubled cumulative growth for a 5-year period, with the most significant increase in environmental investments.

The main areas of investments relevant for internal stakeholders seem to be:

- occupational health and safety
- medical care
- training (human resource development)
- welfare assistance
- social housing programs

In 2014, the allocation of funds between these areas in the examined sample (Fig. 4) showed that companies spent over 70% of the total volume of social investments on improving working conditions and industrial safety. The biggest proportion of funds was allocated by oil and gas companies: the total investments in this area exceeded $54 billion RUB, 74% of which belong to *Lukoil*.

The analysis of trends in investments relevant for internal stakeholders (see Table 2) reveals that since 2010, almost all sample companies showed an upward trend in the amount of investments in these areas. *Tatneft*, as a leading practice, demonstrated a fivefold increase; *Lukoil*, and *Inter RAO Group*—triple growth. However, in 2014, 40% of the sample companies reduced internal investments. The 2014 decline in social costs might have been due to worse market conditions and lower companies' revenues.

External social investments are prevalent among companies of the primary sector. This might be ascribed to significant investments into environmental improvements.

Since 2010 the total volume of investments relevant for external stakeholders has increased practically in all companies, MTS being the only exception: in 2014 it cut external investments by half (Table 3).

The main areas of investment relevant for external stakeholders are the following (as shown in Figs. 5 and 6).

*Investments in Environmental Initiatives* include a variety of environmental projects, aligning company environmental policy with the existing environmental legislation, introduction of environmental management systems, land reclamation (Fig. 6). In 2014 environmental investments of the sample companies totalled over

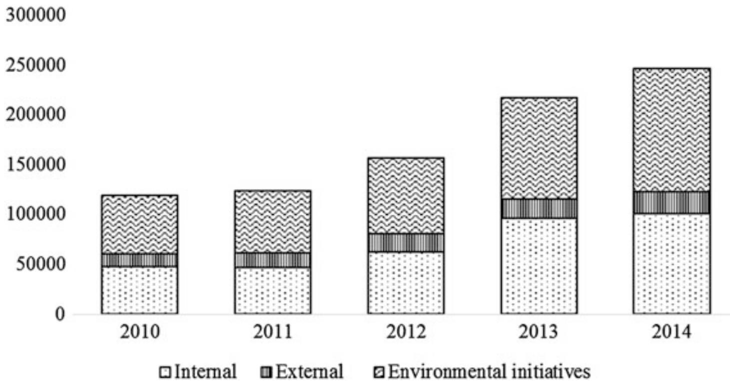


**Fig. 3** Social investments financially relevant for internal and external stakeholders (in million RUB)

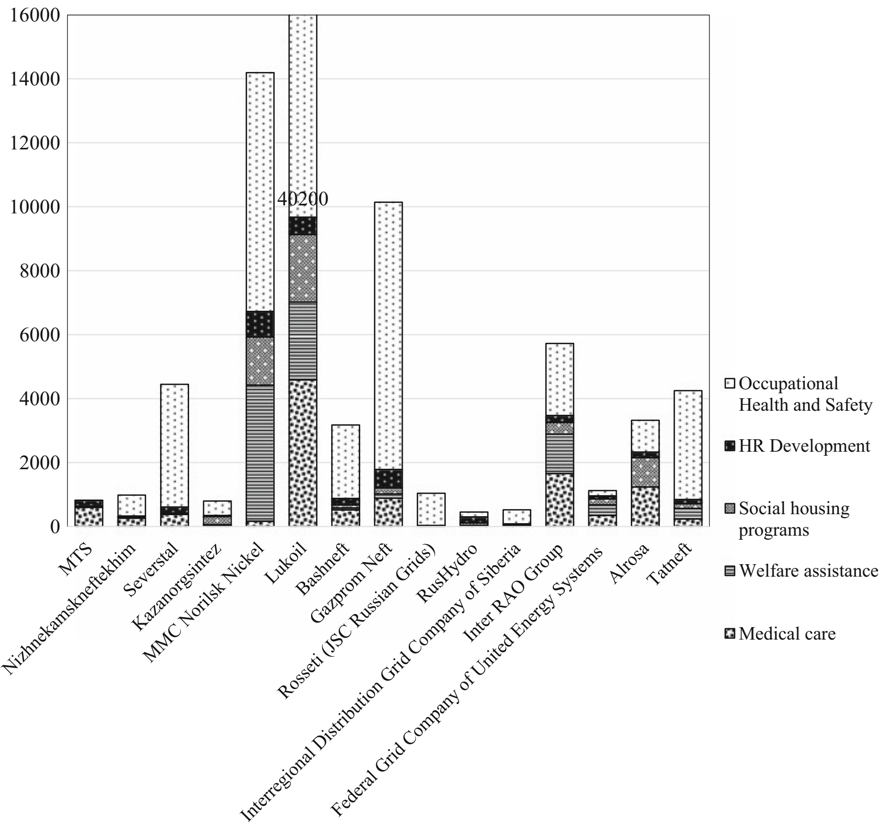


**Fig. 4** Social investments financially relevant for internal stakeholders, 2014 (in million RUB)

**Table 3** Changes in the volume of external social investments by companies, 2010–2014 (in million RUB)

| Industry/company | 2010 | 2011 | 2012 | 2013 | 2014 | 2014/2010 (%) | 2014/2013 (%) |
|---|---|---|---|---|---|---|---|
| *Telecommunication* | | | | | | | |
| MTS | 26.38 | 28.57 | 27.52 | 30.10 | 17.54 | −33.51 | −41.73 |
| *Chemicals* | | | | | | | |
| Nizhnekamskneftekhim | 1614.50 | 2101.80 | 2616.50 | 2550.80 | 2203.20 | +36.47 | −13.63 |
| EuroChem | 1679.30 | 1055.00 | 2178.00 | 689.00 | 3837.60 | +128.53 | +456.98 |
| Kazanorgsintez | – | – | – | 3293.60 | 2159.50 | – | −34.43 |
| *Metallurgy and mining* | | | | | | | |
| MMC Norilsk nickel | 15,939.10 | 18,614.00 | 25,253.61 | 19,205.70 | 22,000.00 | +38.03 | +14.55 |
| Alrosa | 3401.00 | 4174.70 | 5693.10 | 8078.90 | 9162.50 | +169.41 | +13.41 |
| Severstal | 2517.50 | 1874.50 | 3307.20 | 5395.50 | 5408.70 | +114.84 | +0.24 |
| *Oil and gas* | | | | | | | |
| Lukoil | 32,661.60 | 29,608.00 | 32,372.40 | 44,520.20 | 61,873.60 | +89.44 | +38.98 |
| Bashneft | 3302.50 | 3728.90 | 3648.30 | 11,451.40 | 10,650.00 | +222.48 | −7.00 |
| Gazprom Neft | 2916.10 | 3967.70 | 5818.80 | 10,404.50 | 18,559.90 | +536.47 | +78.38 |
| Tatneft | 6288.20 | 7828.10 | 9259.00 | 9282.10 | 8740.00 | +38.99 | −5.84 |
| *Energy* | | | | | | | |
| Rosseti (Russian grids) | – | – | 366.12 | 305.20 | 394.00 | – | +29.10 |
| RusHydro | 647.23 | 1338.20 | 725.66 | 73.57 | 1466.00 | +126.50 | +1892.61 |
| Interregional distribution grid company of Siberia | 88.50 | 127.50 | 138.02 | 939.30 | 132.75 | +50.00 | −85.87 |
| Inter RAO group | 1555.56 | 2754.70 | 4906.00 | 5121.38 | 3238.25 | +108.17 | −36.77 |
| Federal grid company of United Energy Systems | 140.74 | 190.41 | 198.30 | 178.90 | 183.36 | +30.28 | +2.49 |

Dashes indicate data not available

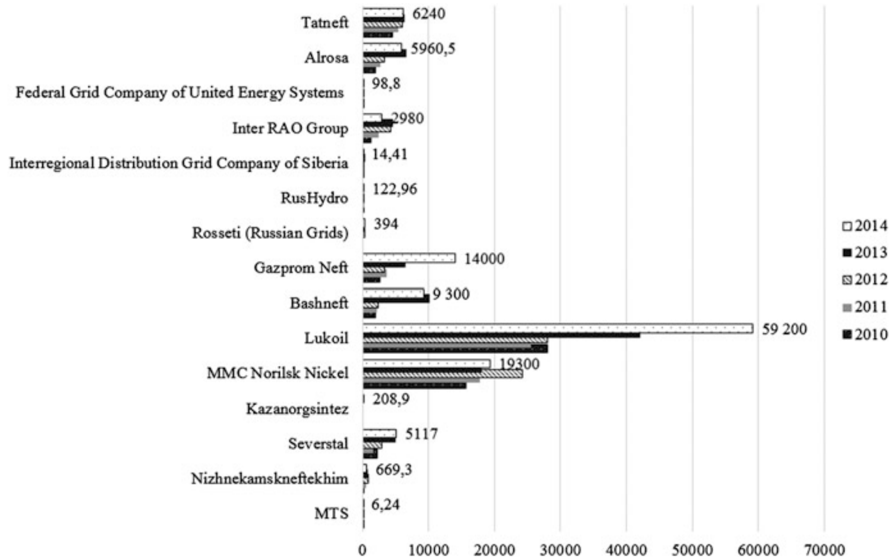


**Fig. 5** Changes in the volume of environmental investments by companies, 2010–2014 (in million RUB)

108 billion RUB. In 2010–2014 the overall amount of money being spent on environmental activities accounted for more than 80% of all external social investments;

*Oblast/Region Infrastructure Improvement* Along with the investment in environmental activities, enhancement of the regional infrastructure and actions aimed at improving the welfare of local residents seem to be the most important for the firms in terms of financing. According to corporate reports in 2014 the companies' entire investment in regional infrastructure improvement amounted to 9.7 billion RUB. Investments of three corporations—*Gazprom*, *Neft Tatneft,* and *MMC Norilsk Nickel* - constituted the largest share, 75%.

*Charity and Community Projects* 11 companies in the sample allocate funds to this type of projects, and the amount of money makes up around 8% of the total investment relevant for external stakeholders excluding environmental investments.

*Targeted Social Assistance* Targeted aid and projects aiming to support the most vulnerable social groups, such as children, veterans, the disabled, are essential for *Kazanorgsintez*: in 2014 the company spent over 1 billion RUB.

*Spiritual Regeneration* This aspect seems to be least financed. In 2014 only two companies *Lukoil* and *Inter RAO Group* used 493.8 million RUB to provide support for religious confessions.

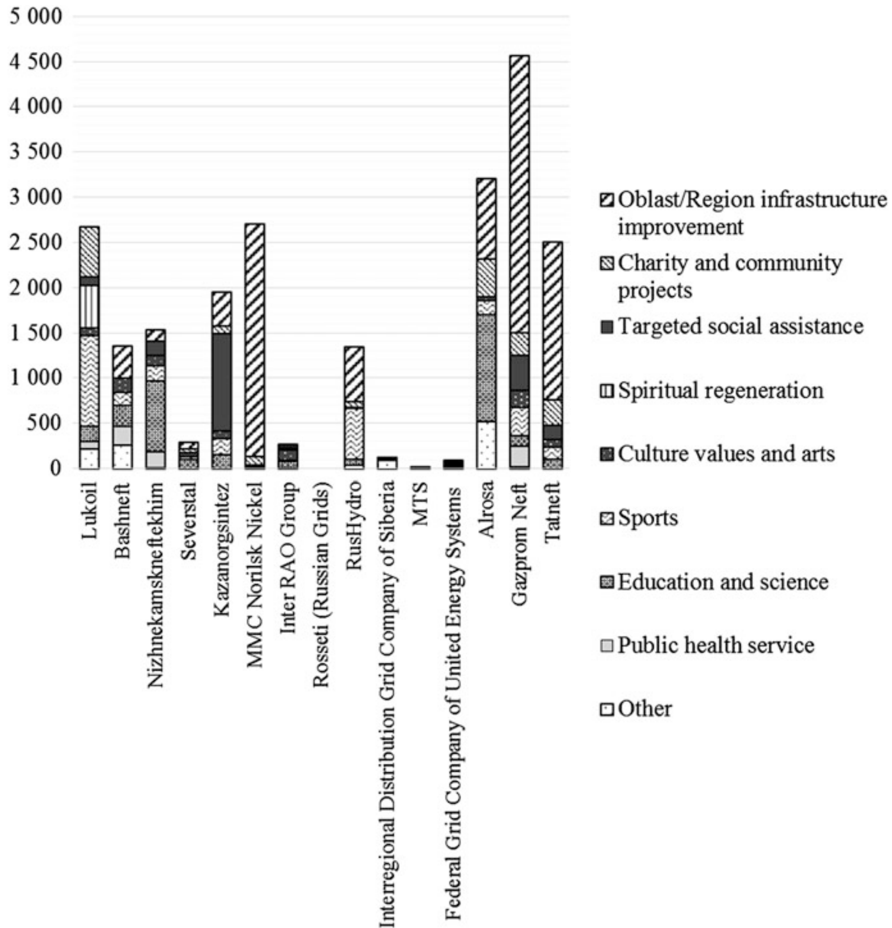


**Fig. 6** Breakdown of external social investments by companies, 2014 (environmental investments excluded) (in million RUB)

*Sports* For the 5-year period the total amount of funds being spent on corporate sponsorship of sport events and sports organizations increased more than 11 times.

*Culture Values and Arts* In 2014 corporate sponsorship of the world of the arts, sharing cultural experience and value of each of the following corporations—*Bashneft, Nizhnekamskneftekhim, Inter RAO Group, Gazprom Neft*—accounted for over 100 million RUB.

*Education and Science* This includes career counselling, building networking with university alumni; endowment. In 2014 the sample companies invested about 3 billion RUB in science and education. The largest amount of funding in this area was provided by *Alrosa*—about 40% of the total educational investments of the sample.

*Public Health Service for the Local Community* In 2014 investments in this area accounted for 734 million RUB, with 84% contributed by *Bashneft*, *Gazprom Neft*, and *Nizhnekamskneftekhim*.

In addition, the analysis of the non-financial reports has allowed us to identify some principle externally addressed initiatives launched by individual companies.

*Lukoil* supports the indigenous peoples of the North.

In 2014 *Bashneft* offered financial assisted to the Republic of Bashkortostan to eliminate consequences of a natural disaster.

*RusHydro* has formed a Social Committee to offer social assistance to victims of the Sayano-Shushenskaya HPP accident.

Every year *Alrosa* transfers funds to the non-profit organization The Target Fund for Future Generations of the Republic of Sakha (Yakutia) for the construction of educational, healthcare, cultural, and sports facilities in the region.

## 6 Social Investments and Company Risks

Within the CG framework risks should be managed continuously and encompass both strategic and operational management of the company. A crucial role in building an integrated risk management system is played by the board of directors. Moreover, corporate risk governance should include not only monitoring and management of company financial risks, but also management of the so-called reputational risk related to business ethics, the conformance to stakeholders' interests, and anti-corruption policy of the company.

One of the focuses of the latest issue of the National Report on CG (2013) is the system of corporate risk governance with regard to corporate ethics and corruption control. Addressing the interests of the wider body of both internal and external stakeholders can minimize company risks. Therefore, this empirical study aims to compare the risks that the sample companies considered as important areas of investments in CSR.

The 2007–2009 global financial crisis made business rethink what the best practices in risk governance were in terms of increased responsibility of the board of directors, and a growing importance of board-level structures related to risk management activities. The Russian CG Code (2014) delegates this function to an Audit Committee and outlines its roles and responsibilities:

(a) ensuring control over reliability and efficiency of the risk management system, including evaluation of the effectiveness and optimization of risk management procedures;
(b) analyzing and monitoring policy implementation in the field of risk management;
(c) ensuring control over company compliance with legal and ethical norms and regulations and the stock market rules;
(d) analyzing the adherence to the conflict-of-interest guidelines.

All these functions are related directly to company responsible corporate behaviour thereby it is extremely important to have a supervisory board that acts honestly and responsively. Some empirical studies verify that the performance of risk committees has positive impact on overall wellbeing of the company. In the study of 20 largest global banks, Mongiardino and Plath (2010) conclude that there exists a positive relationship between the existence (or not) of board-level risk committees, frequency of meetings, committee composition (independent directors with financial expertise) on the one hand and financial performance of the company during the pre-crisis period on the other hand. The other study of 29 largest German banks carried out by Hau and Thum (2010) also confirms that boardroom (in)-competence in finance is related to company losses in the financial crisis.

In line with this evidence, the Russian CG Code puts forward the following requirements for an Audit Committee composition:

(i) an Audit Committee should include independent directors only;
(ii) Audit Committees are required to have at least one member with extensive, first hand financial and accounting experience

Ramenskaya (2015) conducted a study whose purpose was to correlate return on equity and risk in 113 Russian public-limited metallurgical companies. The relevant data were acquired from two sources. Financial data were obtained from the Professional Market and Company Analysis System (SPARK) (http://www.spark-interfax.ru/Front/Index.aspx). Risk management variables were hand-collected from company annual reports for 2013, posted on the websites of authorized agencies (www.e-disclosure.ru, disclosure.skrin.ru, e-disclosure.azipi.ru, www.disclosure.ru, disclosure.1prime.ru) before June 2014. The study reveals that the Audit Committee exists only in 12.4% of the sample companies. Across the sample, the average committee size is 2–4; half or more committee members are independent directors. They are professionals with knowledge of law and relevant experience in law firms. Only in three companies the committee members have background in finance. Thus, none of the companies fulfils the requirements of the Russian CG Code.

In this study risk is understood as ratio of uncertainty of company future earnings vs its assets. Risk is measured as:

$$R_{it} = \frac{\left(EBITDA_{it} - \overline{EBITDA_i}\right)^2}{\overline{EBITDA_i}} / Assets_{it}$$

where $R_{it}$—the degree of company $i$ risk during a period of time $t$

$EBITDA_{it}$—company $i$ earnings before interest, tax, depreciation, and amortization during a period of time $t$

$\overline{EBITDA_i}$—average company $i$ earnings before interest, tax, depreciation, and amortization

$\text{Assets}_{it}$—company $i$ assets during a period of time $t$

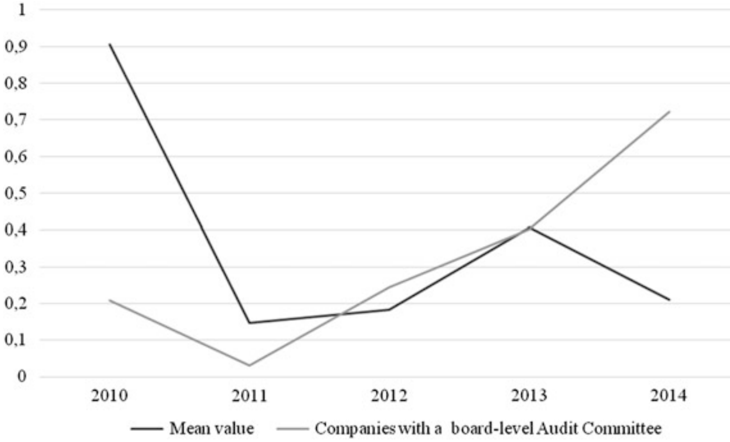


**Fig. 7** The dynamics of degree of risk ($R_t$) for sample companies, 2010–2014

**Fig. 8** The dynamics of return on equity ($ROE_t$, %) for sample companies, 2010–2014

Figures 7 and 8 present the changes in return on equity and risk figures in the companies where the Audit Committee is incorporated in the structure of the supervisory board in comparison with mean values. The received results have not proved any obvious impact on the rates of return and risk. Therefore, the existence of an Audit Committee in Russian companies' boards of directors does not result in effective risk governance.

These findings partially coincide with the findings presented in *Balancing Rules and Flexibility*, a study of CG requirements across 25 markets conducted by KPMG and ACCA in 2014. The study found that requirements related to Audit Committees are the better defined areas of CG, while risk governance is among the less defined areas.

The data for the empirical study in risk analysis we present in this chapter have been acquired from company annual reports posted on their official website. The

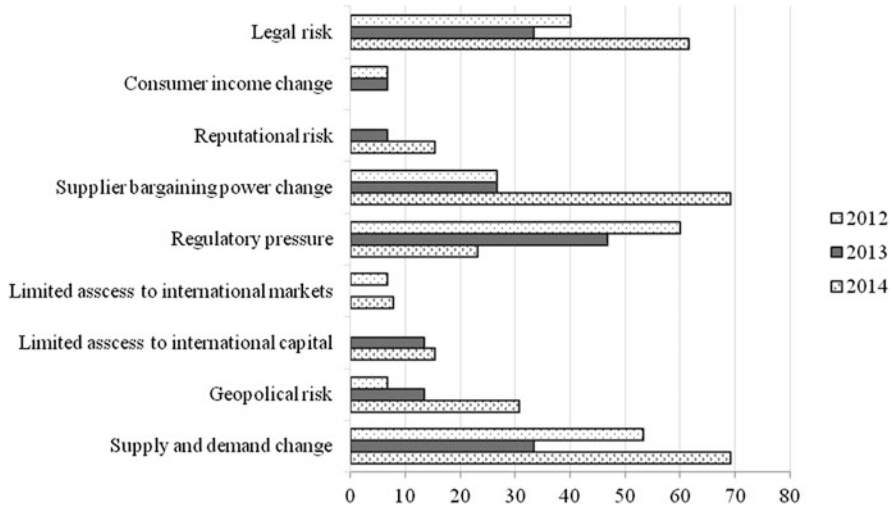


**Fig. 9** Main strategic risks identified by companies, 2012–2014 (% of the total sample)

reason for analyzing annual reports is that in 11 out of the 15 sample companies non-financial reports contain only a description of the risk management system without naming the most important types of risks. Annual reports were reviewed for the 3 year period, 2012–2014, as most statements outlined the details of risk governance restructuring that had taken place in 2010–2011. It should also be noted that the 2014 annual reports of two companies—Rosseti (Russian Grids) and Federal Grid Company of United Energy Systems—did not cite the most important risks for the company, although they were listed in the 2012 and 2013 reports.

The issues highlighted by the sample companies as posing the greatest strategic risks are presented in Fig. 9.

Due to worsening economic conditions and unfavorable political context such as economic sanctions introduced against Russia in spring 2014 and lower country ranking followed by falling market capitalization of Russian firms, the sample companies highlighted the risks connected with changes in company's profitability and in the regulatory environment. At the same time the majority of the firms (85% in 2014 and 93% in 2013) don't see reputation risks as the greatest risk scenario threat. This is somewhat contrary to the results of international research. As reported by *Expectations of Risk Management Outpacing Capabilities –It's Time For Action* (2013), 41% of respondents indicate reputational risk as one of the greatest threats. Therefore, reputation risk is underestimated by the Russian business. It might consider the conformance to the expectations of external stakeholders as an additional "tax" on company performance.

80% of the sample companies have identified monitoring and forecasting as the key tools for managing strategic risks.

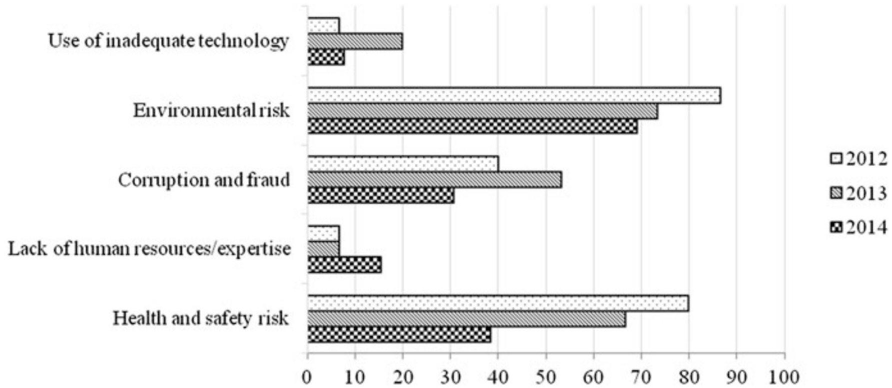


**Fig. 10** Main operational risks identified by companies, 2012–2014 (% of the total sample)

The top three greatest threats among operational risks (Fig. 10), identified by the sample companies for the 3-year sample period from 2012 to 2014, are health, safety and environmental issues (therefore increased investments in these areas are justified), and staff involvement in corrupt practices. In order to minimize the latter, companies offer relevant training programmes, staff auditing and implement compliance control schemes. Lack of human resources/expertise is given the least significance, which could be attributed to regular investment in human resource development embedded in a company strategy.

## 7 Impact of Social Investments on Company Market Capitalization

Changes in company market capitalization—growth or decline—has been used as an indicator to assess an impact of social investments of the company on its market value. Dynamics of investments in relevant areas has been taken as explanatory variables.

A regression model has been constructed to measure the impact of social investments on company capitalization. The underlying assumption has been that there is strong correlation between the volume of social investments in different areas and changes in company stock market capitalization. Changes in company capitalization for a 4-year period in comparison to the previous period have been taken as dependent variables in the regression model; indicators of changes in the most significant social investments relevant to stakeholders—as independent variables. To measure the effectiveness of CSR investments that minimize company risks, a proxy variable, or changes in CSR investments aimed at moderating company risks, has been introduced. The data for the analysis of companies' capitalization were elicited from the Moscow Exchange information portal.

The model looks as follows:

$$\Delta Cap = \alpha_0 + \alpha_1 \Delta I_{dev} + \alpha_2 \Delta I_{wc,hs} + \alpha_3 \Delta I_{ss} + \alpha_4 \Delta I_{hc} + \alpha_5 \Delta I_{hp} + \alpha_6 \Delta I_{env} + \alpha_7 \Delta I_{exs} + \alpha_8 \Delta R,$$

where

$\Delta Cap$—change in market capitalization;

$\alpha_i$—regression coefficients;

$\Delta I_{\text{dev}}$—changes in investments in HR development

$\Delta I_{\text{wc, hs}}$—changes in investments in better working conditions, health and safety;

$\Delta I_{\text{ss}}$—changes in investments in social support and welfare assistance;

$\Delta I_{\text{hc}}$—changes in investments in employees' health care;

$\Delta I_{\text{hp}}$—changes in investments in housing programs for employees;

$\Delta I_{\text{env}}$—changes in investments in environmental initiatives;

$\Delta I_{\text{exs}}$—changes in investments relevant for external stakeholders excluding environmental investments;

$\Delta R$—change in investment aimed at moderating risks. This variable is calculated considering information about financing the events that can lower the types of risks marked as high by sample companies.

The results of the regression analysis are summarized in Table 4.

On the whole, the analysis has given satisfactory results. The coefficient of determination $R^2 = 0.52$ confirms fair correlation between the indicators. $F$-test proves the adequate model construction with a significance level 0.9. However, $t$-statistics have not proved statistical significance of some coefficients for the proposed significance values. Thereby, it is apparent that there is positive correlation between company investments in creating better working conditions, occupational health and safety, environment-related activities and company capitalization. In the majority of cases, these two factors make a major impact on minimizing company risks. Correlation between market capitalization and company's spendings on staff training, social support, health care, housing programs, as well as investments in environmental initiatives has not been found. Company social investments in HR development and charity have had no obvious impact on

**Table 4** Results of regression analysis

| Index | Regression coefficient | $t$-Statistics | Coefficient of determination, $R^2$ | $F$-Statistics |
|---|---|---|---|---|
| $\Delta I_{\text{dev}}$ | 63.751 | 0.045791 | 0.52313 | 9.5356 |
| $\Delta I_{\text{wc, ls}}$ | 60.0717 | 3.011236 | | |
| $\Delta I_{\text{ss}}$ | 122.3664 | 0.222196 | | |
| $\Delta I_{hc}$ | 7.8673 | 0.053121 | | |
| $\Delta I_{hp}$ | 4.4336 | 0.012875 | | |
| $\Delta I_{\text{env}}$ | 4.6451 | 4.814241 | | |
| $\Delta I_{\text{exs}}$ | 2.1378 | 0.073365 | | |
| $\Delta R$ | 65.0125 | 2.014781 | | |

changes in company market value. The majority of the firms considered reputation risks as insignificant.

## 8 Conclusion

This chapter has developed reflections aimed to advance the understanding of the relation between the theme of CSR and company market value. The empirical analysis underscores the importance of establishing relations between non-financial indicators and financial outcomes.

Company socially-oriented policies are positively linked to the company intangible assets (reputation, productivity, legitimacy) and suggest concrete pathways which other companies can adopt to introduce instruments through which stakeholder value can be created.

Nowadays Russian companies are facing challenges of building up a real, not nominal, system of CSR governance. Increasingly essential becomes a transition from discussions built around mission, philosophy and policies of social responsibility toward its practical introduction in the business environment. Non-financial performance of companies is equally important as their financial results. Companies benefit from developing reputation of socially responsible employers, which will affect employees commitment and hence motivation, as well as enabling companies to gain competitive advantage.

The results of our empirical study contribute to the usage of economic-mathematical models for measuring an impact of social investments of sample companies on their capitalization, even though company reputational risks are undervalued.

This conclusion can expand scientific understanding and be used as a criterion for social investment and effective managerial decision making.

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# Corporate Governance in Europe: Has the Crisis Affected Corporate Governance Policies?

**Belén Díaz Díaz, Rebeca García Ramos, and Elisa Baraibar Díez**

## 1 Introduction: Corporate Governance and the Financial Crisis

Initiatives related to best practices in corporate governance (CG) have increased in recent years because of the onset of the international financial crisis and widespread appreciation of the importance of supervising management and transparency at listed companies to generate value, improve economic efficiency, and strengthen investor confidence [Code of Good Governance for listed companies, CNMV (2015)].

According to Kirkpatrick (2009), the financial crisis can be, to a great extent, attributed to failures and weaknesses in corporate governance arrangements, which did not serve their purpose of safeguarding against excessive risk-taking at a number of financial services companies, while regulatory requirements proved insufficient in some areas. Therefore, there have been several legal reform efforts and countries have enacted new corporate governance codes to strengthen governance in light of the collapse of the international financial markets in 2008 and the well-known scandals (Tihanyi, Graffin, & George, 2014).

However, not all countries have reacted to the crisis on the same scale. Although the four countries considered in this study (Spain, Germany, France and UK) decreased their economic activity in 2009, all, except Spain, went on to increase or maintain their activity after 2010 (Fig. 1a). At the same time, the unemployment rate increased in Spain from 8.25% in 2007 to 24.45% in 2014, while in France this figure is around 10%, and in Germany and the UK it is even lower (Fig. 1b).

The decline in economic activity, the destruction of employment, company closures, and the lack of consumer and investor confidence in companies and

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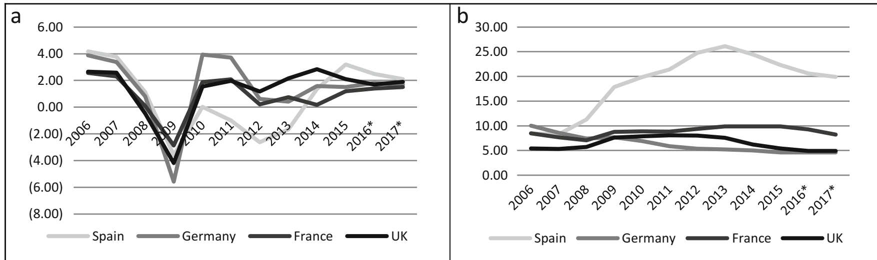


**Fig. 1** (**a**) Real GDP Growth (%). (**b**) Unemployment Rate (%) (*asterisk*) Estimated values. Source: SNL

institutions have created an environment where it is essential to develop mechanisms to generate confidence. Company governance policies help to increase stakeholder confidence, which improves company competitiveness and sustainability.

In this economic environment, and taking into account that countries have different national governance systems, it is worthwhile to ask whether corporate governance practices at firms were different prior to the crisis than after it, and whether there were differences in these practices between the European countries. This research focuses on Spain but also considers another three large economies in Europe (Germany, United Kingdom and France) in order to draw conclusions about significant differences in corporate governance practices among them.

The paper is structured as follows. Section 2 reviews the importance of corporate governance regulations and the revision of codes of conduct in the countries analysed, to establish the framework where the analysis will be performed. Section 3 describes the sample, corporate governance variables, and the methodology for the empirical analysis. Section 4 shows the main results obtained when comparing pre- and post-crisis corporate governance policies in different countries. Finally, Section 5 summarises the main conclusions.

## 2 Corporate Governance Regulation and Codes of Conduct

Research on international corporate governance cannot be addressed without taking into account the contributions of the law & finance approach, initiated by La Porta, Lopez-de-Silanes, Shleifer, and Vishny (1997, 1998); La Porta, Lopez-de-Silanes, and Shleifer (1999) in the late 1990s and which has provided a new perspective on the analysis of corporate governance. This approach is based on the idea that both the laws protecting the rights of investors, and their level of effective enforcement, are the major drivers of corporate governance development in each country. This argument highlights the need for an integrated analysis of corporate governance and the legal system, as a proxy for the institutional framework of the country in which the company operates.

**Table 1** Classification of countries according to their legal protection of investors

| Country | La Porta et al. (1997) classification | Doing business classification (2016). Minority investors protection index |
|---|---|---|
| UK | Common Law | 7.8 |
| Germany | German civil Law | 6 |
| Spain | French civil Law | 6.4 |
| France | French civil Law | 6.4 |

Legal origin is both historically predetermined and highly correlated with shareholder protection (La Porta et al., 1999). Although there are hundreds of legal systems around the world, researchers try to group them by legal families (Matoussi & Jardak, 2012). La Porta et al. (1997, 1998, 1999); La Porta, Lopez-de-Silanes, Shleifer, and Vishny (2000, 2002) show that common law countries tend to provide better protection to minority shareholders than civil law countries do. Within civil law, the strongest legal protection corresponds to the German legal tradition, and the weakest to the French one, with the Scandinavian tradition occupying an intermediate position. The La Porta et al. (1997) classification can be complemented by the Doing Business classification (managed by the World Bank), which estimates an index for minority investor protection for each OCDE country. According to this last classification the UK boasts the greatest investor protection, followed by Spain and France, which are at the same level, followed by Germany (Table 1).[1]

An effective legal system protects shareholders from being expropriated by a firm's management, and protects minority shareholders from being expropriated by large blockholders (La Porta et al., 1997, 1998; Martynova & Renneboog, 2010). Therefore, the presence of comprehensive laws and regulations, together with effective enforcement mechanisms, indicates a well-developed national governance system.

The national governance system consists of formal institutions, such as laws and regulations, political and economic rules and procedures, and other explicit constraints on a firm's behaviour, as well as informal institutions, including unwritten yet quite influential societal norms, conventions, codes of conduct, and values (Kumar & Zattoni, 2014).

Until the financial crisis national governance systems in Europe were dominated by informal institutions, in which voluntary compliance with codes of conduct dominated governance activities, and the legislative framework did not specify rules of corporate governance mechanisms. However, corporate scandals during the crisis period raised serious doubts about the effectiveness of corporate governance policies developed by companies, and corporate law has specified rules on corporate governance.

[1]According to the Doing Business classification, Germany ranks below Spain and France in investor protection, contrary to the conclusion drawn by La Porta et al. (1997), who considered Germany to provide better legal protection.

**Table 2** Characteristics of the Governance Codes

| | Legal basis and compliance | Objective | Predominant board structure |
|---|---|---|---|
| Spain | Disclosure (comply or explain). | Improve quality of board governance; Improve companies' competitiveness; improve investor confidence and transparency; improve corporate social responsibility; guarantee an adequate function, duties and responsibilities division in firms. | Unitary |
| Germany | The Code includes Recommendations, which are to be observed on a comply or explain basis and which are indicated by use of the word "shall"; Suggestions, which are optional and which are indicated by the term "should"; and passages which do not use these terms contain descriptions of legal regulations and explanations. | Improve companies' performance, competitiveness and/or access to capital; improve quality of governance-related information available to equity markets. | Two-tier |
| United Kingdom | The Code includes Principles, which are mandatory; and Provisions, which are to be observed on a comply or explain basis. | Improve quality of board (supervisory) governance; improve governance-related information available to equity markets; improve investor confidence by raising standards of corporate governance. | Unitary |
| France | Disclosure (comply or explain). | Improve quality of board (supervisory) governance; improve quality of governance-related information available to equity markets. | Unitary |

## *2.1 Corporate Governance Codes*

Most of the recommendations in governance codes place great emphasis on formal board structures and board characteristics, such as size, number of independent directors, number of board meetings, board committees, etc. The disclosure of these structural elements enables market participants to evaluate whether boards of directors are complying with the corporate governance recommendations. However, as recent corporate failures have shown, living up to "formal" standards is not enough (Van den Berghe & Levrau, 2004).

The legal basis, objective and predominant board structure in the Governance Code in each of the countries analysed are summarised in Table 2.

Focusing on Spain, different good governance codes based on voluntary compliance have emerged since 1998: the Olivencia Code (1998), which focused on the ethics of the Board of Directors; the Aldama Code (2003), with the objective of promoting transparency and security in markets and listed companies; the Conthe or Unified Code (2006, updated 2013), which includes the sustainability concept and stakeholders in its recommendations; and the Good Governance Code, passed by the CNMV board in 2015, which focuses on 25 main general principals that include 64 recommendations.

This last Code excludes all the recommendations of the Unified Code that have been included in Spanish law (on issues such as the exclusive competence of the general meeting of shareholders or the board of directors, separate voting on agreements, split voting, etc.). The inclusion of specific recommendations on corporate social responsibility should be noted.

Europe's three main economies have also been very active in the revision of their corporate governance codes for listed firms since the crisis, with 8 revisions in Germany, 5 in the UK, and 3 in France (Table 3).

*What is the record of Spanish companies' compliance with the Code's recommendations?* Spanish companies largely comply with the recommendations of the Corporate Governance Codes. According to the CNMV (2015), listed Spanish companies comply, on average, with 85.43% (84% in 2013) of the 53 recommendations found in the Unified Code (partially updated version from 2013), and partially with an additional 6.3% (7% in 2013). On average, Spanish listed companies did not comply with 8.3% of the recommendations. The level of compliance increased in 2014 as compared to previous years. An increase was registered for all the categories of recommendations: statutes and general shareholders' meetings, boards of directors, directors, and compensation and commissions. Recommendations with lower percentages of compliance were those regarding the presence of independent directors on the governing bodies of the company. More specifically, recommendations stating that "the number of independent directors represent at least one third of all directors" and "the majority of members of the appointment

**Table 3** Revision of Corporate Governance Codes in Germany, UK and France

| Country | Governance Code | Dates of revision |
|---|---|---|
| Germany | German Corporate Governance Code | June 2007, June 2008<br>June 2009, May 2010<br>May 2012, May 2013<br>June 2014, May 2015 |
| United Kingdom | The Combined Code on Corporate Governance<br>The UK Corporate Governance Code | June 2008, December 2009<br>June 2010, September 2012<br>September 2014 |
| France | Corporate Governance Code of Listed Corporations | December 2008, April 2010<br>June 2013 |

Source: ECGI

and compensation commissions should be independent directors" are not complied with by 39% and 38.2% of the companies, respectively.

Focusing on the Spanish companies belonging to the IBEX35 index, the CNMV (2013) reports that these companies comply on average with 93.7% of the Unified Code's recommendations and partially with an additional 3.3%. Therefore, companies fail to comply with only 3% of the recommendations (4.3% in 2012).

However, examples like a 4.4% increase in director compensation in 2012, while IBEX 35 companies lost 30% of their value from 2007 through 2011 (OCSR, 2012), evidence the insufficient role of governance codes and the need to legislate in some governance matters.

## 2.2 European Regulations on Corporate Governance

The European Commission has worked on the elaboration of regulations with the aim of improving the governance of companies in Europe since the start of the financial crisis (European Commission, 2012, 2014). These initiatives have focused on three main issues: remuneration, shareholder rights, and transparency/non-financial information disclosure.

With regards to remuneration, *Directive 2010/76/EU* requires credit institution and investment firm remuneration policies to consider present and future risks and to define categories of staff whose professional activities have a material impact on their risk profile (Ben Shlomo, Eggert, & Nguyen, 2013).

*Directive 2007/36/EC* aims to strength shareholder rights, in particular through the extension of rules on transparency, proxy voting rights, the possibility of participating in general meetings via electronic means, and ensuring that cross-border voting rights can be exercised.

Finally, *Directive 2014/95/EU* regards the disclosure of non-financial and diversity information. This Directive addresses the disclosure of non-financial information by companies allowing for great flexibility in actions, in order to take into account the multidimensional nature of Corporate Social Responsibility (CSR), and the diversity of the CSR policies implemented by businesses, matched by a sufficient level of comparability to meet the needs of investors and other stakeholders, as well as the need to provide consumers with easy access to information on the impact of businesses on society.

## 2.3 Spanish Regulations on Corporate Governance

In this European context, Spain has passed different laws in relation to corporate governance.

Some of the major legislative initiatives related to CG in Spain have been: (1) *Sustainable Economy Law 2/2011 of 4 March,* which includes financial market

reforms to increase transparency and improve corporate governance in line with international agreements. In the Law three new groups of provisions stand out: those relating to the corporate governance of listed companies, those relating to the corporate governance of public companies, and those regarding Corporate Social Responsibility. (2) *Royal Decree 771/2011*, which regulates financial entities' compensation policies. (3) *Law 31/2014, of 3 December, which modifies the Capital Societies Law to improve corporate governance*.

Table 4 summarizes corporate governance regulation in Spain.

## 3 Sample, Variables and Methodology

As previously mentioned, the empirical analysis carried out in this research aims to answer three questions: what are the most used corporate governance policies after the financial crisis? Are there differences in governance policies among countries? And, are there differences in governance policies before and after the financial crisis?

### *3.1 Sample*

The empirical analysis considers a sample of 206 firms that belong to Europe's three largest economies, plus Spain (which is in fifth place, based on its GDP). The firms belong to the Stock Indexes of Spain (IBEX 35), France (DAX), Germany (CAC-40) and the United Kingdom (FTSE-100).

Table 5 presents some characteristics of the sample. It shows the average market capitalization of companies in each Index, as well as the maximum, minimum and standard deviation for market capitalization, as an indicator of firm size. Table 5 also shows the number of financial companies in each index to illustrate industry structure.

### *3.2 Variables*

Corporate governance variables were obtained from the *Datastream* database. After the analysis of the 287 variables provided by *Datastream*, 33 governance variables were selected. They were divided in 6 main groups according to the main governance policy they represent.

Therefore, the following categories were established: (1) Board structure/Functioning, (2) Committees, (3) Compensation Policy, (4) Anti-takeover devices, (5) Shareholder rights, (6) Corporate Social Responsibility.

Annex describes all the variables used.

**Table 4** Corporate Governance regulation in Spain

| Regulation | Main policies |
|---|---|
| Ley 26/2003 de transparencia de las sociedades anónimas cotizadas (*Transparency of listed companies Law*). 17th of July. | Improve disclosure and transparency. Since 2004, listed companies have been required to make their corporate governance reports public on an annual basis. They are submitted to the CNMV. |
| Ley 27/2011 sobre actualización, adecuación y modernización del sistema de Seguridad Social (*Updating, improvement and modernization of the Social Security System Law*). 1st of August. | Company Pension funds must report whether or not they use, social, ethical, environmental and good governance criteria, with the aim to facilitate Socially Responsible Investment (SRI). No sanctions if they don't. |
| Ley 2/2011 de Economía Sostenible (*Sustainable Economy Law*). 4th of March. | Expands the minimum content required in the corporate governance report.<br>Listed companies are required to present an annual directors compensation report.<br>Public companies shall adapt their strategic plans to present an annual corporate governance report as well as a sustainability report.<br>Corporations with more than 1000 employees are obliged to publish annual CSR reports (including governance indicators) and submit it to SCCSR (State Council on Corporate Social Responsibility, Known as CERSE in Spain). |
| Royal Decree 771/2011 | Regulates financial entities compensation policy. |
| Ley 19/2013 de transparencia, acceso a la información pública y buen gobierno (*Transparency, access to public information and good governance Law*). 9th of December. | Range of laws for ethical principles and actions that must be overseen by the members of Government and reinforce the sanctions in the case of infraction.[a]<br>Creates the Transparency and Good Governance Council, an independent office for supervision and control of the correct application of this Law. |
| Ley 31/2014 por la que se modifica la Ley de Sociedades de Capital para la mejora del gobierno corporativo (*Modification of the Capital Societies Law to improve corporate governance*). 3rd of December. | The General Meeting of shareholders shall be responsible for fixing board of director compensation every 3 years with respect to maximum compensation, fixed compensation and variable compensation such as separation payments.<br>The amount of equity that a shareholder must own in order to include items on the agenda is reduced from 5% to 3%.<br>A reduction in the required number of shares that a shareholder must own in order to participate in the General Shareholders meeting is established to not exceed 1000 (as opposed to 1 for every 1000 previously used).<br>The duration of the director mandate shall not exceed 4 years (with possible reelection) as |

(continued)

**Table 4** (continued)

| Regulation | Main policies |
|---|---|
| | opposed to the current 6 years.<br>Audit and appointment and compensation committees are required for listed companies, and they must be presided over by independent directors.<br>Establish specific criteria to differentiate categories of directors (executive or non-executive). |

[a]Removal from posts of public responsibility occupied by the offender; the offender may not be nominated to occupy certain public positions during a period of 5–10 years; may not receive compensation payments and is obliged to return any amounts unduly received

**Table 5** Market capitalization and financial companies in each index

| Index | | 2008 (million €) | 2013 (million €) | Number of financial companies |
|---|---|---|---|---|
| Ibex 35 | Average | 21,267.75 | 15,103.04 | 9 |
| | Maximum | 89,865.31 | 64,946.18 | |
| | Minimum | 2432.28 | 729.93 | |
| | Sd. | 25,200.35 | 18,554.42 | |
| DAX 30 | Average | 26,080.91 | 28,057.74 | 5 |
| | Maximum | 84,502.19 | 77,559.19 | |
| | Minimum | 1074.29 | 3288.41 | |
| | Sd. | 21,290.50 | 21,823.78 | |
| CAC 40 | Average | 27,984.43 | 25,750.10 | 5 |
| | Maximum | 128,109.40 | 112,717.10 | |
| | Minimum | 2063.95 | 2196.16 | |
| | Sd. | 26,046.21 | 24,259.99 | |
| FTSE 100 | Average | 13,654.03 | 15,233.20 | 25 |
| | Maximum | 110,071.00 | 115,647.03 | |
| | Minimum | 342.94 | 1057.77 | |
| | Sd. | 20,488.43 | 19,987.57 | |

## *3.3 Methodology*

Different tests were performed to gauge differences between countries and different periods of time (pre- and post-crisis). Based on Aizenman, Jinjarak, Lee, and Park (2016) and Taylor and Williams (2009) we define the beginning of the global crisis in mid-2007. Therefore, 2007 will be considered the pre-crisis year, and 2013 the post-crisis period.

The ANOVA test is appropriate when the dependent variables are continuous and normally distributed and there is a homogeneity of variances (gauged by Levene's test). The Kolmogorov-Smirnov test and Shapiro-Wilk test (appropriate for small sample sizes: Spain, France and Germany are $n < 50$) were conducted to

test normality. In those variables where one of the groups is not normally distributed, the Kruskal-Wallis test, instead of a one-way ANOVA, was conducted to test whether the variables present statistical differences by country. When the dependent variable was dichotomous (categorical), a chi-square test was used to assess the relationship between the variable and its belonging to a given country.

In addition, a dependent t-test was conducted to compare the means between two related groups on the same continuous variable. In this case the same variable in two different periods of time, pre- and post-financial crisis. In those cases where the dependent variable was dichotomous, the McNemar test was conducted. Thus, the McNemar test determines whether the proportion of companies regarding a variable increased or decreased after the financial crisis.

# 4 Corporate Governance Policies in Europe: A Comparison Between Spain, Germany, France and UK

## *4.1 Board Structure/Functioning*

The relationship between CG and firm performance has been broadly studied. However, the role and effectiveness of the board of directors continue to be at the centre of CG research because, in most countries, boards serve as the representatives of shareholders and bear fiduciary responsibility for monitoring management, protecting wealth (agency theory) and improving performance creating wealth (resource dependence theory). Board composition and structure remain at the centre of policy debates as different countries attempt to develop legal and institutional frameworks to improve board performance and diversity (Kumar and Zattoni 2014).

### 4.1.1 Board Size

To guarantee optimal board performance, its size should be adequate to meet business requirements, but not so large as to be unwieldy. Board size has not changed after the crisis. However, there are country-based differences (Table 6, panel A). The UK has the smallest boards, with a mean value of 11 directors in 2013, and Germany has the biggest ones, with a mean value of 16 directors. In Spain and France the size of the board is around 14. Only the Spanish Code makes a specific recommendation about board size: between 5 and 15 members. The other codes only indicate that the number of members should be adequate to enable the board to carry out its mission in the best possible manner.

**Table 6** Corporate governance policies in Europe: a comparison between Spain, Germany, France and UK

| Variables | Spain | | France | | Germany | | United Kingdom | | Country differences | Country differences |
|---|---|---|---|---|---|---|---|---|---|---|
| Panel A | | | | | | | | | | |
| Board structure/Functioning | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 |
| Board size (1) | 14.57 | 14.24 | 13.72 | 14.70** | 17.37 | 16.40 | 11.17 | 11.05 | *** (4) | *** (4) |
| Non executive Directors (1) | 80.09 | 82.65 | 89.40 | 91.12 | 99.63 | 100.00 | 66.42 | 71.82*** | *** (4) | *** (4) |
| CEO Duality (2) | 53.57% | 54.55% | 41.03% | 64.1%** | 0.00% | 0.00% | 2.13% | 2.00% | *** (5) | *** (5) |
| Chairman Experience (2) | 57.14% | 60.61% | 58.97% | 74.36% | 26.67% | 20.00% | 10.64% | 5.00% | *** (5) | *** (5) |
| Director Tenure (1) | 6.07 | 7.99*** | 6.26 | 7.17* | 5.59 | 6.92 | 5.43 | 5.46 | N.S. (4) | *** (4) |
| Meetings per year (1) | 11.54 | 10.97 | 8.13 | 8.44 | 5.66 | 5.75 | 8.98 | 8.70 | *** (3) | *** (4) |
| Meetings attendance (1) | 95.00 | 96.96 | 88.11 | 91.56*** | 67.25 | 86.80 | 93.53 | 96.65*** | *** (4) | *** (4) |
| Panel B | | | | | | | | | | |
| Comitees | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 |
| Corporate Governance Committee (2) | 28.57% | 36.36% | 41.03% | 66.67% *** | 30.00% | 26.67% | 15.05% | 25.25% *** | ** (5) | *** (5) |
| Audit Committee (2) | 46.43% | 78.78% *** | 74.36% | 89.74%* | 53.33% | 70.00% | 90.32% | 96.97% | *** (5) | *** (5) |
| Compensation Committee (2) | 96.43% | 100.00% | 100.00% | 100.00% | 90.00% | 86.67% | 98.94% | 100.00% | ** (5) | *** (5) |
| Panel C | | | | | | | | | | |
| Compensation Policy | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 |
| CEO Equity-based pay (2) | 10.71% | 21.21% | 15.38% | 20.51% | 20.00% | 30.00% | 89.36% | 86.00% | *** (5) | *** (5) |
| Performance-based compensation policy (2) | 60.71% | 90.91% *** | 74.36% | 94.87% *** | 93.33% | 100.00% | 100.00% | 100.00% | *** (5) | ** (5) |
| ESG related compensation policy (2) | 7.14% | 18.18% | 5.13% | 41.02% *** | 0.00% | 40%*** | 26.60% | 70%*** | *** (5) | *** (5) |
| Compensation Policy attract/retain executives (2) | 17.86% | 36.36%* | 25.64% | 43.59% ** | 6.67% | 16.67% | 95.74% | 97.00% | *** (5) | *** (5) |

(continued)

**Table 6** (continued)

| Variables | Spain | | France | | Germany | | United Kingdom | | Country differences | Country differences |
|---|---|---|---|---|---|---|---|---|---|---|
| Say on pay (executive compensation) (2) | 28.57% | 66.67% *** | 2.56% | 7.69% | 3.33% | 63.33% *** | 19.15% | 92%*** | *** (5) | *** (5) |
| Say on pay (stock based compensation) (2) | 28.57% | 63.64% *** | 15.38% | 53.85% *** | 6.67% | 26.67% ** | 1.06% | 60%*** | *** (5) | *** (5) |
| Panel D | | | | | | | | | | |
| Anti-takeover devices | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 |
| Policy limiting anti-takeover devices (2) | 14.29% | 12.12% | 2.56% | 12.82% | 3.33% | 3.33% | 5.32% | 6.00% | N.S. (5) | N.S. (5) |
| Golden parachutes (2) | 52.38% | 35.71% | 24.14% | 50.00% | 48.28% | 62.07% | 36.47% | 38.64% | N.S. (5) | N.S. (5) |
| Staggered Board (2) | 40.74% | 86.37% *** | 76.32% | 97.44% *** | 41.38% | 17.4%* | 90.43% | 6%*** | *** (5) | *** (5) |
| Supermajority vote requirement (2) | 41.18% | 84%* | 38.46% | 94.44% | 58.33% | 64.29% | 20.83% | 98.95% *** | *** (5) | *** (5) |
| Veto power (2) | 20.00% | 24.24% | 14.81% | 13.51% | 8.33% | 13.79% | 0.00% | 5.05% | ** (5) | ** (5) |
| Panel E | | | | | | | | | | |
| Shareholders rights | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 |
| Limited rights to call special meetings (2) | 90.48% | 18.75% *** | 23.08% | 76.92% | 20.00% | 80.00% | 14.06% | 59.65% *** | *** (5) | *** (5) |
| Majority vote for board members election (2) | 32.14% | 84.85% *** | 23.08% | 76.92% *** | 50.00% | 90%*** | 24.47% | 93%*** | ** (5) | * (5) |
| Minimum shares to vote (2) | 3.57% | 6.06% | 0.00% | 0.00% | 0.00% | 0.00% | 0.00% | 1.00% | N.S. (5) | N.S. (5) |
| Director liability limitation (2) | 30.00% | 90.00% | 27.59% | 100%** | 20.00% | 100% *** | 23.08% | 99%*** | N.S. (5) | ** (5) |
| Shares with different rights (2) | 0.00% | 6.06% | 0.00% | 5.13% | 6.67% | 16.67% | 6.38% | 13.00% | N.S. (5) | N.S. (5) |
| Shareholder engagement/activism (2) | 67.86% | 93.94% *** | 15.38% | 56.41% *** | 50.00% | 70%* | 45.74% | 88%*** | *** (5) | *** (5) |

| Panel F | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| CSR | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 | 2007 | 2013 |
| CSR Committee (2) | 28.57% | 87.88% *** | 41.03% | 97.44% *** | 33.33% | 90%*** | 67.02% | 96%*** | *** (5) | N.S. (5) |
| Sustainability Report (2) | 89.29% | 100.00% | 87.18% | 100%* | 76.67% | 100%** | 75.53% | 100% *** | N.S. (5) | N.C. (Constant) |
| External auditor for sustainability report (2) | 95.45% | 96.55% | 67.74% | 100% *** | 32.00% | 88%*** | 63.16% | 91.30% ** | *** (5) | N.S. (5) |
| Sustainability index (2) | 75.00% | 81.82%* | 79.49% | 89.74% | 76.67% | 80.00% | 68.09% | 75.00% | N.S. (5) | N.S. (5) |
| GRI. Guidelines (2) | 91.30% | 100.00% | 95.45% | 100.00% | 90.91% | 100.00% | 83.33% | 94.64% | N.S. (5) | N.S. (5) |
| UN Global Compact (2) | 85.71% | 81.82% | 82.05% | 89.74% | 66.67% | 80.00% | 25.53% | 38%*** | *** (5) | *** (5) |
| Stakeholder engagement (2) | 64.29% | 81.82%* | 56.41% | 74.36% ** | 70.00% | 80.00% | 60.64% | 73%*** | N.S. (5) | N.S. (5) |

Statistically significant at 1% (***), 5% (**) and 10% (*). *NS* not significant, *NC* not conducted
(1) Paired t-test. Differences between different periods of time (pre and post crisis). Continuous variable
(2) McNemar Test. Differences between different periods of time (pre and post crisis). Dichotomous variable
(3) One-way ANOVA. Differences among countries (2007 and 2013). Normal continuous variable
(4) Kruskal-Wallis Test. Differences among countries (2007 and 2013). No normal continuous variable
(5) Chi-square test. Differences among countries (2007 and 2013). Dichotomous variable

### 4.1.2 Outside Directors

Outside directors are considered an independent governance mechanism whose efficacy is determined by directors' incentives and ability to engage in two primary functions: monitoring management and providing resources/counselling to it (Adams & Ferreira, 2007). Agency theorists contend that the independence of outside directors fosters greater transparency, efficiency, and accountability to managerial monitoring (Fama & Jensen, 1983). Resource dependence theorists view outside directors as critical resource providers who use their human and social capital to provide advice and counselling, connections to other organizations, access to external resources, and legitimacy to the firm (Pfeffer & Salancik, 1978). Theoretically, the presence of outside directors should lead to better firm performance, but the empirical findings on the performance implications of these directors are mixed (Yoshikawa, Zhu, & Wang, 2014).

Governance Codes recommend the presence of a significant proportion of independent directors in order to improve the quality of the Board of Directors. In Spain, France and UK it is recommended that at least half the board be comprised of non-executive directors. In companies with controlling shareholders, independent directors should account for at least one third in Spain and France. The two-tier board structure in Germany distinguishes between the Management Board, where by definition all members are executives, and the Supervisory Board, where employees represent one-third or one-half in companies with more than 500 or 2000 employees, respectively.

The mean value of non-executive directors in the sample varies from 71.82%, for the UK, to 100% for Germany (Table 6, panel A), without finding any significant differences in the pre- and post-crisis analysis.

### 4.1.3 Separation of Chairman and CEO

Governance Codes recommend a division of responsibilities at the head of the company between the running of the board and the executive responsibility for the administration of the company's business. Therefore, the roles of chairman and chief executive should not be held by the same individual.

The Spanish Code does not make any recommendation about this separation between Chairman and CEO. The UK Code recommends that a chief executive should not go on to be chairman of the same company. If, in exceptional cases, a board decides that a chief executive should become chairman, the board should consult major shareholders in advance, and should set out its reasons to shareholders at the time of the appointment and in the next annual report. French law offers an option between a unitary formula (Board of Directors) and a two-tier formula (Supervisory Board and Management Board) for all corporations. In addition, corporations with Boards of Directors have an option between the separation of the offices of Chairman and Chief Executive Officer and the maintenance

of the aggregation of such duties. The law does not favour either formula, and allows the Board of Directors to choose between the two forms of executive management (Millstein, 2014). The two-tier board envisioned by the German Code has a chairman of the Supervisory Board separate from the chairman of the Management Board (CEO), and no managers are allowed to sit on the Supervisory Board (Larcker & Tayan, 2011).

The results about CEO duality[2] show significant country-based differences. While this value is 0% for Germany, and very low (2%) for UK, it is over 54% for Spain and 64% for France (Table 6, panel A).

#### 4.1.4 Chairman Experience, Director Tenure, Number of Board Meetings and Meetings Attendance

There are also significant country-based differences in other variables related to board structure and functioning. First, the Chairman/CEO experience at companies is very low for the UK (5%) and Germany (20%),[3] while this value increases to 60.6% and 74.3% for Spain and France, respectively, in 2013. Second, the average number of years each board member has been on the board (director tenure) is between 5.46 for UK and 7.99 for Spain. Third, the mean number of board meetings during the year ranges from 5.75, for Germany, and 11 for Spain. The Spanish code recommends having at least 8 board meetings, but the other codes only suggest meeting often enough to discharge board duties effectively. Fourth, the average overall attendance percentage of board meetings is between 86.8%, for Germany, and 96.6%, for the UK.

Board structure and functioning has not suffered significant changes when compared from 2007 to 2013, except for the case of France, where boards became bigger, CEO duality increased, director tenure increased, and meeting attendance was also up.

### *4.2 Committees*

Three main committees have been considered in this section: the audit committee, the compensation committee, and the corporate governance committee. The results show significant differences between countries. An audit committee was found in 96.97% of companies in the UK in 2013, while only 70% of German companies had

[2]The CEO simultaneously being the Chairman of the Board.

[3]The German Code establishes that Management Board members may not become members of the Supervisory Board of the company within 2 years after the end of their appointment unless they are appointed upon a motion presented by shareholders holding more than 25% of the voting rights in the company.

one. A compensation committee was found in 100% of Spanish,[4] French and UK companies, but only in 86.6% of German ones. Corporate Governance committees were less frequent in European firms, and their presence varied, from 25%, in UK firms, to 66.6% in French ones (Table 6, panel B).

### 4.3 Compensation Policy

Even though executives receive relatively lower compensation in Europe than in the US, there has been an increase in convergence in terms of the structure of compensation, with a greater emphasis on stock-based compensation, such as stock options and long-term incentive payments (De Cesari & Ozkan, 2015).

According to Adams (2012) to align the incentives of CEOs and directors with those of shareholders, CEOs and directors should receive a certain amount of performance-based pay in the form of equity. However, equity incentives may induce managers to take excessive risks. Therefore, it is not always clear whether a given compensation contract is effective or not.

The crisis has increased performance-based pay in the four European countries analysed (Table 6, panel C). Also, the results indicate statistically significant differences in compensation policies among the countries considered.

Even though most companies in Europe feature performance-oriented compensation policies, there are major differences between the countries with reference to CEO compensation linked to total shareholder return before and after the crisis. While in the UK 86% of companies in 2013 had equity-based pay, in other countries this percentage was lower than 30%. Also, in the UK the percentage of firms with a compensation policy related to ESG (Economic Social Governance principals) was higher (70%), than in Spain (18%), Germany (40%) or France (41%).

The top country in terms of a compensation policy to attract and retain executives was the UK, with 97% of companies having such a policy. This percentage lowers to 16.67% for Germany, 36.36% for Spain, and 43.59% for France.

Shareholder voting on executive pay, commonly known as Say-on-Pay, provides an additional tool for shareholder governance via the "voice" channel. The purpose of this mechanism is to promote transparency by providing a new means of expression of shareholder voice, and hence to improve corporate governance efficiency (Stathopoulos & Voulgaris, 2015).

Say-on-Pay was initially introduced in the UK in 2002, and mandates an advisory shareholder vote on executive remuneration proposed by the board of directors. A number of countries have followed the UK's lead, with the introduction of similar legislation (Germany in 2010, Spain in 2011 and France in 2014). Several

[4]Audit and Compensation committees are compulsory by law in Spain since the passing of Law 31/2014.

studies have examined the market reaction to the introduction of Say-on-Pay across different countries. Stathopoulos and Voulgaris (2015) find evidence that the direction and degree of this reaction varies under different settings, a result which raises doubts about shareholders' perceptions regarding the effectiveness of Say-on-Pay.

In 2013 92% of companies from the UK required shareholder approval of executives' compensation (Say-on-Pay). This percentage dropped to 63% and 66% for German and Spanish[5] firms, respectively. All the countries experienced an increase in Say-on-pay when comparing 2007 with 2013, although France had the lowest percentage (7.69%) in 2013 because of its later implementation of the regulation. However, the requirement of shareholder approval prior to the adoption of any stock-based compensation plan is frequently used in France (53.85%) as well as in Spain (63.64%) and the UK (60%), but less common in Germany (26.67%).

### 4.4 Anti-takeover Devices

Previous research has studied how the value of publicly traded firms is affected by arrangements that protect management from removal, and in most cases entrenched boards have been associated with a reduction in firm value (Bebchuck & Cohen, 2005). Also, restrictions on takeover activity due to legislative actions have induced negative share price reactions (Black & Khanna, 2007).

Governance Codes include recommendations to avoid board entrenchment (Millstein, 2014) and establish director re-election on a regular basis. In the UK all directors must be submitted for re-election at regular intervals, subject to continued satisfactory performance. All directors of FTSE 350 companies are to be subject to annual election by shareholders. All other directors should be subject to election by shareholders at the first annual general meeting after their appointment, and to re-election thereafter, at intervals of no more than three years. Non-executive directors who have served longer than nine years should be subject to annual re-election. Under French law, the duration of directors' terms of office is set by by-laws, and may not exceed six years. However, their Governance Code establishes that it should not exceed a maximum of four years so that the shareholders are called to express themselves through elections with sufficient frequency.

The German Code is the only one that makes recommendations in the event of a takeover offer. In these cases the Management Board and Supervisory Board of the target company must submit a statement of their reasoned position so that the shareholders can make an informed decision regarding the offer, and the Management Board is to convene an extraordinary General Meeting at which shareholders

[5]Since the 31/2014 Law the General Meeting of Shareholders is responsible for setting board of director compensation every 3 years in Spain.

discuss the takeover offer and may decide on corporate actions. After the announcement of a takeover offer the Management Board may not take any actions until the publication of the result that could prevent the offer's success, unless such actions are permitted under legal regulations.

*But, has the crisis reduced anti-takeover devices in companies because of their negative influence on firm value?*

According to our results, in Europe very few companies have a policy limiting the use of anti-takeover devices. Spain and France had the highest values in 2013, with around 12% of the companies having such a policy. In Germany and the UK this percentage lowered to 3.3% and 6%, respectively. However, this difference among countries is not statistically significant, and neither are the pre- and post-crisis values (Table 6, panel D).

Golden parachutes or other restrictive clauses related to changes of control are found in 35.71% of Spanish companies, similar to the percentage found in the UK, but lower than the ones for France and Germany (50% and 62%, respectively). The change in the use of golden parachutes after the crisis is not statistically significant either.

Staggered boards weaken shareholders' voices, as this board structure makes only one-third of the board eligible for re-election each year and, hence, reduces accountability for two-thirds of the board members (Aguilera, 2005). Staggered Boards are found in 86% of Spanish companies and 97% of French ones,[6] and have increased significantly after the crisis. However, only 17% of German companies and 6% of companies from the UK had staggered boards in 2013, and their presence has significantly decreased after the crisis.

Most of the companies analysed have a supermajority vote requirement or qualified amendments of charters and bylaws. The lowest level is found in Germany, with 64% of companies having it. Spain and the UK have seen a significant increase in this requirement after the crisis.

In 24% of Spanish companies the biggest owner (by voting power) holds the veto power or owns golden shares. In other countries this practice is less common. In the case of Germany, where there are no shares with multiple voting rights, preferential voting rights (golden shares) or maximum voting rights (Millstein, 2014), the percentage of firms with this veto power is 13.8%, while in the UK and France it is lower.

### 4.5 Shareholder Rights

European companies are making an effort to have policies to facilitate shareholder engagement because of the benefits they can have on corporate governance.

[6]The French Governance Code establishes that terms should be staggered so as to avoid the replacement of the entire board and to favour a smooth replacement of directors.

However, there are significant country-based differences. Almost 94% of Spanish companies have such a policy, as compared to 56.4% of French firms (Table 6, panel E).

Country-based differences are also found in the percentage of companies that have limited the rights of shareholders to call special meetings, which is lower in Spain (18.7%) than in other countries (59.6% in the UK, 76.9% in France, and 80% in Germany).

However, country-based differences are missing with regards to other variables. In most European firms company board members are elected by a majority vote, but very few set requirements for a minimum number of shares to vote, and very few have shares with different rights.

It is worth noting the increase in director liability limitation in companies from all countries after the crisis, with values between 90% of Spanish companies to 100% of the French and German ones.

### *4.6 Corporate Social Responsibility*

Nowadays boards have a mayor responsibility for achieving CSR objectives and sustainability.

In fact, a recent study by Jamali, Safieddine, and Rabbath (2008) found that corporate governance is what drives managers and executives to set goals and objectives in relation to CSR, and the board is key to meeting and promoting these CSR objectives. While the results are mixed and a considerable amount of evidence exists suggesting that various board attributes can have a significant influence on CSR, there appears to be a positive relationship between governance and CSR, suggesting that CG and boards play a major role in CSR (Rao & Tilt, 2016).

The empirical evidence found in our research for this category of variables shows a statistically significant increase in most of the items related to CSR after the crisis in all the countries analysed (Table 6, panel F). Most of the companies in the sample had CSR committees in 2013; 100% of companies publish a separate sustainability report or a section in their annual reports on sustainability; more than 88% of the companies had an external auditor of their sustainability reports; and almost 100% publish the report in accordance with the GRI guidelines. More than 75% of companies report belonging to a specific sustainability index, and between 73% and 82% explain how they engage with their stakeholders.

Therefore, the crisis increased the commitment to CSR policies in all countries, but above all in the UK, where 5 out of 7 of the variables present a significant difference when comparing before and after the crisis.

Before the crisis there were country differences in three variables: CSR committees, with the highest level in the UK (67%) and the lowest in Spain (28.57%); external auditors, with the highest level in Spain (95.45%) and the lowest in

Germany (32%); and belonging to the UN Global Compact, with values between 25.5% and 85.71% for UK and Spain, respectively.

However, after the crisis there are no significant differences in CSR variables between the countries, except for belonging to the UN Global Compact. In the UK only 38% of firms belonged to the UN Global Compact in 2013, while in all the other countries this percentage exceeded 80%.

## 5 Conclusions

This paper analyses CG policies in Spain and in another three European countries. It considers 33 variables that measure policies related to corporate governance, including the areas of board structure and functioning, committees, compensation policy, anti-takeover-devices, shareholder rights, and Corporate Social Responsibility. The results show country-based differences in CG in 25 variables, and pre- and post- crisis differences in 11 variables for Spain, 10 for Germany, 17 for the United Kingdom, and 18 for France. Therefore, the crisis affected corporate governance in common law countries and in civil law ones.

Differences between countries were found in board size, percentage of non-executives directors, CEO duality, chairman experience, director tenure, number of board meetings and attendance at meetings. Also, there were significant differences between the countries with regards to CEO compensation policies, although in all the countries there was an increase in performance-based compensation policies and in Say-on-Pay policies after the crisis.

Analysing different anti-takeover devices, the results showed that staggered boards are mainly present in Spanish and French companies, supermajority vote requirements are mainly present in the UK and France, and golden parachutes are more used in German companies. Thus, there are also country-based differences in these variables, but they are not explained by the legal system the countries belong to.

The increase in most of the variables related to best CSR practices after the crisis shows a greater commitment to CSR policies across all the countries analysed.

Our findings show the importance of a better understanding in each country of how businesses are handling CG, and of the differences in CG practices between countries, in order to make proposals regarding CG in the future, since CG and board structure remain at the centre of policy debates.

A future extension of this research will consider the relationship between CG policies and performance, taking into account the differences in CG between countries and along time found in this paper. The analysis of this relationship will show the efficiency of such policies as disciplinary mechanisms.

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## Annex: Description of the Variables

| Name | Description | Type of variable |
|---|---|---|
| Board Structure/Functioning | | |
| Board size | Size of board (The total number of board members at the end of the fiscal year) | C |
| Non executive directors (%) | Percentage of non-executive board members | C |
| CEO duality | Does the CEO simultaneously chair the board? | D |
| Chairman experience as CEO | Has the chairman of the board been the CEO of the company? | D |
| Director tenure | Average number of years each board member has been on the board | C |
| Meetings per year | The number of board meetings during the year | C |
| Meetings attendance | The average overall attendance percentage of board meetings as reported by the company | C |
| Comittees | | |
| Corporate governance committee | Does the company have a corporate governance committee? | D |
| Audit Committee | Does the company have an audit committee with at least three members and at least one "financial expert" within the meaning of Sarbanes-Oxley? | D |
| Compensation Committee | Does the company have a compensation committee? | D |
| Compensation policy | | |
| CEO equity-based pay | Is the CEO’s compensation linked to total shareholder return (TSR)? | D |
| Performance-based compensation policy | Does the company have a performance oriented compensation policy? | D |
| ESG related compensation policy | Does the company have an ESG related compensation policy? | D |
| Compensation Policy attract/ retain executives | Does the company have a compensation policy to attract and retain executives? | D |
| Say on pay (executive compensation) | Do the company’s shareholders have the right to vote on executive compensation? | D |
| Say on pay (stock based compensation) | Does the company require that shareholder approval is obtained prior to the adoption of any stock based compensation plans? | D |
| Anti-takeover devices | | |
| Policy limiting anti-takeover devices | Does the company have a policy limiting the use of anti-takeover devices? | D |
| Golden parachutes | Does the company have a golden parachute or other restrictive clauses related to changes of control (compensation plan for accelerated pay-out)? | D |

(continued)

| Name | Description | Type of variable |
|---|---|---|
| Staggered Board | Does the company have a staggered board structure? | D |
| Supermajority vote requirement | Does the company have a supermajority vote requirement or qualified majority (for amendments of charters and bylaws or lock-in provisions)? | D |
| Veto power | Does the biggest owner (by voting power) hold the veto power or own golden shares? | D |
| Shareholders rights | | |
| Limited rights to call special meetings | Has the company limited the rights of shareholders to call special meetings? | D |
| Majority vote for board members election | Are the company's board members elected by a majority vote? | D |
| Minimum shares to vote | Has the company set requirements for a minimum number of shares to vote? | D |
| Director liability limitation | Does the company have a limitation of director liability? | D |
| Shares with different rights | Does the company have shares with different rights like priority shares or transfer limitations? | D |
| Shareholder engagement/ activism | Does the company have a policy to facilitate shareholder engagement, resolutions or proposals? | D |
| CSR | | |
| CSR committee | Does the company have a CSR committee or team? | D |
| Sustainability report | Does the company publish a separate sustainability report or publish a section in its annual report on sustainability? | D |
| External auditor for sustainability report | Does the company have an external auditor of its sustainability report? | D |
| Sustainability index | Does the company report on belonging to a specific sustainability index? | D |
| GRI guidelines | Is the company's sustainability report published in accordance with the GRI guidelines? | D |
| UN global compact | Has the company signed the UN Global Compact? | D |
| Stakeholder engagement | Does the company explain how it engages with its stakeholders? | D |

*D* dichotomous, *C* continuous

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# Corporate Governance Best Practice: Tasks and Shortcomings

Maria Aluchna

## 1 Introduction

Corporate governance is one of the dynamically developing theme in the management and finance literature which offers important conceptualization of company functioning and delivers interesting practical insights. As noted by Larcker and Tayan (2011) corporate governance remains an empirical issue since it remains at the fundaments of company operation, the efficiency of stock market and institutional environment as well as investment decisions by individual and institutional investors. The assumptions of strong investor protection, enhancement of corporate disclosure and the efficient monitoring and oversight are the fundamental tasks and goals of corporate governance. These tasks are expected to empower investors and to meet their interests, increase trust, lower risk and in effect improve performance assuring for "long term sustainable value" (Baker & Anderson, 2011; Monks & Minow, 2004). The system of checks and balances is operationalized in the form of corporate governance codes and guidelines formulated at different forums in order to address main control inefficiencies (Clarke & Chanlat, 2009). The nature and efficiency of guidelines and recommendations proposed by governments, regulators as well as national and institutional organizations, must be confronted with expectations of different groups of investors and participants of the stock market.

The aim of the chapter is to discuss the main tasks and shortcomings of corporate governance best practice. More precisely, the goal is to present motivations and functions of adopting corporate governance guidelines as revealed by listed companies in the annual declaration of conformity included in the company report. And finally the chapter aims at referring them to potential shortcomings and limitations revealed in factual implementation of the guidelines in practice and their

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importance for the investment decision by investors. The arguments for best practice code and the statements of compliance with respect to the quality of corporate governance are to be confronted with the insights and observations by 20 invited respondents—board directors, corporate governance experts, auditors, lawyers and funds representatives. The chapter is organized as follows. The concept of corporate governance best practice is outlined in Sect. 2. The case of the Polish code of best practice with the reference to the specific characteristics and shortcomings of the corporate governance system is presented in Sect. 3. Sections 4–6 deliver the results of the series of interviews with corporate governance experts, lawyers, auditors and investors on the functions and role as well as shortcomings and limitations identified in the adoption of best practice code. Final remarks are presented in Sect. 7.

## 2 Corporate Governance Best Practice

Corporate governance aims at protecting investor rights, mostly with respect to the access to information about the company and the possibility to appoint representatives to the board, lowering risk of investing in company stock and assuring for the adequate rate of return (Tricker, 2012). Thus, on the operational level corporate governance offers as set of guidelines which address shareholder rights and the functioning of annual shareholder meeting, procedures and functioning of the board (structure, independent directors, diversity, committee), relations with creditors, whistle blowing policy, standards of transparency and the quality of investor relations as well as the practice of executive compensation (Lipman, 2007). These general guidelines to improve corporate governance may differ with respect to company history, tradition, specialization or sector or operation. Their implementation is strongly embedded in the political, social and cultural systems and are determined by the institutional (Stulz & Williamson, 2003). As comparative analysis indicates the political system and the power of various socio-political groups exert an impact on the shape of law (Roe, 2003). The dominance of certain political sentiments leads to the formulation and implementation of provisions of company acts, financial market regulation and property right law (Doidge, Karoly, & Stulz, 2007). The efficiency of court system and the quality of enforcement are determined by the strength of institutions (Fligstein & Choo, 2005). Social preferences and cultural values influence the time horizon of company operation and investor expectations with the reference to profit distribution, investment and development policy. In result, these factors have impact on the position and power of CEO and other executives, the structure of executive remuneration as well as influence the role of employees, creditors, outside investors and business practice.

Comparative studies reveal significant difference in corporate governance systems amongst countries and companies. Yet, the experience of corporate scandals and frauds help identify governance shortcomings and formulate a set of recommendations to respond to these inefficiencies (Isaksson, 2009; Kirkpatrick, 2009).

Such sets of recommendations are known as codes of best practice. Codes of best practice represent the self-regulation of listed companies and provide a range of recommendations addressing (Larcker and Tayan, 2011; Mallin, 2004; OECD, 2004, 2015; Tricker, 2012):

- Rights of shareholders, stressing the equal treatment of shareholders holding shares of the same class
- The procedures and rules shaping the functioning of the annual shareholder meeting (ASM) and measures empowering shareholders motivating them to active participation in ASM
- Responsibilities of executives who are accountable to shareholders and stakeholders
- The procedures and rules shaping the functioning of the board
- Transparency standards which describe the scope and content of information policy (company operation and strategy, financial situation, ownership structure, composition, structure and procedures of the board, company bylaws and regulations, executive compensation)

According to the concept of corporate governance best practice, the implementation of the code guidelines is based on voluntary approach by listed companies. As provided with the first code in 1992 by the document known as the Cadbury Report, companies follow the 'comply or explain' principles which means that listed firms should comply with the code guidelines (MacNeil & Li, 2006). If otherwise, they are expected to report the non-compliance and provide explanation for the non-compliance with the possible measures to be taken for the improvement (Cadbury Report, 1992). Companies report on the compliance with the code guidelines on the annual basis in the document called 'declaration of conformity' attached or being an integral part of the annual report.

The comply or explain principle is based on the assumptions of (1) the positive effect of corporate governance improvement on firm performance and value (Aguilera & Cuervo-Cazura, 2004) and (2) investor appreciation of the adoption of the code guidelines. Research reveals that regardless of the sector of operation, the company size and the country of origin better corporate governance is associated with better firm performance and higher firm value (Bauer, Gunster, & Otten, 2004). Better corporate governance measured by the quality of the board, transparency, investor activism, structure of executive pay results in improved monitoring and in a consequence leads to better financial results (Bistrowa & Lace, 2012; Goncharov et al., 2006; Renders, Gaeremynck, & Sercu, 2010). As shareholders expect increasing firm value they positively react to the adoption of widely recognized corporate governance guidelines as the compliance plays the function of the proxy for good and efficient monitoring. Taking into account the above listed companies should be interested in compliance with the best practice codes on the voluntary basis as in the long run this would benefit the company itself, its shareholders and stakeholders.

The concept of the best practice code and the comply or explain principles reveal however severe limitations. First, the declarations of conformity published by

companies are neither verified nor audited which means the lack of any external control over their content and relations to real company practice (Arcot, Bruno, & Faure-Grimaud, 2010; Chizema, 2008). This may be particularly problematic in countries with weaker institutional environment, lower transparency and weaker governance by external, market mechanisms (e.g. stock market). Second, the code guidelines are generally accepted and recognized standards which may be differently defined or interpreted in various cultural contexts. This may lead to differences in understanding certain guidelines and the lack of comparability of the conformity declarations. And third, the arguments on 'one size does not fit all' shows that the universality of code guidelines may post shortcomings in various institutional environments (Davies, 2008). The universal guidelines may not play their monitoring or governance functions in less developed economies or weak stock market (Aluchna, 2009; Cuervo, 2002; Hermes, Postma, & Zivkov, 2007). For instance, the recommendation on the presence of independent directors or the formation of specialized board committees may be too strong for countries where the group of professional board directors is still limited and boards are dominated by shareholders.

## 3 Polish Corporate Governance Code

Polish corporate governance has been developing for the last 27 years within the process of transition from command to market economy and socialistic regime to democracy. The privatization of the state owned enterprises, the establishment of the de novo firms, reforms of the financial market and legal system as well as creating new institutional order belong to the milestone on the way of the emergence of the corporate governance system. This process was additionally influenced by the inflow of foreign direct investments and harmonization of corporate governance regulation within the accession to the European Union. In result, currently Polish companies operate in the post transition emerging market reality (Berglöf & Claessens, 2006) characterized by following features:

- Significant ownership concentration with the stake of the largest shareholder estimated at ca. 40% (Aluchna, 2015)
- The engagement of industry shareholders as well as individual investors in the ownership structures. The control by industry shareholder is connected to the operation of the company within a Polish or international business group, while the individual investor in the shareholder structure is either the founder and/or an individual play an important role in management or governance (Aluchna, 2015)
- The moderate but rising use of control leveraging mechanisms such as pyramidal structures, dual class shares, shareholder agreements and other legal and statutory rules
- Two tier board model composed of supervisory and management boards. Supervisory boards are significantly dominated by the representatives of shareholders

and affiliated directors with low participation of independent directors and low participation of female directors (Campbell, Jerzemowska, & Najman, 2006, 2009)

- Insufficient investor protection and insufficient transparency combined with the low efficiency of legal system and contract enforcement

In line with the international initiative for improving corporate governance, the Warsaw Stock Exchange engaged in formulating the code of best practice. The concept of the code follows the international practice—it assumes the firms' voluntary approach, is based on the comply or explain principle and requires the annual publication of the declaration of conformity. The evolution of the code delivers interesting insights as it reveals significant improvements in corporate governance both at the country and the company level illustrating as the same time the shortcomings posted in emerging markets and weaker institutional contexts.

The first version of the code known as Best Practice Code was formulated in 2002 followed by quick amendments in 2004. The code consisted of 48 guidelines with the main goal of the company is to increase its the value for shareholders with the respect for the interests of different stakeholders (company creditors and employees). The guidelines addressed the functioning of the annual shareholder meeting, functioning of management and supervisory boards and company's relations with the third parties.

Starting from 2008 listed companies were required to follow a new document called Best Practices for Companies Listed on the Warsaw Stock Exchange which within a new structure offered a set of recommendations and guidelines addressing transparency standards, principles implemented by the management board, principles addressed to members of the supervisory board and guidelines for shareholders. Over the years 2007–2012 the code guidelines were amended, replaced and developed as presented in Table 1.

As shown in Table 1 over the years the code has been evolving addressing the aspects of disclosure and information policy, remuneration schemes, internal control and risk management, exercising shareholder rights and introducing interactive annual shareholder meetings. Starting from January 2016, a new code called Best Practice for GPW Listed Companies is effective. According to the document, "the objective of corporate governance is to develop tools supporting efficient management, effective supervision, respect for shareholders' rights, and transparent communications between companies and the market". The document covers the issues of (1) disclosure policy and investor communication, (2) management board and supervisory board, (3) internal systems and functions, (4) general meeting and shareholder relations, (5) conflict of interest and related party transactions and (6) remuneration.

**Table 1** The development the best practice code on the Warsaw Stock Exchange

| Resolution | Changes introduced | Effective from |
|---|---|---|
| Historical | | |
| Resolution no. 12/1170/2007 of the WSE Supervisory Board<br>Resolution of the WSE Supervisory Board | Adopting Code of Best Practice of WSE Listed Companies 2007, July 4, 2007 | January 1, 2008 |
| Resolution No. 1013/2007 of the WSE Management Board dated December 11, 2007 | Adopting amendment of the WSE Rules and defining the principles of preparing reports on the application of the corporate governance rules in 2007 | |
| Resolution No. 1014/2007 of the WSE Management Board dated December 11, 2007 | Defining the scope and structure of reports partial waiver of the obligation to publish reports | |
| Resolution No. 17/1249/2010 of the WSE Supervisory Board dated May 19, 2010 concerning | Adopting amendments to Code of Best Practice for WSE Listed Companies<br>• Increased transparency standards and disclosure requirements<br>• Formulation of remuneration policy | January 1, 2011 |
| Resolution No. 20/1287/2010 of the WSE Supervisory Board dated October 19, 2011 | Adopting amendments to Code of Best Practice for WSE Listed Companies<br>• Introducing disclosure on gender balance | |
| Resolution No. 15/1282/2011 of the WSE Supervisory Board dated August 31, 2010 concerning | Adopting of amendments to Code of Best Practice for WSE Listed Companies<br>• Introducing interactive shareholder meeting and on line voting | January 1, 2012 |
| Resolution No. 19/1307/2012 of the WSE Supervisory Board dated November 21, 2012 | Adopting amendments to Code of Best Practice for WSE Listed Companies<br>• Exercising of shareholder rights<br>• Further increased transparency standards and disclosure requirements | January 1, 2013 |
| Code of Best Practice for WSE Listed Companies | Adopting<br>• New structure of the code, introducing general and specific rules<br>• Introducing guidelines on internal control and risk management procedures<br>• Introducing guidelines on the conflict of interest and related party transactions | Effective until December 31, 2015 |
| Currently effective | | |
| Resolution No. 646/2011 of the WSE Management Board | Defining rules of providing current and periodical information<br>Introducing EBI system access application form | |

(continued)

**Table 1** (continued)

| Resolution | Changes introduced | Effective from |
|---|---|---|
| Resolution No. 718/2009 of the WSE Management Board dated December 19, 2009 | Publication of reports on corporate governance rules by listed companies | |
| Commission Recommendation of February 15 2005 | Defining the role of non-executive or supervisory directors of listed companies and on the committees of the (supervisory) board | |
| European Commission Recommendation of April 30, 2009 complementing Recommendations 2004/913/EC and 2005/162/EC (2009/385/EC) | Defining the regime for the remuneration of directors of listed companies | |
| European Commission Recommendation of December 14, 2004 (2004/913/EC) | Defining the appropriate regime for the remuneration of directors of listed companies | |
| Commission recommendation 2014/208 of April 9, 2014 | Defining the quality of corporate governance reporting ('comply or explain') | |
| Best Practice of GPW Listed Companies 2016 | Adopting:<br>• New structure<br>• Disclosure<br>• Internal systems<br>• General meeting and shareholder relations<br>• Conflict of interest and related party transactions<br>• Boards functioning<br>• Remuneration | January 1, 2016 |

Source: own compilation based on WSE materials, http://www.gpw.pl/regulations_best_practices

# 4 The Research

## *4.1 The Method*

The goal of the research is to identify the main functions and tasks of adopting by a company corporate governance best practice as represented by the declarations of conformity published with the annual report. Listed companies present their corporate governance structure according to recommendations and guidelines suggested by the best practice code, referring to the issues of transparency, functioning of supervisory and management boards, risk management, effectiveness of executive remuneration and policy empowering of shareholders. The adoption of the guidelines is believed to improve the monitoring and oversight over the company activity, to comply with regulation and assure for certain standards, to increase investors' trust and to lower risk of investment. Additionally, the study

**Table 2** The breakdown of respondents

| The type of respondents | The number of respondents |
|---|---|
| The representative of investors | 5 |
| Layers | 2 |
| Auditors | 2 |
| Board directors | 8 |
| Corporate governance experts | 3 |

aims at revealing any potential shortcomings and limitations associated with the declaration of conformity.

The study was based on a series of in-depth interviews with board directors, corporate governance experts, auditors and layers and representatives of investment and pension funds. The number of respondents totaled 20 individuals. The breakdown of respondents is presented in Table 2.

The research questions were formulated as follows:

1. What are the main drivers for adopting corporate governance best practice by a company?
2. Which of the code guidelines are the ones least frequently adopted?
3. What are the main explanations for the non-compliance with the code guidelines?
4. Is the conformity with best practice a determinant for investment decision in a company?
5. Is the declaration of conformity a key document for assessing company's corporate governance?
6. What are the shortcomings of best practice conformity?

The declarations of conformity are included in the annual reports and are publicly available on the companies' website. Yet, these documents remain the declarations provided by the companies and are not verified by an auditor, authority or any other entity. The voluntary approach of the code guidelines adoption and the flexibility of the reporting on compliance are viewed as the efficient approach to self-regulation. This assumption is based on the belief that in the long term investors are able to identify the implementation of the guidelines and assess the quality of the declarations. The investors' reactions are viewed in the pricing effect. As this study focused on the practical dimensions of the best practice compliance, the respondents were asked to address the credibility of the declarations of conformity.

## 5 Results

The content of the insights provided by respondents was analyzed from the perspective of the paper goal and the research questions. First, with respect to the main drivers for adopting corporate governance best practice by a company (research question 1), the respondents aimed at the legitimacy aspects. The board directors and representatives of investors mostly argued for the importance of the adoption of the widely recognized recommendations to address the expectations of the stock market and its participants. The report on best practice compliance is required from all listed companies and listed companies simply need to meet this requirement. The respondents emphasized the aspects of the improved reputation, the mitigation of structural conflicts and enhanced transparency provided by declarations of conformity. These aspects are particularly significant in the case of large companies being in the public spotlight. The respondents addressed however the legitimacy argumentation arguing that the declaration of conformity may not actually be implemented and internalized in companies' practice. As one of the respondents mentioned "*The declaration is only a part of the story as nobody is able to verify the content of the document. The main issue is how the company behaves in practice. And this may be very different from what was declared*" (R1).

Addressing research question 2 respondents indicated that the guidelines on the presence of independent directors on board, formation of specialized board committees, selected aspects of disclosure and the e-voting installed during the annual shareholder meetings are amongst the ones least frequently adopted. Most precisely, with respect to transparency standards the companies do not want to report on the list of shareholders' questions and company replies on them, do not want to disclose the video coverage from the proceedings of annual shareholder meetings and refrain from publishing information which in their opinion may be detrimental to the company (information useful for competitors, disclosing private information). Weak compliance is also identified in the area of reporting on the remuneration policy. Additionally, companies are reluctant to assure for gender balance on board providing however the information on the balance (or rather lack thereof) of their investor relations websites.

According to the adopted rule of "comply or explain" listed companies which do not follow corporate governance guidelines need to provide an explanation and set the possible date for improvement. The respondents suggested that the most frequently found explanations for the lack of best practice compliance refers (research question 3):

- The compliance with hard law which is obligatory. The law sets adequate standards for company operations—some firms argue that as long as they follow the legal regulations they are not obliged to introduce additional rules and guidelines
- The primacy of company by-laws and shareholder interest over the set of best practice formulated by the stock exchange. Companies claim some recommendations either limit shareholder rights (e.g. to appoint the best board director not

necessarily the independent one) or may be at the cost of shareholders and their interest (e.g. disclosing names of shareholder present during annual meeting or disclosing the questions they ask)

- The threat of acting at the cost of the company and/or shareholders—this explanation is mostly used for non-compliance of certain disclosure guidelines (e.g. publishing information on the independence status of directors)
- The threat of inducing chaos or turbulence—such explanation is often used in the case of non-compliance with the recommendation on e-voting. Companies suggest that poor internet connections could cause disturbances in the proceedings of the annual shareholder meeting, lead to delays or even result in shareholders calling for repetition of the meeting to technical problems
- Additional costs for companies in the case of compliance—this explanation is often used for non-compliance with the transparency guidelines (the standards of the investor relations website, both in Polish and English) and providing interactive communication with shareholders and installing e-voting system

Addressing research question 4 all respondents admitted that the conformity with best practice is not a determinant for investment decision in a company. More precisely, the investment decision based these days mostly on the use of sophisticated algorithms, rely on the financial and technical measures which indicate the potential for increase of firm value and share price as well as the dividend payout. However, as argued by one of the respondents: "*although we do not include the corporate governance variable into our models, we cannot make a serious mistake investing in a company of a risky or fraudulent corporate governance as we are also responsible and accountable towards our clients or beneficiaries. The possible mistake would deteriorate our reputation showing that we do not understand risk management*" (R2). On the other hand the other respondent admitted that sometimes they "*need to invest in a company characterized by some inefficiencies in corporate governance, if the company is a large firm or is targeted by our competitor [another investment fund]. We need to invest in this company based on the benchmark strategy. When the investment in this company would prove to be profitable we would lose against our competitors and customers would blame us for to high risk aversion*" (R3).

The respondents also agreed on the research question 5 arguing that the declaration of conformity should be a key document for assessing company's corporate governance. It provides a general overview of the adopted mechanisms and rules that shape corporate governance at the firm level. The significant advantage of the compliance concept is that companies need to formulate and report their rules and practices. They also need to critically address the implemented solutions from the perspective of the efficiency of the company and the safety of the investment in their shares. The declaration delivers important information on the transparency standards, communication with investors, the structure of the board and the remuneration policy.

However, according to the interviewed respondents the declaration of conformity reveals some significant limitations (research question 6). As mentioned above

the declaration of conformity is not verified or audited. The content of the declaration is assessed by the general public of investors. However, as put by one of the respondents "*the compliance is rather checked in the behavior and practical actions the company undertakes and not necessarily has to be illustrated by the declaration of conformity*" (R4). Thus, the main shortcomings of best practice conformity as noted by respondents refers to the lack of the verification of the report and the difficulty to foresee how a certain company would act in a specific situation. Moreover, the shortcomings of the best practice code refer also to the "one size does not fit all" issue. As suggested by companies and argued by the respondents the general rules transmitted into the national code may not necessarily address the needs of the specificity of the Polish reality. Moreover, an additional limitation was revealed while discussing the possibility of the improvement of the compliance quality. The improvement may be blocked in the case of companies with stable ownership structure characterized by the dominance of the majority shareholder. In such situation even if in the institutional/financial investors are being engaged in the shareholder structure and propose improvements of corporate governance standards, their proposals may be blocked by the dominant owners.

## 6 Discussion

The analysis of the collected material shows that the functioning of the best practice code and the shortcomings of the compliance with the code recommendations corresponds with the structural problems of Polish corporate governance. First, Polish companies operate in the post-transition, emerging market and are characterized by the significant ownership concentration in the hands of mostly industry shareholders or individual investors who often tend to be founders and/or play a key position on management board. Such ownership and governance reality limits the willingness of companies to adopt some of the best practice. As the study on the degree of compliance reveals and as the interviews indicate there is a significant group of companies which do not follow best practice on the presence of at least two independent directors on the supervisory board, formation of the specialized board committees (audit and remuneration), disclosure of the proceedings of annual shareholder meeting and installing on line voting system. The non-compliance with the board best practice may be to some extend explained by the dominant position of the majority shareholders who are not eager to share control on the board with minority shareholders. The non-compliance with the e-voting recommendation is also result of the dominance of the majority shareholders not willing to empower small investors to actively participate in the annual meeting. Thus, some of the best practice are problematic to be implemented due to the national specificity and structural shortcomings. This may support the one size does not fit all approach making some of the recommendations inactive.

Second, Polish corporate governance has relatively short history of 27 years still facing insufficient investor protection and insufficient transparency. The

institutional structures are weak and in line with the fundaments of the best practice code the declaration of conformity published by companies are not verified, the real degree of compliance may be even lower as reported. As argued by respondents the declaration is a subject of a good will, communication policy and probably in some cases imagination of companies and may not necessarily be internalized at the organizational level. Thus, companies declaring compliance may not implement some of the recommendations in practice. Respondents identify this risk claiming that the real compliance is rooted in company behavior and its practice on the market speaks for itself as opposed to the declaration of conformity.

Third, the lack of verification of the compliance statements, the lack of strong liquid stock market combined with the passivity of institutional/financial investors may also lead to the instrumental treatment of either the declaration of conformity or the contents of the explanations (Arcot et al., 2010; Zattoni & Cuomo, 2008). Companies may incrementally resist implementing best practice providing general explanation for the non-compliance not perceiving it as a process of improvement.

And finally, respondents also linked compliance to some additional efforts to be undertaken by companies, costs incurred and adjustments made (e.g. investor relation, the content of the website, translation of corporate materials and documents from Polish into English). Thus, the respondents indicated that the compliance may be endogenously driven in the case of larger companies, companies with largest budgets or companies at the public and market spotlight (e.g. state controlled companies, banks, companies operating in petrochemical industry). Companies being in a weaker interest of investors and market analysts are to lesser extend exposed to public pressure and control on compliance. This may lower their motivation to adopt the code guidelines.

## 7 Conclusion

The chapter aimed at discussing practical implications of the adoption of corporate governance code by Polish companies seen by the eyes of board director, fund representatives and corporate governance experts. The main goal was to confront the concept of the self-regulation provided by the best practice code and the statistics of the compliance with the recommendations as reported in the declarations of conformity against the opinion of invited respondents. As long as companies follow official line of communication with the market and declare formal governance policy, some aspects of practical adoption of the code remain unidentified. Yet, the insiders and experts who are exposed to the corporate practice may provide an important and unique insights into the way the compliance really works. The material collected during the interviews with board members, auditors, investment and pension funds representatives and other corporate governance experts revealed essential functions and tasks of the code guidelines indicating at the same time significant limitations. Respondents agree that the declarations of conformity published in annual reports deliver important information on the

practice of corporate governance in listed companies. At the same time they however point the threat of the instrumental treatment of the compliance statement under the conditions of weak market, passive institutional investors, insufficient investor protection and lack of the verification of the contents of companies' reports. This weakens the message provided by the declaration of conformity and encourages market participants to carefully observe the daily behavior of listed companies.

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# Part II
# Balancing Stakeholders and Shareholders

# Extending the Frontiers of Responsible Corporate Governance: Exploring Legitimacy Issues of Multi-stakeholder Initiatives

**Lars Moratis**

## 1 Introduction

Governments, non-governmental organizations and transnational corporations realize that it has become difficult to address sustainability challenges by themselves. The social, environmental and economic externalities of 'footloose' corporations are large, interconnected and globe-spanning, requiring new forms of regulation with and without government. As a novel way of collaborative governance these actors increasingly coordinate the design, implementation and monitoring of rules and standards in multi-stakeholder initiatives (MSIs) that provide firms with guidance and prescribe desired behavior in a range of policy areas (Kalfagianni & Pattberg, 2013; Moog, Spicer, & Böhm, 2015). MSIs, defined here as "private governance mechanisms involving corporations, civil society organizations, and sometimes other actors, such as governments, academia or unions, to cope with social and environmental challenges across industries and on a global scale" (Mena & Palazzo, 2012: 527), seem a promising way for developing such new forms of regulation and deal with externalities of companies in a democratic way (Scherer & Palazzo, 2008). However, these governance arrangements are not equally well-embedded in established democratic mechanisms as regulation through governmental bodies. This calls for the examination of the conditions under which MSIs can be viewed as governance arrangements that legitimately transfer regulatory power from the public to the private domain.

Management scholars Mena and Palazzo (2012) developed a framework containing criteria for assessing the input and output legitimacy of MSIs in the context of corporate social responsibility (CSR). This chapter can be seen as a

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critical investigation of their framework. While Mena and Palazzo shed important light on a phenomenon that has only rarely been the subject of scholarship on global governance (Hachez & Wouters, 2011), this chapter argues that their framework ignores several legitimacy aspects of MSIs in the CSR realm and adopts a classification that may obscure several important characteristics of MSI legitimacy. This chapter hence serves the purpose of refining and extending the Mena and Palazzo framework to assess MSI legitimacy. It presents a critical investigation through looking at recent work of scholars on aspects of democratic legitimacy and informing proposed adjustments of the framework by Mena and Palazzo on insights from this literature. A new category of criteria for assessing MSI legitimacy (i. e., throughput legitimacy) is added to the existing categories of input and output legitimacy and the chapter draws on the ISO 26000 standard for global responsibility to illustrate the arguments made.

The chapter first contends that the classification in their timely conceptual article should include the dimension of throughput legitimacy next to input and output legitimacy. To substantiate this contention, it draws on recent work on deliberative democracy and examinations of the legitimacy of governance structures in general and MSIs in particular. Second, this chapter proposes an extension and refinement of the legitimacy criteria that Mena and Palazzo have formulated. Third, this chapter consequently presents a new categorization and suggested operationalization of criteria determining the legitimacy of MSIs under the input, output and throughput dimensions. By answering Mena and Palazzo's call for scholarly contributions on this topic, this chapter aspires to provide additional insights for an enhanced understanding of legitimacy aspects of MSIs and strengthen the framework developed by Mena and Palazzo for analyzing MSIs from a legitimacy viewpoint.

## 2 Input, Output and Throughput Legitimacy

Drawing on insights from literature on deliberative democracy (e.g., Habermas, 1998, 2001; Scharpf, 1999, 2009), Mena and Palazzo distinguish between an input and output dimension of MSI legitimacy. They define input legitimacy as the extent to which regulations are perceived as justified or credible. Output legitimacy is defined as the extent to which regulations solve the issues targeted. The authors subsequently identify several MSI legitimacy criteria within these categories, including inclusion, procedural fairness, consensual orientation, transparency (together comprising input legitimacy), rule coverage, efficacy and enforcement (comprising output legitimacy). Input legitimacy, the authors write, represents governance *by* the people; output legitimacy represents governance *for* the people.

While the dichotomy of input and output legitimacy allows for understanding MSIs through *a priori* and *a posteriori* assessments of MSIs, the criteria identified by Mena and Palazzo may also serve as MSI design variables. Despite the contribution of their work in this context, it seems to neglect a third type of democratic legitimacy, namely throughput legitimacy. It is proposed here to include the

dimension of throughput legitimacy into the framework developed by Mena and Palazzo as moving beyond their input-output dichotomy may help shedding additional light on legitimacy aspects of MSIs and help develop effective private governance arrangements. Before expounding on and understanding the arguments for this third type of legitimacy, it is necessary to first define the concept of throughput legitimacy.

## *2.1 Defining Throughput Legitimacy*

Grounded in ideas of discursive institutionalism, throughput legitimacy typically relates to the justification of governance modes based on the quality of procedures (Bekkers & Edwards, 2007). Engelen et al. (2008: 11) write that this type of legitimacy "emphasizes the importance of the design of the actual decision-making procedure—ensuring fair and inclusive fora in which each participant has equal standing and equal speaking time" and that it serves "the transformation of individual *interests* into collective *reasons*" (cf. Bohman, 1998; Elster, 1998). Throughput legitimacy deals with interest intermediation and deliberative actions and is linked to issues of balance in access and influence among organized interests. This reflects Habermas' arguments of the importance of communicative action (Habermas, 1996, 2001) and aligns with what Mena and Palazzo have identified as the input legitimacy criterion of procedural fairness. Throughput legitimacy is thus concerned with the presence, characteristics and quality of the interactions between the actors involved in the MSI. Its main object of reference is 'the black box of governance'.

In the view of Schmidt (2013), who has particularly written about the democratic legitimacy of the European Union governance system, throughput encompasses efficacy, accountability, transparency, inclusiveness and openness to interest consultation of governance processes. In the context of an MSI, accountability is taken to mean that it is judged on its responsiveness to participatory input demands and can be held responsible for its output decisions (Harlow & Rawlings, 2007) as well as that its governance processes meet ethical standards of governance. Transparency (one of the input legitimacy criteria within the Mena and Palazzo framework) is often seen as a prerequisite of accountability but not as qualifying as accountability on its own because the latter also demands some form of monitoring and scrutiny by a specific forum which may lead to sanctions (Bauhr & Grimes, 2013; Bovens, 2007; Hood, 2007; Schmidt, 2013). Marx (2013) argued that attention for aspects of enforcement mechanisms (i.c., certification and verification through conformity assessments) should be complemented by accountability mechanisms that serve to hold organizations to account after a decision has been reached and to raise a dispute. The notion of accountability is however conspicuously missing from the Mena and Palazzo framework.

Input legitimacy primarily reflects the constitutional diversity (i.e., presence of a variety of backgrounds and ideological orientations) and the societal relevance of

the constellation of actors participating in MSIs. Output legitimacy follows a more consequentialist logic of performance (Wolf, 2002) and, as such, ignores the process through which the results have been realized. Throughput legitimacy emphasizes the construction of meaning and consensus through interaction between actors involved in MSIs. While input legitimacy may be about consent (governance by the people) and output legitimacy about utility (governance for the people), throughput legitimacy revolves around process and represents governance *with* the people.

## 3 Why Distinguish Throughput Legitimacy?

Despite the fact that throughput legitimacy has remained a largely underinvestigated dimension of normative legitimacy it is argued here that institutional throughput should be identified as a separate analytical category for understanding the legitimacy of private democratic governance systems (cf. Lieberherr, 2013; Schmidt, 2013). The argument for doing so is mainly grounded in the conceptual overlap between the different legitimacy dimensions. In addition, it is based on the deviating legitimacy dynamics of throughput legitimacy and a better understanding of the interaction effects between input, output and throughput legitimacy.

### *3.1 Conceptual Overlap*

The interpretation of throughput legitimacy as revolving around the process of governance rather than stakeholder consent or performance utility may already give rise to identifying it as a separate dimension of MSI legitimacy. However, some conceptual overlap exists between input, output and throughput legitimacy and several of the criteria identified by Mena and Palazzo within the category of input legitimacy obviously bear witness to this.

Both input and throughput legitimacy tend to be seen as being essentially procedural, as opposed to the consequentialist or utilitarian orientation of output legitimacy (Dingwerth, 2007; Wolf, 2002). As a result, the throughput dimension has often been assumed under input legitimacy (Mayntz, 2010; Scharpf, 1999; Steets, 2010). Input and throughput legitimacy however relate to different processes of democratic governance. Schmidt (2013) contends that interest-based throughput is categorically different from interest group-based input. While the former relates to MSI decision-making processes or Mena and Palazzo's criterion of procedural fairness, the latter is concerned with the articulation of demands "through interest group pressures, protests, petitions, letter-writing campaigns, social movement activism and the like", aimed at influencing the actors involved in the MSI (Schmidt, 2013: 7).

Next to serving the purpose of conceptual differentiation, Schmidt's (2013) notion of interest group-based input reveals another legitimacy aspect of MSI legitimacy: the extent to which the MSI is prepared to be open, responsive and accountable to voices expressed by relevant outsiders and secondary stakeholders. Examples of these include knowledgeable observers and groups that are affected indirectly rather than directly by the functioning of the MSI (cf. De Bakker & Den Hond, 2008). MSIs that do not recognize this ignore a basic tenet of stakeholder theory saying that who is not affected now, may well be affected in the future (cf. Mitchell, Agle, & Wood, 1997). From an accountability viewpoint, it is important for MSIs to also recognize that those affected may not have the ability to voice their concerns, influence and demand compliance. In the realm of CSR the group that is affected and may demand accountability is broader by definition. The Ethical Trading Initiative (ETI), for instance, provides an 'Alleged Code Investigation Guidelines', allowing NGOs and trade unions to forward complaints from Southern members (Fuchs, Kalfagianni, & Havinga, 2009). Fransen and Kolk (2007) in this respect distinguish between narrow or broad inclusiveness by MSIs, representing an orientation on the involvement and consultation of stakeholders respectively. One could consequently argue that for an MSI in the realm of CSR to be perceived as legitimate, it should have an integral focus on inclusiveness, comprising both broad and narrow orientations. If not, an MSI could have the effect of what Hazenberg and Mulieri (2013) call the 'undemocratic domination' of constituents that are not properly represented or do not avail of ways of expressing their voice to influence the MSI. Examining GLOBALG.A.P., a leading standard scheme for good agricultural practices and food safety, Hachez and Wouters (2011) conclude that while the standard's accountability as a regulatory actor towards its internal members suffices, it should make extra efforts to ensure stronger accountability towards external stakeholders, especially those from developing countries.

Throughput legitimacy is also related to output legitimacy in the sense that it relates to the effectiveness and efficiency of policy-making (Risse & Kleine, 2007). Efficiency has often been linked with output legitimacy in the political sciences (Bekkers & Edwards 2007; Kronsell & Bäckstrand 2010; Scharpf, 1999). However, efficiency arguably also relates to processes rather than outputs. For instance, an output could be more or less efficiently accomplished but the actual efficiency occurs along the way, not at the end (Lieberherr, 2013). Schmidt (2013) notes that throughput legitimacy can be comprised of both participation-oriented legitimacy of input and the results-oriented legitimacy of output with a focus on the quality of interaction and procedures. In a somewhat similar vein, Lieberherr (Lieberherr, 2013; Lieberherr, KIinke, & Finger, 2012) distinguishes between regulatory accountability and performance accountability in her interpretation of throughput legitimacy. Regulatory accountability then relates to the checks and balances that are built into the MSI; performance accountability relates to cost utility and competitive regulation. While both forms of throughput legitimacy may coexist in modes of governance, as Lieberherr notes, typically one of them tends to predominates the other. In the context of private retail standards, Fuchs et al. (2009) have argued that while throughput legitimacy may be analytically distinguished as a

stand-alone category of legitimacy, it is also a precondition for determining consensual orientation. In more general terms, throughput legitimacy can be viewed as a form of legitimacy that partly 'functions on the background' of the input and output dimensions of MSI legitimacy. From a deliberative democracy point of view, throughput legitimacy may thus be the very heart of the fabric of MSIs.

### *3.2 Different Legitimacy Dynamics*

As an extension of the first point, a second reason for distinguishing throughput legitimacy as a separate category is that the 'legitimacy dynamics' are different for input and output legitimacy on the one hand and throughput legitimacy on the other. Unlike input and output legitimacy, which affect public perceptions of legitimacy both when they are strengthened or compromised, throughput legitimacy is by definition less observable. Its prominence may be particularly perceived by internal stakeholders (i.e., MSI participants), while external constituents experience high levels of opacity in this regard. Throughput legitimacy consequently tends to be most salient when it is compromised, "because oppressive, incompetent, corrupt or biased practices throw not just throughput but also input and output into question" (Schmidt, 2013: 2).

### *3.3 Understanding Interaction Effects*

The third reason for identifying throughput legitimacy as a separate category is that, through promoting analytical clarity, it enhances understanding of interaction effects between different dimensions of legitimacy, a phenomenon that Mena and Palazzo also address in their article. Lieberherr (2013: 2) in this regard writes that, as an intermediary dimension between input and output legitimacy that is based on both procedural and more performance-oriented criteria, throughput can serve to understand how tensions between input and output legitimacy arise. Next to its explanatory value, throughput legitimacy can function as a moderator of input and output legitimacy. It can have (positively and negatively) amplifying as well as mitigating effects and can foster synergies between input and output legitimacy (Mayntz, 2010; Schmidt, 2013; Steets, 2010). Throughput legitimacy may however also contribute to dilemmas between input and output legitimacy and cause trade-offs (i.e., conflicts between the dimensions may arise, depending on the form of throughput legitimacy) (Pierre, 2009). In a recent empirical article on MSIs in the global governance of sustainable fishery Kalfagianni and Pattberg (2013) conclude that there is no linear relationship between inclusiveness and representativeness (input) and effectiveness (output) *per se*. The authors contend that while input legitimacy may result in more rule stringency and comprehensiveness, stringent governance arrangements will probably be the ones to be least taken up.

Throughput legitimacy may in such cases account for amplifying as well as mitigating effects between inclusion and adoption. Intensive participation in rule-setting negotiation and decision-making processes can improve stakeholder consent and their preparedness to adopt a more stringent standard. An example of throughput legitimacy having influenced standards adoption can be found in the development process of the ISO 26000 standard for social responsibility. During the process, the International Labour Organization (ILO) demanded that the standard would not become certifiable, supposedly to protect its own authority as the primary rule-maker in the CSR realm (Hahn & Weidtmann, 2012). Although there was an interest from business (especially SMEs) to develop a certifiable CSR standard, the ILO standpoint directly led to the decision of dismissing the more stringent certification option and ISO 26000 was developed as a guidance document instead. In this case, procedural fairness was thus compromised which may have led to lagging ISO 26000 adoption rates in the face of lowered value of the standard for firms as it is not certifiable and, as such, an instrument that may not help reveal their CSR quality. Another consequence has been the emergence of various certifiable CSR management systems standards worldwide that serve as substitutes for ISO 26000 which contribute to a further rather than a halted proliferation of CSR standards (Moratis, 2017, forthcoming).

While Mena and Palazzo are silent on the reasons why they have not identified throughput legitimacy as a separate dimension for assessing the legitimacy of MSIs, the reason for not having done may be exactly in the conceptual overlap between throughput legitimacy and input and output legitimacy. Throughput legitimacy, the authors may have reasoned, constitutes an analytically redundant category. However, as has been argued sofar in this chapter, the absence of a separate throughput category is particularly salient as throughput legitimacy reflects processes of deliberative democracy.

## 4 Extending and Refining Legitimacy Criteria

Next to arguing for the inclusion of throughput legitimacy as a separate analytical category for assessing the democratic legitimacy of MSIs, the second main point of this chapter concerns an extension and refinement of the legitimacy *criteria* identified by Mena and Palazzo. The next sections consider the criteria of inclusiveness, rule coverage, efficacy, and enforcement respectively.

### *4.1 Inclusion of Stakeholders and Their Interests*

Following the principle of affectedness (cf. Hazenberg & Mulieri, 2013), Mena and Palazzo define inclusion as the involvement of stakeholders that are affected by the issue. “As for any democratic polity”, they note, “the way in which an MSI includes

different stakeholders is important to its input legitimacy" (Mena & Palazzo, 2012: 536). Referring to Young (2000: 52), the authors further write that "even if they disagree with an outcome, political actors must accept the legitimacy of a decision if it was arrived at through an inclusive process of public discussion." As a consequence, even in cases where it includes a large number of stakeholders, an MSI may possess low legitimacy when it does not include relevant stakeholders.

A first problem with this interpretation of inclusiveness is that it relates to the inclusive process of public discussion, which fails to recognize a difference between input and throughput legitimacy. Inclusive discursive processes particularly pertain to the domain of throughput legitimacy. Next to the basis of stakeholder inclusion in participative processes in terms of how they are able to influence these processes (which Mena & Palazzo integrate in the criterion of procedural fairness), an important aspect of the inclusion of stakeholders relates to the process of their inclusion (strategies of stakeholder selection) and resulting balanced actor coverage. In an article on the legitimacy of biofuel certification Partzsch (2011: 416) poses that in contrast to democratically controlled governance structures, in private governance stakeholders are usually selected (not elected) by an executive authority. Hence, MSIs suffer from an input-legitimacy deficit.

While Mena and Palazzo distinguish between included and excluded actors, MSI legitimacy is likely to be dependent on a balanced inclusion of affected stakeholders. In the context of ISO 26000, for instance, small and medium-sized enterprises (SMEs) and institutions representing their interests were involved in the multistakeholder standard development process. However, as a minority group, representing SMEs has proved difficult in the ISO 26000 standards committee (Egyedi & Toffaletti, 2008; Perera, 2009). Whereas SMEs were deemed a relevant stakeholder and were included in the process, their influence was rather limited, leading to limitations in the spectrum of relevant issues covered (i.e., rule coverage) and compromising the value of the standard for SMEs (Perera, 2008). The earlier mentioned stand-off in the deliberations on ISO 26000 invoked by the influential ILO clearly seems a breach of the criterion of procedural fairness: it neglects the principle of equal participatory opportunities and signals asymmetric power relations. Balanced actor coverage in this respect would perhaps have resulted in a superior outcome—at least from the perspective of SMEs, comprising over 95 per cent of the world's businesses—such as an optional certification amenity. An improved balance in actor coverage could have been reached, for instance, by putting more effort into the process of stakeholder selection through inviting relevant representatives of this stakeholder group and only starting the process of developing the standard with a certain critical mass of actors in relevant categories.

In the context of CSR, interpreted here as the roles and responsibilities of business in sustainable development (cf. Dahlsrud, 2008; Garriga & Mele, 2004), there is another conspicuous problem of stakeholder inclusion, namely that of including future generations. While this stakeholder group arguably is among the most important to include from the perspective of the rule-targets of MSIs, this is essentially impossible and they are likely to be poorly represented (cf. Dobson, 1996; Jacobs, 1997; Loreau et al., 2006). In fact, this may point at an inevitable

paradox of MSIs in the CSR domain since these ventures are ultimately aimed at protecting and promoting the interests of future generations while being deprived of the possibility to actually involve them. The input legitimacy criterion of actor coverage may thus not account for fully equitable outcomes, posing stakeholders included involved in the MSI with an intricate responsibility.

### 4.2 Rule Coverage

The second criterion within the framework of Mena and Palazzo that is proposed to be refined here is rule coverage. According to the authors, rule coverage concerns "the number of actors bound by an MSI rule, and, as such, is directed toward the quantity of actors involved in standard implementation" (Mena & Palazzo, 2012: 37). The more (peer) actors are bound by an MSIs rules, the higher the level of output legitimacy of the MSI becomes.

Here, it seems useful to differentiate between rule coverage and actor coverage on the one hand and rule coverage and rule adoption on the other.[1] Rule coverage may concern the extent to which an MSI comprehensively addresses the domain it aims to standardize or provides guidance on rules for rather than the organizations it intends to be relevant for. While this resembles the criterion of efficacy as identified by Mena and Palazzo, it is not the same: efficacy primarily deals with the extent to which the rules enable or require firms to deal with the problem at hand (Mena & Palazzo, 2012). To illustrate this, one may look at the ISO 26000 standard once more. Being an umbrella standard, ISO 26000 addresses an extensive and perhaps unparalleled range of topics in the CSR domain, including processes such as managing stakeholders, reporting on sustainability performance and implementing CSR next to subjects such as human rights, the environment and community involvement. The level to which it covers rules may hence be high. ISO 26000 also includes organizational governance as one of its seven core subjects and even implies that without addressing this subject effectively, an organization cannot take appropriate action on the other six core subjects. However, its specification of this core subject is rather weak and several key issues in the realm of organizational governance are absent (Moratis, 2016). In addition, the standard does not include the subject of animal welfare either and thus does not specify expectations towards organizations and actions that they may take. These latter two aspects of the standard consequently compromise its rule coverage. Actor coverage of ISO 26000 is also high as it intends to be useful "to all types of organizations in the private, public and non-profit sectors, whether large or small, and whether operating in developed or developing countries " as well as to "those beginning to address social responsibility, as well as those more experienced with its implementation"

[1]The criterion of actor coverage should not be confused with the previously suggested homonymous input legitimacy criterion.

(International Organization for Standardization, 2010: vi). Representing an encompassing domain that requires the participation of state- and non-state actors in developing solutions to successfully live up to the challenges of sustainable development, CSR may require MSIs to be assessed on both rule coverage and actor coverage.

In the light of the previous suggestion, rule coverage may be replaced by rule adoption for an enhanced understanding of MSI legitimacy. Whereas actor coverage refers to the organizations that are potentially bound by an MSI (i.e., the organizations that the MSI applies to or target audience), rule adoption would refer to the actual number of organizations that are bound by the rules specified by the MSI (i.e., those that have adopted the standard and voluntarily submitted to the governance arrangement). This notion of adoption indeed reflects the operationalization of the criterion of rule coverage as suggested by Mena and Palazzo, but is semantically closer to the notion of empirical legitimacy that seems to be behind this criterion (cf. Hahn & Weidtmann, 2012; Mueller, Dos Santos, & Seuring, 2009; Scharpf, 2007).

## *4.3 Efficacy*

Mena and Palazzo define rule efficacy as "the extent to which the rules fit the problem at hand, and are relevant for solving it effectively" (Mena & Palazzo, 2012: 38). This alignment between the rules of an MSI and the societal problem it aims to address, or rule-problem fit, is however only one aspect of efficacy. In order for an MSI standard to be efficacious, it should have competitive (signalling) value, enabling participants to differentiate from non-participants or high-quality from low-quality firms (cf. Djupdal & Westhead, 2013; Miles & Munilla, 2004; Rasche, 2011). This is especially relevant in the realm of CSR as CSR is a relatively hard to observe underlying quality of a firm which may be difficult to signal (Connelly, Certo, Ireland, & Reutzel, 2011; Johnston, 2006; Terlaak, 2007). MSIs may thus not only need to be perceived as not being a competitive *dis*advantage, as Mena and Palazzo argue in the context of the criterion of rule coverage—MSIs need to provide for some kind of visible competitive advantage. In order to offer such value, MSI standards typically try to follow strategies of reducing information asymmetries between complying firms and their stakeholders on the CSR commitment, actions and performance (CSR quality) of firms. These strategies lead to enhanced signalling opportunities and may include certifications, public registers, trademarks, logos, quality labels, public relations or combinations thereof in order for stakeholders to identify and recognize complying firms in the marketplace.

A second aspect of efficacy relates to the notion of Raines (2003) that MSI standards may not accommodate for the different processes and characteristics of firms (Mena & Palazzo, 2012). Organizations differ both in terms of outputs they produce as well as rules of participation and decision-making even though they seem to perform similar roles and functions (Kalfagianni & Pattberg, 2013).

Examining private retail standards, Fuchs et al. (2009: 58) write that "different stakeholders will tend to define different objectives, or even similar objectives differently. (...) Different stakeholders define the objectives of private retail standards very differently, even though they all tend to broadly refer to sustainability objectives" (cf. Kalfagianni, 2006). Especially on the normative domain of CSR, which has been described as essentially-contested and fragmented (Moon, Crane, & Matten, 2005), it is important for MSIs to strike a balance between its primary rule-target and the diversity of seemingly similar firms that want to comply with the rules. In order to be perceived as efficacious, an MSI should thus adopt a governance approach that allows for idiosyncratic manifestations within the principled agreed-upon boundaries of the rule-targets instead of being guided by a 'one-rule-fits-all' approach. The Roundtable on Sustainable Palm Oil serves as an example here as 'sustainability' is not an unequivocal quality of palm oil. Multiple approaches to evaluate sustainable palm oil exist and compete with each other. Whereas *de facto* legitimacy may not be possible in such a case, as Partzsch (2011) argues, and while NGOs may think that MSI criteria are flawed and lack stringency, providing for multiple interpretations may be the best option available and can enhance adoption of the MSI standard as well.

### *4.4 Enforcement*

As a final criterion for assessing the output legitimacy of MSIs, Mena and Palazzo identify the criterion of enforcement which they, following Fransen and Kolk (2007), understand as the ability of an MSI to ensure that the rules MSIs establish are followed and applied in practice. Enforcement may lead to the prospected results under the condition of rule-problem fit (the efficacy criterion). However, research on firm behavior has shown that the availability of enforcement mechanisms is all but a guarantee for good firm performance (e.g., Christmann & Taylor, 2006; King, Lenox, & Terlaak, 2005; Terlaak, 2007). The problem with this output legitimacy criterion thus lies not so much in the enforcement of compliance, but in the notion of compliance itself. A compliance orientation may lead to complacency following attitudes of 'satisfying the system' and result in suboptimal outcomes (cf. De Colle, Henriques, & Sarasvathy, 2014). Terlaak (2007) in this respect observed patterns of 'satisficing signalling' in firm behavior, suggesting that compliance with established norms, rules or criteria does not account for improved performance *per se*. In fact, it may be a way to acknowledge good performance, obscure poor results or areas for improvement and be perceived as a permit for not taking further action. Even if such loose coupling between policy, practice and performance can over time lead to more aligned or integrated organizational behavior (e.g., through activist pressure or regulation), this partly ceremonial behavior may also be a sign of purposeful hypocrisy (Bromley & Powell, 2012; Brunsson, 2003; Christensen, Morsing, & Thyssen, 2013). Compliance with MSI rules may therefore not lead to the action and effects desired in the light of the

objectives of the MSI. Or, in other words, enforcement does not automatically lead to improved performance, let alone progress.

This is an important point for at least three reasons. First, sustainable development, which is the general objective of MSIs in the context of CSR, is not advanced through compliant behavior, but through actual progress and innovation (Hall & Vredenburg, 2003; Seyfang & Smith, 2007; United Nations World Commission on Environment and Development, 1987). Symbolic firm behavior will arguably not suffice to deal with the urgency of current sustainability challenges; novel, integrative and inclusive methodologies, technologies, organizational forms, governance arrangements, and economic approaches are required to escape from the structures and systems that have led to the current levels of unsustainability. Second, compliance with MSI rules targeted at one domain of sustainable development and even progress in one domain, may compromise compliance or progress on others. From a business ethics perspective this requires MSI participants to be knowledgeable on the aspects to strengthen and appropriate interventions (Kalfagianni, 2013). A third reason relates to the credibility risk involved in symbolic or selective rather than substantive behavior that an compliance orientation may invoke (King et al., 2005; Spence, 1973). While firms experience increasing pressures to effectively address their social and environmental responsibilities, the aspiring nature of MSIs may even heighten expectations towards participating firms. As research has shown that many stakeholders may think that firms do not honestly communicate about CSR (Dawkins, 2004; Globescan, 2012), mere symbolic compliance instead of substantive change could further compromise the credibility of firms and, among other things, lead to reputational damage and decreasing levels of public trust. In fact, these effects may radiate through the network of MSI participants and compromise their legitimacy as well as the legitimacy of the MSI itself.

## 5 Conclusion

This chapter has argued that, in addition to the dimensions of input and output legitimacy, the dimension of throughput legitimacy should also be included into the framework developed by Mena and Palazzo for assessing the legitimacy of MSIs. It has also proposed an extension and refinement of the legitimacy criteria that the authors have formulated. The suggestions in this chapter lead to a somewhat different interpretation of the phenomenon. Herein may lie a theoretical implication in the sense that not explicitly including throughput legitimacy as an additional category of assessment criteria may obscure relevant aspects of MSI legitimacy. IN fact, the concept of throughput legitimacy may ‘connect’ input and output criteria for assessing MSIs in a way that allows for a better understanding of MSI legitimacy through investigating interaction effects between legitimacy criteria. The critical assessment of the Mena and Palazzo framework also revealed the possible need to refine or reinterpret legitimacy criteria as identified by the authors (e.g., rule coverage vs. actor coverage).

**Table 1** Legitimacy criteria framework and operationalization (adapted from Mena & Palazzo and adjusted)

| Legitimacy dimension | Criterion | Description |
|---|---|---|
| Input legitimacy | Inclusiveness | • The extent to which MSI participants are representative for the issue at stake<br>• The extent to which important stakeholders are included in the process<br>• The extent to which the MSI involves (broad inclusiveness) and consults (narrow inclusiveness) with stakeholders<br>• The extent to which the MSI strives for a balanced coverage of relevant stakeholders and their interests, including future generations |
| | Consensual orientation | • The extent to which the MSI promotes mutual agreement among participants |
| Throughput legitimacy | Procedural fairness | • The extent to which relevant stakeholders have a valid voice in decision-making processes<br>• The extent to which governance processes meet ethical standards |
| | Accountability | • The presence of checks and balances in the rule-setting process<br>• The extent to which the MSI can be held responsible for decisions by MSI participants<br>• Openness and responsiveness of the MSI to voice of unrepresented actors |
| | Efficiency | • The degree of cost utility of realized MSI output for MSI participants |
| | Transparency | • The extent to which decision-making processes, standard-setting processes, the performance of MSI participants and the evaluation of their performance are transparent |
| Output legitimacy | Actor coverage | • The extent to which the MSI covers the spectrum of relevant actors that are potentially bound by its rules |
| | Rule coverage | • The extent to which the MSI comprehensively addresses the domain it aims to create rules for |
| | Rule adoption | • The extent to which rule-targets are complying with the MSI rules |
| | Efficacy | • The extent to which the MSI rules address the issue at hand<br>• The extent to which the MSI provides for visible differentiation of rule adopters from non-rule adopters<br>• The extent to which the MSI allows for the idiosyncratic approaches to the domain subjected to its rules |
| | Enforcement | • The extent to which the MSI is able to have its rule-targets comply with the rules<br>• The extent to which compliance is verified and non-compliance is sanctioned |
| | Impact | • The extent to which the compliance of rule-targets results in actual progress on sustainable development |

As a result, Table 1 presents a re-arrangement of the legitimacy criteria identified by Mena and Palazzo under the rubrics of input, output and throughput legitimacy.

While this adjusted framework for assessing the legitimacy of MSIs in the realm of CSR should also be perceived as work in progress, it aspires to extend and refine the work of Mena and Palazzo and, by doing so, contribute to the debate on the important topic of private governance in the global marketplace. Probably the most important next step is to empirically corroborate the legitimacy framework, both in terms of its completeness and (perceived) operationalization and the category level and the criteria level. This chapter should hence not only be seen as an attempt to further the conceptualization of MSI legitimacy, but also as a call for future research.

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# New Categories for Responsible Corporate Governance Starting from the "Unity in Multiplicity"

**Maria-Gabriella Baldarelli and Mara Del Baldo**

## 1 Introduction

The enterprise development must involve the integrated dimensions of responsibility inside governance.

The chapter moves from the theoretical and empirical view of the discovery of the logic of reciprocity, that is the combination of dialogue and trust (Argiolas, 2006, 2014), as the "engine" of socially responsible governance. In our opinion, reciprocity inside of responsible corporate governance pushes the enterprise to pass from weak to strong sustainability.

Methodology is based on deductive and inductive approach (Ferraris Franceschi, 1978; Naumes & Naumes, 2006).

About the deductive approach, the reflections that follow are intended to present and develop the dimensions of sustainability following the discipline of business administration, which, through the accounting data, sees the people and activities that are synthesized within it (Broadbent, 2015; Catturi, 2001) and therefore lead us to reflect on the role of the company within economic and social context (Sorci, 2006). The prospect of analysis also leads us to consider how the three guidelines relate under which the company can be analyzed, which are: mission, governance and accountability (Matacena, 2010).

Literature review involves the description of sustainability and of EoC pillars and tools that in our opinion are useful to pass from weak to strong sustainability.

Attributions: The paper is the result of a common work. However, Del Baldo Mara wrote sections: 1, 2 and 5 while Baldarelli Maria-Gabriella wrote sections 3 and 4.

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The empirical research is based on focus groups to understand the degree of implementation of EoC park management pillars during the 2013–2014. We made 3 direct interviews to the President: Doct. Eva Gullo to better understand the strategic orientation of the enterprise, that lasted 30′ each one in the arch of the 3 years. Then we analyzed the financial statement to understand the production and distribution of value added in the same period (Gabrovec Mei, 1997; Baldarelli, 2005).

The first part of the chapter outlines literature about sustainable development and integral development by asking what the determinants are that enable the transition from weak sustainability to strong sustainability in corporate governance.

The second part presents the answer to this question through the analysis of the pillars and instruments inherent in the Economy of Communion (EoC) and how they intervene in the dynamics of difficult transition from weak sustainability to strong sustainability.

The third part describes and analyses the experience of the EoC Pole Spa (the business pole "Lionello Bonfanti"), which reunites over 20 EoC companies in Tuscany, through a study conducted both through the analysis of the literature and the qualitative research approach centered on the analysis of the case (Naumes & Naumes, 2006).

In the following paragraph, we are going to present the literature review.

## 2 From Weak and Strong Sustainability in Integral Development of the Enterprise: Literature Review

There is much talk, perhaps too much, about the current state of sustainable development, with many projects moving forward in spite of having few concrete results emerging from the application of such agreements (Baldarelli, 2006; Bebbington & Contrafatto, 2006; Del Baldo & Demartini, 2012). This discourse concerns the company and the economic and social system, because only through the direct involvement of individual actors can one proceed to develop the world fairly.

Giving that, we focus on the meaning of sustainable development, which can be defined as follows: "The key issue concerning sustainable development, therefore, seems to invest in the ways in which to organise the economic system, so that the development is realised without damaging the environmental heritage, on which everything present and any future development is based" (Bebbington & Contrafatto, 2006: 217).

Sustainable development can be analyzed according to two different, but related, points of view, the first being economic-political, which defines the ways in which society is organized and therefore begins with economic "behavior", social and environmental impact of various components of the economic system, of which companies assume a very relevant part (Sen, 2001).

The second is a corporate point of view, to which we refer, that drops corporate behavior in such a context and translates itself into orientation aimed towards

sustainability, which can be translated into action with diverse intensity (Elkington, 2007; Gray, Adams, & Owen, 2014; Kolk, 2008; Sethi, 2003).

Among the many international stages that have marked the path towards this direction, it should be cited, the Stockholm Conference of 1972, where a concept of eco-development was primarily developed, in addition to the previous one linked to the sustainability of population growth and 1987, the year of the famous Brundtland Report[1] (WCED, 1987), from which the aspect of sustainability understood as intra- and inter-generational equity began, which will then direct all further stages and how "rational sustainability" is geared towards preserving the social aspects and environmental benefit of future generations involving both the economic policy and the company.

In particular, companies are brought to question the concepts of growth and development and to rethink the growth in size as a necessary "finish line" (Baldarelli, 2010; Bastia, 1989; Del Baldo, 1997; Freedman & Jaggi, 2010), because growth also involves paths, like the evolution of corporate culture, management development, business dynamism (Ferraris Franceschi, 1997), and the development of networks that enhance the elasticity and flexibility, generating learning processes (Birley, 1985; Rullani, 1994) that permit the company to be "global" and local.

Sorci (2007) distinguishes between growth and corporate development: the first refers to an almost exclusively quantitative/dimensional phenomenon (growth in revenues, or market shares), often discontinuous and unharmonious, while development is a qualitative and quantitative process, continuous and harmonious in time, that starts from the system of shared corporate values, i.e. the corporate culture: "They open the scenarios that lead to a correct connotation of development in all of its dimensions, which we call integral development" (Sorci, 2007: ix). The integral development involves all aspects of the company, namely: the size of the economic development, the dimension of the development relative to the 'growth of individual and group professionalism'; the development of the user/customer dimension, the dimension of socio-environmental development" (Sorci, 2007: 17). It becomes important then to allow attention to the transcendental dimension of integral development to grow within the companies, which is only guaranteed by a basic shared corporate values system (Alford, Clark, Cortright, & Naughton, 2006; Goodpaster, 2007; Zadek, 2006). For this reason, the company is considered to be a converter of "values", that is, the data and information reflect the anthropological culture and corporate culture (Catturi, 2007; Chapman, Cooper, & Miller, 2009; Rusconi, 1997, 2006).

This concept of development is also part of Ruisi's work (2009), which emphasises how integral development expresses "being a company" rather than "doing"; accordingly, for the entrepreneur to grow and develop, he/she must know how to

[1] In this context, for the first time, the term "sustainable development" is widely defined as "the development that meets the needs of present generations without compromising the ability of future generations to do the same".

"be" and this does not require a degree, as being is "cultivated through intelligence and will".

Finally, it is interesting to draw a further concept of sustainable development which, in addition to the economic, social and environmental one, actively involves people (especially people with different abilities) and focuses on the relationship and its quality (Nussbaum, 2006).

As can be noted, the characteristics that are assumed by sustainable development are more and more numerous, and it is possible to see an evolution from the characteristics that are purely quantitative and of the distribution of wealth to those of a qualitative-relational and inclusive character. Therefore, in relation to the intensity with which sustainability inserts itself into the company and the economic and social system, we present the weak concept of sustainability and the other relative to strong sustainability always briefly outlining the origins of this approach and subsequently identifying the dimensions of what we are going to deal with.

The origins of this approach derive from the exigency to measure these dimensions, that develops in the current of social accounting, of which Gray (2000) is the founder and one of the leading exponents. He highlights how social accounting has the same weight of conventional accounting and is not relegated to a minority appearance, as other authors including Solomon (1974) have found. Gray's basic idea (2000), shared by other authors, is to enable a development process of economic and social relations through the measurement process and the communication of corporate social responsibility process, attainable through the reporting process (accounting and accountability) (Bebbington, 2007; Gray, Owen, & Adams, 1996; Larrinaga-Gonzàlez & Bebbington, 2001).

Alongside the three traditional dimensions that involve the measurement of sustainability (social, environmental and economic), over time these authors have considered several issues, which are inherent to the insertion of the dimension of sustainability (Larrinaga-Gonzàlez, 2007) and the issues entailed within the business management processes (Bebbington & Contrafatto, 2006; Contrafatto, 2011; Gray & Bebbington, 2000). One of the aspects that these scholars point out is the intensity of sustainability, which we present below.

Weak sustainability translates itself strategically and operationally into the reduction of "unsustainability" (indefensibility), through measures which aim to achieve an eco-efficiency, which consists in taking into particular account the impact on the ecological environment (Bebbington, 2007). The concrete translation of this type of sustainability is, for example, participating in projects such as EMAS (Eco Management Audit Scheme), or basic environmental reporting. Weak sustainability may also be oriented towards eco-justice, which consists in taking into particular account the intra- and inter-generational distribution of resources and wealth produced. The origin of this type of sustainability is represented by the satisfaction of fundamental human needs and is achieved when the company issues documents which summarise the sustainability in respect to the employees and analysis of the behaviour towards other stakeholders.

**Table 1** Weak and strong sustainability

| *Type of sustainability* /Tools for evaluation/ measurement/ sustainability communication | *Weak sustainability* Reduction of indefensibility | *Strong sustainability* Recognition and internalization of the sustainability requirements |
|---|---|---|
| Eco-efficiency | EMAS, Eco-labels, Basic environmental reporting, etc. | Calculation and reporting of sustainable cost; full cost accounting (calculation of the full cost); environmental reporting and sustainability |
| Eco-justice | Reporting for employees, statements based on added value, stakeholder analysis | Accounting and social reporting systems; external social auditing; issues related to ensuring transparency in the calculation of the transfer price, etc. |

Instead, the company oriented towards strong sustainability encompasses aspects regarding eco-efficiency and eco-justice in social responsibility. In the first case, the affordable cost is calculated and draws up a precise and detailed environmental and social reporting including that of sustainability. In the second case, social reporting tools and sophisticated social auditing tools are adopted, including a process of social and environmental auditing of a certain level (see: Bebbington & Gray, 2000: 44). The company that has really become aware of the dimensions of sustainability is demonstrated by measuring qualitative/quantitative results of the impact on the environment and also by investments and costs incurred for the preservation of it.

Among the schemes that can help us in this sense, we start from the above table (Table 1) (Bebbington & Contrafatto, 2006: 230).

The processes and tools through which the defined weak sustainability is measured have an optimistic attitude and can initiate a wider process of internalization of sustainability, becoming part of the basic strategic orientation of the company (Coda, 1988). Weak sustainability aims to consider some groups of interest from the company, starting with the most important and trying to reduce the lack of justice in the allocation of resources, but the problem with how to maintain those resources at the same level between generations doesn't arise.

The processes and tools of strong sustainability however require commitment and continuous finalized monitoring to assess how much the company contributes to improving sustainability for the benefit of present and future generations. The behavior in this case is not only a "re-design "or "green washing" but it is also directed to renew the entire company through the creation of a new corporate culture.

The problem that arises is thus to identify the dynamics that allow the transition from weak sustainability to strong sustainability and in the next paragraph, we propose some reflections starting with the theory about Economy of Communion (Bruni, 2009).

# 3 The Contribution of EoC in the Transition from Weak Sustainability to Strong Sustainability: Literature Review

## *3.1 The EoC Pillars in the Transition from Weak to Strong Sustainability*

In the transition from weak sustainability to strong sustainability we must proceed gradually, therefore we will first focus the attention on some pillars, which are evident in the project in question and that also take on considerable importance from a theoretical and practical point of view (Buckeye & Gallagher, 2013; Gold, 2010; Lopez, Martínez, & Specht, 2013). Among the authors who have studied the phenomenon of the companies of Economy of Communion (EoC), some scholars developed reflections in different stages that come to define a few pillars and tools that are found in these companies. In particular, the pillars include: dialogue, trust and reciprocity (Argiolas, 2014; Argiolas, Baldarelli, Ferrone, & Parolin, 2010; Baldarelli, Del Baldo, & Ferrone, 2015; Golin & Parolin, 2003).

Such pillars are considered by Argiolas (2014) as the "evolution" of the socially responsible company. Extending them to the concept of sustainable development seems particularly important in achieving integral and harmonious development, which we discussed initially. Furthermore, dialogue, trust and reciprocity are the managerial expression and business-economic reality of EoC and the ultimate goal of the project is a concrete expression, which is the "universal brotherhood" (Bruni & Sena, 2013; Bruni & Uelmen, 2006; Bruni, 2009; Lubich, 1991, 2001, 2007; Sorgi, 1991; Zamagni, 1995).

Dialogue, understood as a real dialogue which generates confidence in itself, it is the result of attention and a positive and sincere connection. It is a dialogue that doesn't build itself without listening and sharing with another, therefore it is not only a contractual relationship but a relationship that wants to develop a connection that involves the whole person and requires gratuity (Baldarelli, 2011; Gui & Sugden, 2005; Libholz, 2005). The significance of the dialogue is better understood if we refer to the importance of relational goods, which can be explained as: "the relational good is an asset where the relationship *is* the asset, but the relationship is not a meeting of interests, but a gratuity meeting (Bruni, 2006a: 87). In this sense, some scholars emphasise the importance of interpersonal relationships, and propose an evolutionary taxonomy (Ruisi, 2011). In this regard, we must not forget that the progressive decline of relational goods has led to the presence of the new "poor", who have many positional goods, but a paucity of true relationships and for that are unhappy (Bruni & Porta, 2006). Consequently, the presence of "new relational poverty" tends to worsen the economic system as a whole and thus also the companies. Sincere and continuous dialogue, carried out with commitment, care and perseverance, is also a significant antidote against the temptation to betray the trust (Pelligra, 2007), which is generated through the relationship when people are

placed on the same level, without the will to bully one another and without utilitarian purposes, and therefore can identify the other party's problems, able to understand them through and through.

Reciprocity, according to the model used, identifies different ways of relating, that we explain with a quote: *"reciprocity is intended as the social bond, such as connections that keep a city together. This bond is plural, but its various expressions have, in coming-and-going, giving-and-receiving, giving-and-restore and reci-pro-cum, a common denominator*" (Bruni, 2006b: x). The same author divides reciprocity in three categories, namely "cautious", *philia* and "courageous" (Bruni, 2006b: 72). The second type of *reciprocity-philia* cooperates if there are conditions present (the adequacy of the response, equality, freedom, non-transitivity, and a common point), while "courageous" reciprocity instead always cooperates because the "reward" is in the relationship itself and not in the result, and it is "good life" because it leads people to seek the truth, the good and the beautiful in the process of corporate decision-making.

This form of interaction is well expressed by the reciprocal experience of giving and receiving. There is the presence of an intrinsic reward that the actor gets from the action itself, before and regardless of the outcome. This concept is also connected to the importance of the good life and management, that is: "the good life entails giving oneself or giving himself without 'disappearing', but to be, to live in communion ..." (Ruisi, 2009: 67) looking for the truth, the good and the beautiful in corporate decision-making. Furthermore, the same Author distinguishes: "unity in multiplicity" a qualifying character of the modern company, which is implemented in the case and analyzed.

The pillars identified above enter into the dynamics of economic activity and thus of companies engendering creativity and awareness of poverty and becoming the "engines" of the transition from weak sustainability to strong sustainability, including eco-justice and eco efficiency.

### *3.2 The Concrete Tools of EoC in the Transition from Weak Sustainability to Strong Sustainability*

In the EoC company, a part of the operational time is spent on continuous building and weaving of relationships. Communion must be continually refined. Therefore, it is important to have tools that enable the process of activating or rebuilding it (Argiolas, 2014).

Signing a "pact on mission" means defining it clearly, indicating in which basic core values the company must draw inspiration from the relationships that it will establish with all stakeholders, both internal and external, both near and far.

The second instrument is the sharing of oneself: to give of oneself, sharing with others what one is, personal characteristics and abilities, successes or failures, or concerns and hopes, and not so much of what one has.

The third tool is the communion of experiences. Some knowledge and experiences risk ‘turning off’ in those who possess them if they are not shared. In addition, this sharing allows one to acquire new knowledge and discover knowledge that is unconsciously at my disposal, because it is the relationship, with others, that make them emerge.

The fourth is the verification, also known as “the moment of truth”, which consists of a path that allows both the employee and the internal and/or external collaborator, to qualitatively improve his employment relationship (Baldarelli & Del Baldo, 2013; Baldarelli, Del Baldo, & Ferrone, 2014). It is achieved through regular meetings in small groups coordinated by a facilitator with the task of ensuring that what is said is to go to the real benefit of the individuals and the business. It’s an opportunity to remove the obstacles together or focus strongly on what favors new “life” and new “ideas” within the company, because it does not stop with error correction but with mutual growth. The moment of truth allows one to streamline the decision-making process. However, if one avoids this, conflicts grow, weakening courage and confidence.

Finally, the interview tool addresses both the issues related to the performance of the enterprise’s life and the relationships of communion among its protagonists, but also the position of the individual with their various kinds of needs. In the interview, not necessarily done with the entrepreneur or one who occupies a higher hierarchical position, but also between people in different roles and positions, face to face calm and tranquility are required with those who are further “ahead” of us as to resolve doubts and to share with more tenacity, like a car that must periodically have a servicing. Because the interview performs its effects, it is necessary to listen fully, to set aside our culture and our feelings, to accept others and also build a relationship even though one may “disagree” with the ideas of others (Argiolas, 2009). The novelty of governance, closely linked to the mission, is to never take individual decisions, but together, for the good of the “third party” who must receive them; through dialogue with trust, reciprocity is generated. The tools used translate into the definition of objectives in the governance modes and in company communication. They allow the decision-making process of gradually modifying to include the characteristics of strong sustainability that we are dealing with.

## 4 The Relationship Between Governance and Accountability in the “EoC Spa” Ltd Among Multidimensional and Unity

The EoC Pole Spa Lionello Bonfanti, located in Italy, near Florence (Loppiano), currently hosts 22 companies: shops, laboratories, production and service companies, professional firms of consulting and training, that belonging to various sectors found in the structure, created in 2006, which also provides spaces for various types

**Table 2** Internal stakeholder map

| | Business name | Scope of business | Working members | Employees at the pole | Professionals | Tot. |
|---|---|---|---|---|---|---|
| 1 | Associazione Lionello Bonfanti | Association | | | | |
| 2 | Banca Pop. Ethical Company for Cooperative Actions | Financial promoter | | 1 | | |
| 3 | Luca Bozza—Sole proprietorship | Insurance | 1 | 1 | | |
| 4 | CHARIS Consortium-Cooperative | Social cooperative | | | | |
| 5 | Association for All | Association | | | | |
| 6 | E. di C. S.p.a. | | 1 | 5 | 4 | |
| 7 | Enertech S.r.l. | Plant | 2 | 2 | | |
| 8 | Fantasy Centro Ave P.A.F.O.M. | Childhood Furnishings | | 4 | | |
| 9 | GM&P di Giovanni Mazzanti & C. S.a.s. | Consulting | 4 | | | |
| 10 | Cecilia Mannucci—Rag. Commercialista | Accountant | 1 | 2 | | |
| 11 | Clinic RISANA Cooperative Society | Polyclinics | 2 | 7 | 15 | |
| 12 | Teamdev Srl | Informatics | 4 | 1 | | |
| 13 | Terre di Loppiano S.r.l. | Capital food-trade company | 2 | 1 | | |
| 14 | Legno Service—Wood Service | Furniture fixtures | 2 | | | |
| 15 | Firenzi Servizi | Capital food trade company | | 4 | | |
| 16 | BMP S.r.l. | Bioconstruction soc. capital | 1 | | | |
| 17 | Tecnoambiente S.r.l. | Technologies for environment soc. capital | 2 | | | |
| 18 | Stranilivelli-sole proprietorship | Web agency | 1 | | | |
| 19 | Confindustria | Ass. category | | | | |
| 20 | SEC—Scuola di Economia Civile—School of Civil Economy | Society of capital | | 1 | | |
| 21 | Philocafè | Yarn trade | 2 | | | |
| 22 | Gen Verde | Art and entertainment—organisation | | 20 | | |
| | Total | | 25 | 49 | 19 | 93 |

of events (Table 2) the first European industrial pole and convergence point for more than 200 Italian companies.

Participating in the EoC project (Del Baldo & Baldarelli, 2015), a project of civil economy that aims to contribute to the worldwide realisation of a more equitable society, no longer indigent. The Pole is a “constituent” of the “international citadel” of Loppiano.

The main activities include: conferences, organization of events, training. Among the main products and services, training courses, professional courses, meetings and events management and leasing are included. The Polo has obtained the quality certification: ISO 9001 Vision. The legal type, called “Pole”, is a public company, not listed under the legal form of a joint stock company, with 5700 members.[2]

To complete the mission analysis of the case, we present what the president (since 2009)-Eva Gullo says:” “*The Polo is, first of all, an important life experience, as it is a permanent workshop for those who want to live the EoC project (anyone who has a company here or holds a job or is interested in the project) and, therefore, want to share with others entrepreneurs and other people an entrepreneurial life inspired by the EoC principles. It is an extraordinary experience; you stay within a reality that you feel you must build in person along with others. I approached the EoC world for a thesis: I was a political science student, with sociological direction and I wrote a thesis in economic sociology on the EoC project. On this occasion, I took the opportunity to pursue this issue and I went in Brazil, and there I got to know the Spartaco Pole, the lives of these entrepreneurs and the Araceli citadel. Following this experience, I decided that I wanted to continue both professionally and personally in this path*”.

The pole is in fact a “home for entrepreneurs”, a place where you can experience in everyday life what it means to live the values of the economy of communion and civilian economy at the enterprise level. It is always an active lab, a landmark both at a national and European level for companies already in the project or simply interested. In the Pole, each company maintains its autonomy. The interdependence of motivational and moral character has encouraged development of synergies at a business level, and an intense collaboration of entrepreneurial projects. Reciprocity is experienced in a variety of forms of concrete and relational sharing.

“*In particular, we hold a meeting once a month between entrepreneurs in which we discuss the updates and the notice of events, ideas and projects to which we would like to devote time and energy. Another aspect in which we live reciprocity is education through regular meetings (every two months), open to everyone: entrepreneurs, employees, suppliers, etc*”.

The governance of the “Lionello Bonfanti” pole is based on the following organs:

1. The General Shareholders Meeting

[2] The members are 5659 individuals and 44 legal entities.

2. The Board of Directors
3. The President
4. The Board of Auditors
5. The Board of Reviewers

Four employees also collaborate by follow different business areas: real estate area, conference area, training area with training agency. The responsibility of the shareholders stated in the mission of the Pole is: "to focus the attention on the person, concern for the common good, lawfulness, trust, justice, equality, fraternity, reciprocity". The personnel management policy is based on encouraging employees to develop their skills, to encourage their long-term career, and involve them in the consultation and sharing of decisions, to ensure a balance between work and private life for their own staff.

Among the many initiatives promoted by the Pole for the community, which embody the pillars mentioned above and their translation in governance and concrete choices, one that should be mentioned is the "Permanent Bundle" project, an initiative promoted by the Lionello Bonfanti Association in collaboration with the New Humanity Movement (Focolare movement), which wants to be a concrete proposal at this time of general distrust and economic crisis, helping to spread the culture of giving, of sharing and brotherhood. The idea of the "Permanent Bundle" is inspired by the practice set into motion by Chiara Lubich (founder of the Focolare movement which gave rise to the EoC project) with her first companions in Trento, during World War II: one browsed everything in the house that was superfluous or could serve others: clothes, books, shoes, objects that were deposited on an old sheet and closed with a knot, making a "bundle" that was to be distributed to the poor and those in need. Even today the exchange, which aims to provide basic goods and services to the needy in the local community and to those in need much further away (food products, health products, educational, etc.) is carried out on the basis of gratuity, selfless solidarity and the principle what is in surplus for us, may be necessary for others. It is not a small market and it is not a bargain: it is a real space of Communion.

A second sign of real commitment is the attention to the environmental aspects that brought the pole to implement cost savings measures through environmental impact reduction (i.e., with the construction of a photovoltaic system). In order to communicate the many social and environmental aspects of its activities, in 2015, it initiated the preparation of a simplified social report (Baldarelli, 2014) attached to the financial report and presented them to the shareholders. The social report allows one to highlight what the achievements are, how the performances are developed in terms of sustainable governance, and the distribution of value added, as can be seen in the graph (Fig. 1).

As one can see, the company's staff has a very high amount of remuneration, like the company's remuneration, which in recent years has had a positive trend, characterized by a progressive growth.

Some "paradoxes", from the foregoing in the previous sections, have emerged in the stakeholders map of the EoC Pole that seem to guide the governance from the

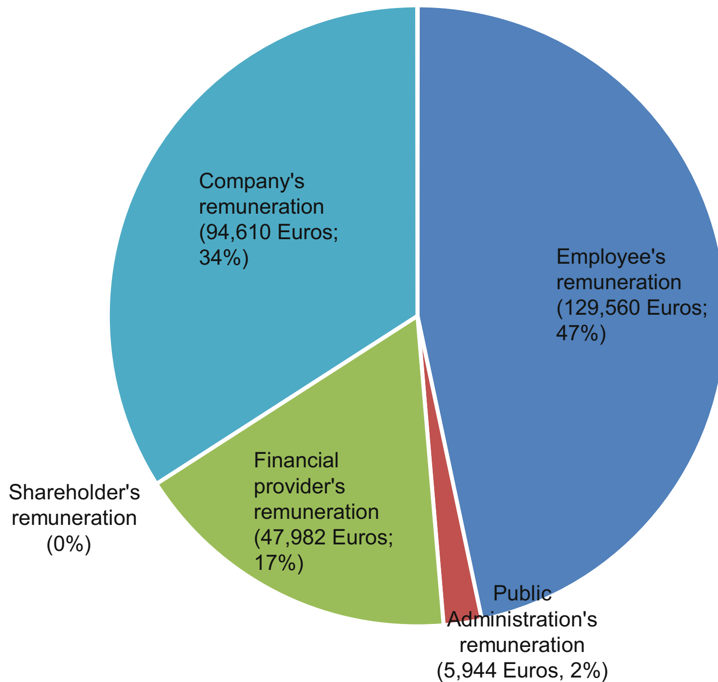


**Fig. 1** Distribution of value added (2013)

outer fraternity to the inner fraternity. Within the EoC Spa, in our opinion, a paradox is created, which concerns the identification of the map of stakeholders. If we analyse the activities and initiatives that the Pole develops, this paradox derives from the objectives that are in fact all projected towards developing a new culture of fraternity and bringing typical values of Economy of Communion into the territory in which the Pole operates, leading them to constantly open up to new stakeholders, and to precisely be the pivot of a new culture. Consequently, the focus on "the people" of the pole, i.e., internal stakeholders, is almost overcome by attention towards external stakeholders. This reflection is also confirmed by the analysis of other poles in the world, including the newly established one in Germany, called "Outside the box" (Del Baldo & Baldarelli, 2015). In other words, the wealth that is produced in the EoC Pole is redistributed externally, almost taking for granted the growth of internal stakeholders that have made the courageous decision to make its business, supporting risks sometimes far too high (sometimes too much) to transfer its business or part of its activities into the pole. At the same time, the process of reciprocity and openness to collaboration develops mainly with external stakeholders. The Polo encompasses aspects of mutual trust based on transparency and non-opportunistic behaviour (Lorenzoni, 1992) that must have a developmental process of internal reciprocity (Table 3).

**Table 3** From the network of companies to the company—Economy of Communion Pole Spa

| Network characters | Characters of the economy of communion poles | Characters of the EoC Pole Spa |
|---|---|---|
| (1) High Frequency and continuity of reporting | Similarities in the EoC poles | Similarities in the EoC poles *with greater attention to external stakeholders* |
| (2) Reciprocity of interactive flows, despite the presence of information asymmetries | Reciprocity assumes many forms, but the reciprocity that is always open to cooperation is always present | Reciprocity assumes many forms, but the reciprocity *that is always open to cooperation is always present, especially with external parties* |
| (3) The external relations affect and permanently change the internal relations | The external and internal relations interact and change in a reciprocal process | External relations tend to condition the internal relations.<br>*The reciprocal process develops mainly with external stakeholders* |
| 4) Strategic Pluralism (Businesses pursue their goals) | Own objectives, but aimed at achieving a common goal already pre-ordered and ethical values: giving, communion and fraternity | Own objectives, but aimed at achieving a common goal already pre-ordered and ethical values: giving, communion and fraternity |
| (5) shared language | Shared anthropological language, from which business economics derive | *Partially shared anthropological language*, from which business economics derive |
| (6) Enterprise coordinator who only coordinates | Presence of a company that provides the first financing for the start up of the Pole and the companies within it, provides services to companies of the pole and coordinates part of the assets | Presence of a company that provides the first financing for the start up of the Pole and the companies within *it, partially provides services to companies of the pole and coordinates part of the assets* |
| (7) Possible presence of a leader, which also makes use of other networks to develop projects | In the poles, limited entrepreneurship becomes more widespread and in addition there are no reciprocal business leaders, but substantial coordination, effective and equal for all members | In the poles, limited entrepreneurship becomes more widespread and in addition there are no reciprocal business leaders, but substantial coordination, effective and equal for all members that must have a developmental process of internal reciprocity |
| (8) These are for-profit enterprise networks | They are “mixed” networks comprising for-profit companies and non-profit companies | They are “mixed” networks comprising for-profit companies and non-profit companies |

(continued)

**Table 3** (continued)

| Network characters | Characters of the economy of communion poles | Characters of the EoC Pole Spa |
|---|---|---|
| (9) Involves small and medium-sized businesses | The Economy of Communion Pole is not closely related to small businesses, although most are of this size, but it turns into a "network of Communion" | The EoC Pole Spa does not include only small businesses, although most are of this size; the Pole also encompasses aspects of mutual trust based on transparency and non-opportunistic behaviour that to become a "network of Communion" needs a development process for internal reciprocity |

The development of internal reciprocity is particularly important in highlighting the peculiarities of the inhabitants of the pole (internal stakeholders of the network) and thus makes a more thorough comparison possible, although more difficult, to make the development of that common thread of brotherhood and unity possible, which Ruisi spoke about (Ruisi, 2011), and the economic declination of charisma from which these companies derive (Bruni & Sena, 2013; Buckeye & Gallagher, 2013).

The suggestion derives from this reflection, directed to the entrepreneur of the pole, to better balance the importance of all stakeholders. Another possible point for improvement looks at the necessity of a greater focus on the managerial skills of the created value and affordability of the pole companies, which is sometimes placed in the background in respect to the focus on social, environmental and ethical aspects. Thus in the characteristics scheme of business combinations, compared to the Economy of Communion Poles, we can identify at which point the EoC spa is found.

## 5 Conclusions

The dynamics that derive from the pillars and the instruments analyzed have indeed the effect of revitalizing the market, the economy and society, to the extent that they represent a possible path of orientation towards strong sustainability which is greatly discussed in the scientific, political and managerial world.

Reciprocity, along with the instruments of communion, in the dynamics of the EoC (Economy of Communion) industrial parks, generate creativity and sensitivity towards poverty and becomes an engine of intrinsic motivation, that is able to establish motivation and potential innovative framework of responsible governance to better encounter and face new environmental and social challenge.

The EoC companies offer space, through the reading of the cases, the interviews, the study and the analysis for comparison with scholars from different disciplines that while "reading" this project, will continue to develop insights that lead to research in an interdisciplinary dimension of "true wisdom" (Zanghì, 2012). This approach requires a radical change of perspective and methodology of work, where one is willing to silence their own specific knowledge to go out into a "common space", where one can see the foundations of all disciplines through dialogue with experts from other disciplines, subsequently returning into his own and bringing the required changes (Coda, 2008).

The external perception is a place of experimentation, in which entrepreneurs and enterprises have made a radical choice. As the president says: "*If I think of the territory in which the pole is inserted, I realise that the institutions see the Polo as a service for the territory. The Polo isn't a shopping centre where one only attends events and meets people. It's a starting point for sharing a mission which also pursues itself as a single entity. The Pole allows us to share with others in a space for discussion and communion. At least from what I have personally experienced since I've been to the Pole, there were never realities that we have 'worked against'*".

A particularly important project of the Pole was carried out in the Tuscany region, participating in a proclamation for a 3-year funding, to be part of the network of technological innovation centres. The Bonfanti Pole has become one of the 12 incubator poles of regional businesses.

"*With the project 'Business and Cultural Development of Reciprocity, incubation space inside the Lionello Bonfanti Pole', we proposed our characteristics of excellence, namely the fact that one lives the culture of reciprocity in the Polo and therefore these services that we could carry out (entrepreneurial scouting services, business plan, qualified training) would have been offered with our characteristics, that is, with our way of doing business. We have ensured the provision of such services to the public, free of charge: we carried out 120 scouting and 70 business plans, we have destined 1700 square meters of the Pole to companies that wanted to come here to incubate and so we did experience a great truth: innovation is not so much the specific product, but the process, the culture that is the base of the process, which shapes the work that takes place in various modes*".

Finally, from an analysis of the strengths and weaknesses, among the aspects of strengths, the choice of entrepreneurs to "come into Polo" is revealed. Secondly, the project itself is an aspect of strength, although in an early stage, the project is proving to be "prophetic", that is, pioneering and innovative. On the contrary, one aspect of weakness is the fact that the visibility of the project is still limited, for which the knowledge of this experience must grow. The Pole is ultimately an "opportunity" that, according to the event that hosts it, the company that acts as an incubator, to the people who it receives, or the project which promotes it, it changes tools, approaches and plans incrementally, but does not limited itself to organizational or specific directional schemes. However, it remains firmly anchored to deep values, such as reciprocity, the relationship and the common good, embraced by anyone who wants to be part of this environment even occasionally.

Hence there is a need to broaden the scope of knowledge to better spread the economic and corporate culture through training geared towards fully understanding the professional aspects, which belong to the management of EoC companies, but simultaneously not slowing down the ideal tension (Bruni & Smerilli, 2009) towards what is the actual purpose of these companies: the universal brotherhood, which represents an anchor, as one can read: "the realisation of a world, more united, cannot ignore the economic dimension but at the same time is not limited to it. As a closed economy itself does not make sense, neither does a closed EoC. The 'World united' needs the culture of communion to penetrate itself more and more into all aspects of social life… It supports humanisation of economics, alongside and simultaneously in a harmonious relationship with other spheres of social life, and other scientific disciplines" (Argiolas, 2009: 344).

The limitations of the research are that we considered a short period of time, so the future perspective of research will take into consideration further analysis during a more extended timeframe, in order to better define the variables that can act on the eco-justice and eco-efficiency dimension to pass from weak to strong sustainability.

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# Relationship Between Corporate Social Responsibility (CSR) and Corporate Governance (CG): The Case of Some Selected Companies in Ghana

George K. Amoako

## 1 Introduction

The issue of Corporate Governance and Corporate Social Responsibility has become very critical for the success of firms in modern business. The success of business depends on how well management decisions are made and management issues are strongly influenced by quality and constitution board of directors. The confidence investors have can be influenced by good governance and CSR activities in today's competitive business environment. The issue is, do corporate governance issues influence CSR and do CSR issues influence corporate governance of business organisations? This research seeks to bring out the individual uniqueness and experience on the practice of corporate governance and corporate social responsibility and to assist the companies to effectively practice and improve upon the phenomenon of corporate social responsibility. This study is also important because it can act as a source document for business executives, entrepreneurs, government agencies and policy makers in Ghana and Africa, serving as a source of reference to help them make effective decisions on good corporate governance. The findings can help to improve on national and institutional CSR and corporate governance regulations and policy development to help achieve national and the African continent development agenda. It can also help formulate policies for sustainable CSR and corporate governance development in Africa.

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## 2 Objectives of the Study

The main objective of the study is to assess how corporate social responsibility affects corporate governance of employees. Other specific objectives to be looked at are to:

1. To investigate the influences of Corporate Social Responsibility on Corporate Governance and Corporate Governance on Corporate Social Responsibility.
2. To investigate Corporate Social Responsibility and Corporate Governance policies and its impact on society and organization's performance.
3. To find out if good Corporate Governance and Corporate Social Responsibility leads to competitive advantage.
4. To investigate peoples opinion on Corporate Social Responsibility and Corporate Governance in Ghana.

## 3 Research Questions

1. How does corporate Social responsibility influence corporate governance and CG on CSR?
2. How does CSR and CG policies impact on society and the organization's performance?
3. Does good CG and CSR lead to a competitive advantage?
4. What is CSR and CG?

## 4 Literature Review

### *4.1 Corporate Governance Issues*

The 1992 U.K Cadbury Committee defines corporate governance as the system by which organizations are directed and controlled. The Federal Reserve Bank of Richmond defines the subject as "...the framework by which a company's board of directors and senior management establishes and pursues objectives while providing effective separation of ownership and control. It includes the establishment and maintenance of independent validation mechanisms within the organization that ensure the reliability of the system of controls used by the board of directors to monitor compliance with the adopted strategies and risk tolerance." However, Andrew Graham (2006) sees it as the exercise of authority, direction and control of an organization for ensuring that it's (the organization's) purpose is achieved. The management of the company hence assumes the role of a trustee for all the others. Corporate governance is the framework by which the various stakeholder interests are balanced, or, as the IFC states, "the relationships among

the management, Board of Directors, controlling shareholders, minority shareholders and other stakeholders. In support, the OECD Principles of Corporate Governance states that corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and to effectively monitor performance. While the conventional definition of corporate governance acknowledges the existence and importance of 'other stakeholders' they still focus on the traditional debate on the relationship between disconnected owners (shareholders) and often self-serving managers. Indeed, it has been said, rather ponderously, that corporate governance consists of two elements: First, The long term relationship which has to deal with checks and balances, incentives for manager and communications between management and investors and secondly, the transactional relationship which involves dealing with disclosure and authority.

As defined by Okeahalam and Akinboade (2003) corporate governance is concerned with the processes, systems, practices and procedures that govern institutions. To the authors, two perspectives of corporate governance have emerged over the years. One viewpoint sees corporate governance as dealing with issues of shareholder protection and management control. In the ideal situation, investors provide capital to a firm, and managers manage the firm in the interest of the investors for a fee. The issue of corporate governance arises because of the separation of management and ownership. The problem is reflected in management pursuing activities that may be detrimental to the interest of the shareholders of the firm. The other viewpoint sees corporate governance as dealing with the processes of appropriate management of a company's resources to the satisfaction of all stakeholders. This definition of corporate governance brings the values of democracy to the corporate level and ensures that effective rules of the game allow equal access and protection for all participants. This is achievable only with good corporate culture and applies to all kinds of firms, irrespective of ownership structure. Stakeholders in this context include shareholders, management and workers as well as all groups of persons that come into contact with the firm in its day-to-day activities.

There are other perspectives on corporate governance such as the corporation's perspective and the public policy perspective.

The corporation's perspective is about maximizing value subject to meeting the corporation's financial, legal, contractual, and other obligations. This perspective stresses the need for boards of directors to balance the interests of shareholders with those of other stakeholders, employees, customers, suppliers, investors' etcetera, in order to achieve long term sustained value for the corporation.

From a public policy perspective, corporate governance is about nurturing enterprises while ensuring accountability in the exercise of power and patronage by firms. The role of public policy is to provide firms with the incentives and discipline to minimize the divergence between private and social returns and to protect the interests of stakeholders.

These two perspectives provide a framework for corporate governance that reflects the interplay between internal incentives (which define the relationship among the key players in the corporation) and external forces (notably policy, legal, regulatory and market) that govern the behaviour and performance of the firm (Iskander & Chamlou, 2000).

The challenge for institutional investors in emerging economies is how to weight country factors, even if the investors conclude, that “optimal governance is firm-specific.” Alongside the country factors—rule of law, risk of corruption, competitive intensity, and capital market capabilities—the Private Sector.

## *4.2 Corporate Social Responsibility*

Within the world of business, the main ‘responsibility’ for corporations has historically been to make money and increase shareholder value. In other words corporate financial responsibility has been the sole bottom line driving force. However, in the last decade, a movement defining broader corporate responsibilities for the environment, society or small communities, the working conditions of employees and for ethical practices has gathered momentum and taken hold. This new driving force is known as Corporate Social Responsibility (CSR). This is often described as the corporate triple bottom line which is the totality of the corporation’s financial, social and environmental performance in conducting its business.

Corporate social responsibility is a hard-edged business decision. Not because it is a nice thing to do or because people are forcing us to do it... because it is good for our business’ (Nial Fitzgerald Former CEO, Unilever). ‘The business of business should not be about money, it should be about responsibility. It should be about public good, not private greed’ (Dame Anita Roddick, Body Shop). The World Business Council for Sustainable Development in its publication Making Good Business Sense by Lord Holme and Richard Watts defined CSR as the continuing commitment by business to behave ethically and contribute to economic development while improving the quality of life of the workforce and their families as well as of the local community and so society. There are varied definitions of CSR, definitions as different as CSR is about capacity building for sustainable livelihoods. It respects cultural differences and finds the business opportunities in building the skills of employees, the community and the government from Ghana, though to CSR is about business giving back to society from the Phillipines. The European Commission defines CSR as a concept whereby companies decide voluntarily to contribute to a better society and a cleaner environment. A concept whereby companies integrate social and environmental concerns in their business operations and in their interaction with their stakeholders on a voluntary basis. It is much more focused on operating the core business in a socially responsible way, complemented by investment in communities for solid business case reasons. This definition is a bit more varied because:

1. Social responsibility becomes an integral part of the wealth creation process—which if managed properly should enhance the competitiveness of business and maximise the value of wealth creation to society.
2. When times get hard, there is the incentive to practice CSR more and better—if it is a philanthropic exercise which is peripheral to the main business, it will always be the first thing to go when push comes to shove.

But as with any process based on the collective activities of communities of human beings (as companies are) there is no 'one size fits all'. In different countries, there will be different priorities, and values that will shape how business act. In addition, even the observations above are changing over time. There is no one definition for CSR. It varies according to the organization and the individual. Then again, there are those who argue against CSR. As EbowHaizel-Ferguson Corporate Affairs and Community Relations Director of Sigma-Base Technical Services (GH) Limited says, "the projects companies do and call Corporate Social Responsibility (CSR) in Ghana, is a sham'. According to Haizel-Ferguson, many companies that operate in Ghana, throw out a little school building here, a borehole there and call it CSR. He said, "Comparing it with the high profit they make, this is tokenism." "They do not even consult the members of the community for which these projects are meant for", he added. "The CSR should be about what the indigenes need and not what the companies think they want," he said. According to Carroll and Buchholtz (2003), Corporate Social Responsibility (CSR) can be defined as the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time. In addition, KCCGID (2002), saw Corporate Responsibility as an obligation towards society in which an organization thrives. To the committee, the concept of CSR is an act but not a process, rather an act or a behaviour that an organization learns and which serves as an implied contract between a society and an organization. This means there is a right or entitlement that the society has from the organization. CSR is a process, which requires planning, and organizing organizational resources to perform an action to help society in a particular need. To Buchholtz, CSR is a moral obligation of an organization even though it has little law backing.

However, Nedobega (2005) claimed that CSR requires organizations to adopt a broader view of its responsibilities that includes not only stockholders, but many other constituencies as well, including employees, suppliers, customers, the local community, local, state, and federal governments, environmental groups, and other special interest groups. Collectively, the various groups affected by the actions of an organization are called "stakeholders. Conversely, corporate social responsibility is related to, but not identical with, business ethics. While CSR encompasses the economic, legal, ethical, and discretionary responsibilities of organizations, business ethics usually focuses on the moral judgments and behaviour of individuals and groups within organizations. Thus, the study of business ethics may be regarded as a component of the larger study of corporate social responsibility.

Carroll and Buchholtz's four-part definition of CSR makes explicit the multifaceted nature of social responsibility. The economic responsibilities cited in the definition refer to society's expectation that organizations will produce goods and services that are needed and desired by customers and sell those goods and services at a reasonable price. Organizations are expected to be efficient, profitable, and to keep shareholder interests in mind. The legal responsibilities relate to the expectation that organizations will comply with the laws set down by society to govern competition in the marketplace. Organizations have thousands of legal responsibilities governing almost every aspect of their operations, including consumer and product laws, environmental laws, and employment laws. Finally, the discretionary responsibilities of corporations refer to society's expectation that organizations be good citizens. This may involve such things as philanthropic support of programs benefiting a community or the nation. It may also involve donating employee expertise and time to worthy causes The term corporate social responsibility is often used interchangeably with corporate responsibility, corporate citizenship, social enterprise, sustainability, sustainable development, triple-bottom line, corporate ethics, and in some cases corporate governance. Though these terms are different, they all point in the same direction: throughout the industrialized world and in many developing countries there has been a sharp escalation in the social roles corporations are expected to play. Companies are facing new demands to engage in public-private partnerships and are under growing pressure to be accountable not only to shareholders, but also to stakeholders such as employees, consumers, suppliers, local communities, policymakers, and society-at-large. Moreover, in the public sector, Government ultimately bears the responsibility for levelling the playing field and ensuring public welfare. In order for corporate social responsibility programs to work, government and the private sector must construct a new understanding of the balance of public and private responsibility and develop new governance and business models for creating social value.

## 5 CSR Drivers

The topic of CSR has been the subject of much research over the past two decades. Researchers have identified the reasons why firms develop CSR strategies, such as reputation improvement, government regulations, competitive advantage, stakeholder pressures, critical events, and top management pressures (Hall and Vredenburg, 2004; Kassinis and Vafeas, 2006). Other demands for CSR come from internal stakeholders, reflecting instrumental, relational and oral needs of employees, for example (Aguilera et al., 2007). Of interest, then, is what shapes or drives a firm's CSR response arising from stakeholders' demands. In effect, the reason most companies take CSR actions is either for the purpose of complying with regulations (Wagner, 2005) or as a response to external constraints (Jaffe et al., 1995). Apparently, business leaders react to CSR issues forced by exogenous

factors rather than truly understanding the advantages that CSR will bring Chen and Delmas (2011).

Whether stakeholders ultimately regard actions by business that provides business benefits as socially responsible is a question that remains open. There are emerging methods of assessing corporate social performance but these are not established and are subject to considerable debate. However, common threads in the literature involve establishing principles for action and using stakeholder analysis and engagement as a way of determining precise activities. Nevertheless, there is an increasing focus both by business on CSR and by society on the actions of business Moir (2001). Business firms are the economic engine of society and the making of profits is a social responsibility (Carroll, 1999; Henderson, 2005). However, in the current climate, issues of a social nature are bearing on firms to the point that CSR appears to be the new battleground for competitive success (Porter & Kramer, 2006).

## 6 Nature of CSR in Ghana

In relation to Ghana specifically, Ofori (2007) recognised that Ghanaian managers believe that operating in a community involves supporting the community through social programmes, beyond corporate philanthropy, to strategic actions that respond to the different needs of the communities in which businesses operate. Ghanaian managers seem to have positive attitudes toward CSR and these attitudes are largely influenced by both individual and societal ethical values. However, managers and executives in Ghana engage in CSR activities primarily to enhance their corporate image among customers and second, for the well-being of the society. No comprehensive policy framework to set the parameters of CSR activities in Ghana exists. Furthermore, there is no institutional body regulating corporate activities on CSR and as such reporting on CSR is not consistently done among corporate bodies (Ofori & Aboagye-Otchere, 2005).

According to Dartey-Baah and Amponsah-Tawiah (2011), CSR is a controversial issue for business managers and their stakeholders. Due to the large range of contrasting definitions, and often varying use of the terminology (O'riordan & Fairbrass, 2008), it has no universal definition. The concept is constantly being re-examined and redefined to serve changing needs and times. In defining what CSR means in Africa, Dartey-Baah makes the following observations, which poses a challenge to defining the actual meaning and intent of CSR activities. In view of this, he noted the following characteristics:

- CSR tends to be less formalised or institutionalized in terms of the CSR benchmarks commonly used in developed countries, i.e. there are rarely CSR codes, standards, management systems and reports.

- Where formal CSR is practised, this is usually by large, high profile national and multinational companies, especially those with recognized international brands or those aspiring to global status.
- Formal CSR codes, standards, and guidelines that are most applicable to developing countries tend to be issue specific (e.g. fair trade, supply chain, HIV/AIDS) or sector-led (e.g. agriculture, textiles, mining).
- In developing countries, CSR is most commonly associated with philanthropy or charity, i.e. through corporate social investment in education, health, sports, development, the environment, and other community services.
- Making an economic contribution is often seen as the most important and effective way for business to make a social impact, i.e. through investment, job creation, taxes, and technology transfer.
- Business often finds itself engaged in the provision of social services that would be seen as government's responsibility in developed countries, for example, investment in infrastructure, schools, hospitals, and housing.
- The issues being prioritized under the CSR banner in Africa are different from most developed countries. For example, tackling HIV/AIDS, improving working conditions, provision of basic services, supply chain integrity, and poverty alleviation.
- Schmidheiny (2006), noted that social issues are generally given more political, economic, and media emphasis in developing countries than environmental, ethical, or stakeholder issues.
- The spirit and practice of CSR is often strongly resonant with traditional communitarian values and religious concepts in developing countries, for example, African humanism (Ubuntu) in South Africa.

Baskin (2006) notes that corporate responsibility in emerging markets, while more extensive than commonly believed, is less embedded in corporate strategies, less pervasive and less politically rooted than in most high-income countries (Visser, McIntosh, & Middleton, 2006).

## *6.1 Merits of CSR*

The rise of the modern corporation created and continues to create many social problems. Therefore, the corporate world should assume responsibility for addressing these problems. In the long run, it is in corporations' best interest to assume social responsibilities. It will increase the chances that they will have a future and reduce the chances of increased governmental regulation. Large corporations have huge reserves of human and financial capital.

They should devote at least some of their resources to addressing social issues. A very different argument in favour of corporate social responsibility is the self-interest argument. This is a long-term perspective that suggests corporations should conduct themselves in such a way in the present as to assure themselves of a

favourable operating environment in the future. This view holds that companies must look beyond the short-term, bottom-line perspective and realize that investments in society today will reap the benefits in the future. Furthermore, it may be in the corporate world's best interests to engage in socially responsive activities because, by doing so, the corporate world may forestall governmental intervention in the form of new legislation and regulation (Carroll & Buchholtz, 1999).

### *6.2 Demerits of CSR*

Taking on social and moral issues is not economically feasible. Corporations should focus on earning a profit for their shareholders and leave social issues to others. Assuming social responsibilities places those corporations doing so at a competitive disadvantage relative to those who do not. Those who are most capable should address social issues. Those in the corporate world are not equipped to deal with social problems. There are several arguments in favour of corporate social responsibility. One view, held by critics of the corporate world is that since large corporations create many social problems, they should attempt to address and solve them. Those holding this view criticize the production, marketing, accounting, and environmental practices of corporations. They suggest that corporations can do a better job of producing quality, safe products, and in conducting their operations in an open and honest manner.

Competitive argument recognizes the fact that addressing social issues comes at a cost to business. To the extent that businesses internalize the costs of socially responsible actions, they hurt their competitive position relative to other businesses. According to Carroll and Buchholtz, since CSR is increasingly becoming a global concern, the differences in societal expectations around the world can be expected to lessen in the coming years. Finally, some argue that those in business are ill equipped to address social problems. This capability argument suggests that business executives and managers are typically well trained in the ways of finance, marketing, and operations management, but not well versed in dealing with complex societal problems. Thus, they do not have the knowledge or skills needed to deal with social issues. This view suggests that corporate involvement in social issues may actually make the situation worse. Part of the capability argument also suggests that corporations can best serve societal interests by sticking to what they do best, which is providing quality goods and services and selling them at an affordable price to people who desire them.

When considering the broader conception of CG, it is clear that good governance entails responsibility and due regard to the wishes of all key stakeholders (Kendall, 1999) and ensuring companies are answerable to all stakeholders (Dunlop, 1998). There is thus a clear overlap between this conception of CG and the stakeholder conception of CSR that considers business as responsible in relation to a complex web of interrelated stakeholders that sustain and add value to the firm (Freeman, 1984; Jamali, 2007; Post, Preston, & Sachs, 2002).

## 7 Importance of Corporate Social Responsibility

According to the World Business Council for Sustainable Development, Social responsibility in business is related to the obligation of companies and other business organizations to increase their positive influence and reduce their negative activity toward society.

In that sense, while ethics is a matter for each individual in the business field, social responsibility is related to the influence of an organization's business decisions on society. In synthesis, the benefits and advantages that corporations adopting corporate social responsibility initiatives may obtain are Increased employee loyalty and retention, Gaining legitimacy and access to markets, Less litigation, Increased quality of products and services, Bolstering public image and reputation and enhanced brand value, Avoiding state regulation; and Increased customer loyalty.

Corporate social responsibility (CSR) activities amongst various corporations and its stakeholders could contribute to the macroeconomic development of a developing country through sustainable benefit to all. At the same time, optimum national impact, cooperation, and communication would be encouraged and socialized. Conversely, companies that deal with CSR maintain Goodwill and Community acceptance, Profit, Growth, competitive edge and image and genuine dialog with stakeholders and Spiritual and Pride values to their families and employees.

## 8 Definition of Corporate Governance

According to Thompson (2009), corporate governance refers to the set of systems, principles and processes by which a company is governed. They provide the guidelines as to how the company can be directed or controlled such that it can fulfil its goals and objectives in a manner that adds value to the company and which will be beneficial to all stakeholders in the long term. Stakeholders in this case would include everyone ranging from the board of directors, management, shareholders to customers, employees and society.

The Organisation for Economic Cooperation and Development (OECD) Principles of Corporate Governance states that corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined.

## 9 The Nature of Corporate Governance

Corporate governance describes all the influences affecting the institutional processes, including those for appointing the controllers and/or regulators involved in organizing the production and sale of goods and services. Described in this way, corporate governance includes all types of firms whether or not they are incorporated under civil law. Firms can exist as common or civil law companies, partnership, joint ventures, limited liability partnerships, co-operatives, mutual associations, building societies, friendly societies, trading trusts, even considered churches (Fama and Jensen, 1983). However, organizations like a church, not engaged in the production and sale of goods and services, do not meet the generally accepted description of a firm.

If firms including all social institutions engaged in the production and sale of goods and services, then both public and private sector organizations such as schools, hospitals, clubs and societies, need to be included. With firms defined in this way, the scope of corporate governance includes nearly all the economic activity of a nation Coase (1937). It considered the existence of a master and servant relationship, or an employer and employee relationship as a defining feature of a firm. However, this condition would exclude activities carried out by teams, partners, joint ventures, strategic alliances, associations and networks. This led Alchian and Demsetz (1972) to support by defining a firm as an entity, body regulated by law with the aim of making profit.

In Ghana and Africa as a whole, governance requires a broader definition. Globalization and liberalization of economies have presented both challenges and opportunities for African countries. The need to strengthen corporate governance has therefore become vital for the promotion of sustainable development and self-dependence in Africa. Corporate governance is now generally accepted as a necessity for corporate development in Africa and the world over.

At the African Consultative Meeting held in Kenya in 2000, it was agreed that there should be a harmonized development of corporate governance standards and practices in the continent, taking into consideration the needs of the continent. This and other issues confronting corporate governance in Africa were re-echoed at the Pan-African Consultative Forum on Corporate Governance (2001) in South Africa.

There are three systems of corporate governance systems practiced worldwide, the unitary board model, the tier board model and the business network model. Ghana falls under Unitary Board Model 3. It can be deduced from the theory of corporate governance that any corporate entity with a standard version of any of the models of corporate governance system in practice should at least be viable and capable of achieving its corporate objectives and monitoring its performance. Most, if not all, the corporate entities (limited liability companies) in Ghana use some form of the Unitary Board model of corporate governance in managing their affairs.

It makes sense therefore that those institutions should be able to satisfy the expectations of their stakeholders in terms of returns. Ironically, the Ghanaian business environment is fraught with a high incidence of business failure and

corporate fold ups. Interestingly, most of such collapsed institution obtained good reports from their demise. The collapse of the Bank for Housing and construction and the Ghana Co-operative Bank lend credence to this assertion. This situation raises questions as to why such institutions collapse in spite of the existence of a corporate governance system in them and casts doubts on the suitability of the corporate governance system practiced in Ghana.

## 10 Measurement of CSR

Measurement of CSR can be done by assessing the impact. Thus, if the objective of corporate social responsibility efforts is to provide schooling to all children in a particular village, then one obvious outcome would be the percentage increase in high school graduates in that village. On the other hand, the real impact could be enhanced economic well-being of families in the village. The challenge in focusing on impact is its measurement. How does one-measure effects that may be complex, and sometimes unclear and intangible. However, this challenge should not dissuade one from attempting to measure impact, because with some basic understanding of issues, useful and relevant impact measurement can be made. Simple guidelines can lead to useful impact measurements.

Maignan and Ferrell (2000) argued that, four comprehensive four dimensions of CSR that consists of economic, legal, ethical and discretionary responsibilities can be used to measure CSR.

## 11 Links Between CG and CSR

In light of the overview presented above, there is a discernable overlap between CG and CSR. More specifically, when considering the comprehensive concept of CG, it is clear that good governance entails responsibility and due regard to the wishes of all key stakeholders (Kendall, 1999) and ensuring companies are answerable to all stakeholders (Dunlop, 1998). There is thus a clear overlap between this conception of CG and the stakeholder conception of CSR that considers business as responsible in relation to a complex web of interrelated stakeholders that sustain and add value to the firm (Freeman, 1984; Jamali, 2007; Post, Preston, & Sachs, 2002). Conversely, various CSR scholars emphasize the need to uphold the highest standards of governance internally, particularly in discussions of the internal dimension of CSR (Perrini, Pogutz, & Tencati, 2006; Rosam & Peddle, 2004).

Both disciplines are also perceived to confer important long-lasting benefits and to ensure the endurance of the business. With respect to CG, it is observed that good governance mechanisms reconcile the interests of owners, managers, and all those dependent on the corporation, allowing corporations to secure long-term capital, retain the confidence of financiers, and to use the obtained capital proficiently.

## 12 Three Relational Models of CG and CSR

A potential convergence is alluded to in a recent paper by Elkington (2006), where there is a mention of a progressive overlap between the CG agenda and the CSR and sustainable development agendas. Elkington (2006) claims that it is timely to review the increasingly complex cross-connects between the rapidly mutating governance agenda and the burgeoning world of CSR, social entrepreneurship and sustainable development.

Elkington brought three models that have posited a relationship between CG and CSR, namely: (1) CG as a pillar for CSR, (2) CSR as an attribute of CG, and (3) CG and CSR as coexisting components of the same continuum.

## 13 Making CG as a Pillar of CSR: The Conceptual Framework for This Research

This research conceptual framework is based on making CG a pillar of CSR.

This depiction of CG as a pillar of CSR requires an effective CG system to be in place as a foundation for solid and integrated CSR activities. This is clear in the postulation of Hancok (2005) who delineates four pillars for CSR, with strategic governance thus entailing traditional CG concerns coupled with strategic management capability. Hancok (2005) argues that investor and senior management attention should be focused on these four core pillars such as strategic governance, human capital, stakeholder capital, and the environment, which together help account for about 80 per cent of a company's true value and future value creating capacity. In other words, consistent with a resource based perspective (Barney, 2007). The model argues that value creation, even in relation to CSR, is contingent on leveraging human, stakeholder, and environmental capital through (or coupled with) good strategic governance. CG is thus considered according to this model as one of CSR's basic building blocks. This conception is consistent with Elkington's (2006) who views CSR as the responsibility of corporate boards, and good CG as a foundational requirement or pillar for sustainable CSR. Corporate Social Responsibility is a difficult and elusive topic for companies to deal with. It can often be very costly and yield benefits that are hard to quantify. Perhaps this is one reason why companies, according to the literature, have put so much focus on the internal improvements that can be made, such as improving corporate governance and transparency. This literature also explains why the most important stakeholders, after customers, are the traditionally important employees and shareholders.

There is also the issue of just what standard of CSR should companies use and how far companies should go to perform their responsibilities beyond what the law calls for. The issue of what is the responsibility of a corporation is far from being settled, and there is an unresolved argument over what CSR means.

Nevertheless, it is clear from the literature that, there is a link between Corporate Governance and Corporate Social Responsibility where CSR is an independent variable to CG.

# 14 Methodology

This section presents the methodology and procedures for the entire research. It involves the source of data, population characteristics and process of data presentation and analysis.

## *14.1 Research Design*

The research design used for this specific study was based on, interviews of the employees MTN Ghana, Glico Life Insurance, Latex Foam, Quality Insurance Co. Ltd. and Akan Printing Press. This is a joint and comparative study on these companies. The goal of this section is to identify the instrumentation and procedures used for data collection and presentation. Qualitative research was used. This allowed the researcher to use interviews and focus group discussion to gather the data needed for the research. This approach also allowed the outcome to be described from the subject's point of view. Burns & Grove (2003) argue that qualitative is a systematic subjective approach used to describe research experiences and give them meaning.

## *14.2 Data Collection and Sampling*

The five companies chosen are leaders in their industries. For example, MTN is the market leader in the Telecommunication industry in Ghana. Latex Foam is leader in the manufacturing of mattresses in Ghana. Before collecting the information, permission was asked to collect the data from the case study companies, namely: Latex Foam Co. Ltd., MTN Ghana Ltd., Glico Life Insurance Co. and Quality Life Insurance Co. The management of the various companies agreed and arrangements were made with the respective officials to fix a date for the interview. The interview took place from February 4th to 20th 2013. All the respondents were scheduled during these days and the intended dates were obeyed hence the interview went on with the authorities. I started by introducing myself to the respondents and then explained the purpose of the research.

As this study is qualitative and descriptive, in-depth interviews were held. Subjects were selected each from the companies mentioned above. Among them are officers, managers and other titleholders concerning the research. The

respondents were selected based on conveniently sampling approach in line with their experience on the field and with the company. A total number of five senior officials were interviewed.

## *14.3 Population*

The study had respondents directly from the MTN GHANA LTD., LATEX FOAM COMPANY, AKAN PRINTING PRESS, GLICO INSURANCE COMPANY and QUALITY LIFE INSURANCE COMPANY who are senior officers.

## *14.4 Sample Procedure*

For the purpose of this research, one person from each organization was selected to represent the company. Telephone calls were made to ten companies and five responded positively. In order to conduct the research in a qualitative manner, interviews were conducted for the respective members of the various organizations.

## *14.5 Data Collection Procedure*

The collection of data occurred primarily through the personal interviews with the various employees nominated by the companies mentioned above, and data collected was immediately analyzed for evaluation. Permit records of these submissions were used as information for the research and deleted from the system should it contain any identifiable information.

## *14.6 Reliability*

Reliability measures the consistency of a particular criterion produces a certain result. A reliable measurement therefore generates consistent results. Due to this, the interview responses were carefully collated and analyzed. The reliability of the interview can be judged in a variety of ways. In practice one common way to assess reliability is to correlate the magnitude of interview questions and response given. Alternative from reliability is determined by correlating scores from two alternate forms of the same test (Sims, 2002).

### 14.7 Validity

Validity determines the extent to which a certain factor predicts CSR and CG, for example, good governance is a pillar for effective CSR. The interview evaluation measures the skills, knowledge or ability of the interviewer i.e. how the question was asked and the type of response expected by the interviewer to the degree. Response of interview question depends on how the questions were asked. Therefore, the interviewer took his time, to carefully ask the questions each by each to all the selected Companies.

## 15 Discussion and Data Analysis

Tech's approach was used in analyzing data. According to De Vos (1998), Tech's approach is a method of data analysis whereby the data are first analyzed in the language in which interviews were conducted. The method of data analysis according to Techs approach involves the following;

1. Reading carefully through all the notes or transcript to get of the whole
2. Picking my transcript file and reading through it, jotting down ideas as they come to mind, asking myself what the interview is all about, while writing thoughts in the margin and identifying the major categories represented in the questions.
3. Putting all the answers giving by the respondents together by classifying the major and minor points, coupled with their perception on the topic.
4. Identifying the relationship between major and minor themes.

The questions asked are as follows,

1. How do we ensure good Governance?
2. Does the Board influence CSR activities?
3. Does CSR activities bring out the right results and why?
4. What is your perspective on CSR and Governance?
5. How does Governance influence CSR?
6. How does CSR influence Governance?
7. Does CSR and good Governance give you competitive advantage and why?
8. Does good Governance give confidence for investors?
9. Does CSR activities of organizations give the investors more confidence to invest?
10. Does Governance Mechanism-company size, board number, ownership structure, number of years of operations, influence performance?
11. Can you say something about Governance and CSR for Ghana's top ten companies on the Ghana Stock Exchange?
12. Do you consider political influence a major issue in governance for public organizations?

13. Does the legal framework and environment in Ghana encourage good corporate governance and CSR activities?

I however, identified relationship between the major and minor issues concerning the topic. There is a link between corporate governance and social responsibility. Due to this, I decided to group the questions into themes.

## 16 Discussion of the Responses

On the issue of the practice of good governance, it was evident that corporate governance is been practiced in all the organizations interviewed. All the respondents understand the concept of corporate governance is control and effective policing system. The response they gave symbolized that corporate governance is base on Control, Principles, Policies, Leadership and management. From the responses, good governance is ensured through good structures, policies, communication and good principles. This means good governance is something that is created and practiced when certain issues are appropriately put in place.

It was also evident they believe that corporate social responsibility is influenced by corporate governance. Corporate governance is concerned with control measures and decisions from the strategic heads of the organization. These organizational heads determine the direction of the organization and shows where and what the organization should do at a particular time. Majority of the respondents believe that an organization as an entity must be responsible and must give part of its profit to help the society.

From their responses, it can be deduced that all the respondents agreed that organizations that perform their corporate social responsibility activities well get good results.

This shows that organizations that are obliged to their social responsibility are highly protected by the society. A good socially responsible organization develops good image and excellent reputation.

It was clear that all the companies believe that CSR activities can influence the governance of a company.

Response from all the companies shows that, the respondents see corporate governance as a practice, which requires companies to continuously learn how to adapt to it before it can be part of them. In addition, it is clear that, CSR is seen as a subset of corporate governance. When corporate governance goes at a specific direction, which is deemed good, it will shape the company's obligation to be responsible to society.

All the respondents accepted the fact that, organizations listed on the Stock Exchange are in good standing when it come to the issue of CSR. Most of the organizations listed perform their legal, moral, social and ethical responsibilities. This means that, as most of the companies under study understand the benefits of practicing CSR.

## 17 Interpretation of Data

The answers given by the respondents reveal the factors of corporate governance, such as formulating effective and efficient policies, developing procedures and setting a path for the organization to follow. Other factors such as management principles, board decision-making process, chain of information flow, organizational culture and control, leadership beliefs and organizational climate. All these factors determine the movement and operation of the organization. The external and internal movement of the organization is determined by the factors mentioned above and these are well practiced and shaped in good directions, the organizations of study will be good one in the eyes of the society. From the responses, it is clear that the organizations under study are putting more effort to practice their obligation towards the society.

However, from the responses, it is stated by most of the companies that, the government interferes in the affairs of the public services and thus making it difficult for the public organizations to practice their CSR obligations.

Majority of the respondent's view of a firm is different again. It considers that investors, employees, suppliers, customers and stakeholders generally contribute and receive benefits from a firm. In addition, other parties may be involved in relationships such as unions, trade associations, government and even political groups.

From the interviews conducted, most of the companies describe the existence of two or more controls whether or not they are required by law, the constitution of the firm or are created by relationships external to the firm. The board members make cultures although they may not be recognized as such. Publicly traded corporations controlled by a parent company, control group, relationship investor or family shareholder create different viewpoints on the practice of corporate governance. The management is reserved to describe processes, which involve executive action, which again describes a subset of governance processes. However, most managers perceive on corporate governance matters as strategic issue, which has a major impact on the organization's internal and external affairs. Many board activities are subject to management processes such as establishing sub-committees.

## 18 Summary, Conclusions and Recommendations

The purpose of this study was to establish the relationship between corporate governance and corporate social responsibility with selective interviews. Purposive sampling was used for the research to select the appropriate respondent's base on these factors, experience in the organization, and knowledge on the topic, managerial position and number of years working with the company.

Ten companies were contacted for the interview but only five responded positively. MTN Ghana Limited, GLICO Company Limited, Quality Insurance

**Table 1** Interpretation of Respondents

| Company | Location | Respondents |
|---|---|---|
| MTN GHANA LIMITED | Osu, Accra Ghana | Corporate Affairs Officer |
| LATEX FOAM | Industrial Area Ghana | Operations Manager |
| QUALITY LIFE | Asylum Down Accra Ghana | Manager, Life Insurance |
| AKAN PRINTING PRESS | Asylum down Accra Ghana | Chief Operations Manager |
| GLICO LIFE | Adabraka Official Town Ghana | Sales Executive |

Source: field survey, February 2014

Company, Akan Printing Press Limited and LATEX Foam Company Limited were the companies that responded. Each of them delegated one person to represent the company. So the five represent hundred percent for the research (Table 1).

## 19 Summary of Findings

The study showed that all those interviewed had been working with the company for a long time and have been involved in some sort of social commitment before with their company. However, the study identified the basic elements of corporate governance as formulating policies, principles, procedures, control and managerial measures, organizational structures and information flow chain. From the responses, it is clear that all the organizations practiced a form of corporate social responsibility; the respondents said that, corporate governance could be ensured through effective policymaking, good organizational control and communication process, ensuring effective standards to govern organizational processes and behaviours.

In addition, the study reveals the relationship between corporate governance and corporate social responsibility. The responses from the companies indicates that, corporate governance is an independent variable to social responsibility meaning that, whether an organization will be responsible or not, will depend on the type of policies, values and culture of the leaders and managers. If the organizational leaders do not think of the external environment, it will be difficult to think of the environment in which they operate.

According to the respondents, their organizations are responsible to their environments and these were because of the good leaders and managers they had, who drafted good policies and values for the organizations to follow.

Moreover, a response from Latex Foam Company shows that the company practices its social obligation by drilling boreholes to the deprived communities, giving scholarships to the needy and creating employment to people within the country. According to them, this has created a good relationship between the company and the community, which has earned them a good reputation.

## 20 Assessment of Corporate Governance Practices

A good feedback about current Corporate Governance practices, generally indicating awareness of and engagement with CG issues and what they entail was obtained. All interviewees discussed various aspects of CG that are commonly integrated in the practice of their respective firms, with the most frequently discussed aspects revolving around compliance, transparency, and disclosure. While firms in our sample exhibited different ownership structures involving large, small, and institutional shareholders as well as family owned structures, they mostly had independent directors, and board of directors committees. In about three of the companies, the chairpersons of the board of directors also acted as the CEO. Majority of the companies had formulated a remuneration policy for board members and key executives, highlighting on the link between remuneration and performance. The majority of the firms had codes of conduct in place, and all stressed on the importance of required disclosure and the regular review of internal controls.

All the interviewees generally shared the view that the emphasis in their CG practice is on ensuring compliance with laws and regulations, establishing codes of conduct, and the oversight of internal control systems for financial reporting. Generally, the control aspect of CG was certainly more emphasized in the discussions held than the strategic leadership component.

## 21 Assessment of Corporate Social Responsibility Practices

Interesting feedback regarding the current CSR practices of the sampled firms was obtained. All the managers interviewed adhered to a voluntary action or philanthropic type of conception of CSR. When asked about the type of CSR performed, all managers consistently referred to philanthropic activities and programs revolving mainly around philanthropic donations and ranging from the sponsoring of scholarships and events to donations/programs involving the orphans or handicapped, to volunteering and promoting good working conditions. When asked about the principles motivating CSR behaviour, most managers mentioned the principle of legitimacy and the principle of managerial discretion. As noted by several of the managers interviewed, legitimacy is generally conceived as a license for continued operation and appreciation by society, despite the conspicuous absence of specific institutionalized expectations. Hence, as illustrated in Table 6, all the managers interviewed—with no exception mentioned the importance of maintaining legitimacy and credibility in a shared environment, and providing their share of reciprocal benefits and investments. Four managers also mentioned the principle of managerial discretion in the sense that their firm's CSR orientation had been moulded by the philanthropic values and enlightened entrepreneurship exercised by founders, owners, or top managers of the enterprise.

## 22 Major Challenges of Practice of Corporate Governance

From the responses, three (3) major challenges (management, weak policies and monitoring) that militate against the practice of effective social responsibility were identified.

## 23 Conclusion

In conclusion, it could be deduced that the companies probably by policy, permits an official practice of corporate social responsibility. The impact of corporate social responsibility is (1) To grow and develop the business; (2) To provide for the community; (3) To empower and improve living standards of the community; and (4) Contribute to the development of inhabitants in the community.

The overall effective process of the corporate governance exhibited an overwhelming satisfaction by the company managers who responded to the questions. Companies are encouraged to promote ethics, fairness, transparency, and accountability in all their dealings. They are expected to continue generating profits while maintaining the highest standards of governance internally.

The research has proved the relationship between corporate governance, corporate social responsibility in a way that, corporate social responsibility is about meeting societal needs, and this can be done through effective rules and policy system of the organizations.

It was also realized that, the board of directors does affect the CSR activities of organizations, depending on their own beliefs and policies. Therefore in order enhance good governance within an organization, there should be a laid down structure, with a set of policies and rules to follow, not to mention effective communication. It was also found out that to an extent CSR activity brings out the right results, depending on the motive of the organization in practicing CSR in the first place, the timing environment, culture, targets and place. Therefore, this is not set in stone. Positive effects of CSR say on the bottom line be it sales, profit or revenue induces the board to continually practice it. Then again, good governance generates investor interest and trust. Especially when there is high turnover, profit and such, investors want to invest and gain some of that money plus they have the assurance that their money is safe. In addition, CSR brings about competitive advantage through the enhancement of the company's image, increase in market share and the breeding of customer loyalty. It was therefore realized that CSR and CG overlap. At the end of the day they share the same purpose and bring the same benefits to the organization, when both are well done, they maximize profit, enlarges market share, breeds investors' confidence and creates customer loyalty, not to mention the fact that it creates a good reputation for the organization. One can say that good CSR engenders good governance, but in Ghana, most companies do not necessarily inculcate CSR in their governance issues.

## 24 Recommendation

In view of the findings of the research, it is recommended that managers should cultivate the habit of thinking of the external environment. The entrepreneurs of the companies are expected to contribute and create special funds as a portion of the company profit to be managed by an independent body. Giving to public is a habit that must be cultivated and managers must make it a point to tune their minds to the practice.

Government should take the lead in promoting a national policy that will foster good corporate responsibility. A national policy for companies including advisory strategies should be formulated, implemented and monitored. It is expected that the government should provide resources to create an incentive scheme for companies to make flexible policies to help promote the community. The government should also make available awards to create awareness and boost the morale of companies through the award of exemptions on machinery and equipment for their companies. Again, the government should take bold initiatives to introduce more schemes into the system with appropriate policy objectives.

Educational and training workshops should be organized for the companies to ensure efficient and effective management of company resources for the projection of the community.

The board of the organization should state the corporate responsibility standards that will guide their work and their expectations of management.

Companies should be allowed to operate on their own with minimum government interference. Because it has been realized that in Ghana whenever there is a change in government, it affects policies and the leadership of major organizations under government control and this affects performance and output. Companies should become more involved in CSR activities and effectively publicize this to the public, for maximum results.

Organizations should consider engaging board of directors who are CSR oriented because in the long run it is to their benefit. Government should implement issuance of CSR license to corporate entities renewable annually. There should be a legal framework to incentivize companies to engage in CSR activities. Example tax exemptions, award of government contracts. This is because CSR activities are to the benefit of the society and the environment and when government encourages it, it makes government work easier.

## 25 Limitation of Study and Suggestions for Further Research

More research could be undertaken into the issue of corporate governance and CSR activities in today's competitive business environment.

The study was a case of five companies in Ghana; however, a further study on about ten to twenty companies in Africa would be appropriate to determine the effectiveness and the impact of Corporate Social Responsibility and Corporate Governance in Ghana and Africa.

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# Stakeholder Perception of Corporate Governance Codes and Frameworks in the Nigerian Banking Industry

**Adebimpe Lincoln and Oluwatofunmi Adedoyin**

## 1 Introduction

There is no universally acceptable definition of corporate governance due to a number of significant factors. Firstly there is disparity between the narrow agency theory that has dominated corporate governance in the last century and the broader stakeholder theory advocated in the last two decades (Letza, Sun, & Kirkbridge, 2004). Secondly the fluid nature of corporate governance and the reforms adopted in various countries around the world makes arriving at a universal definition a complex endeavour (Clarke, 2004). The definition of corporate governance is often based on the theoretical stance of the researcher, practitioner or policy-maker, which ultimately emphasises different sets of stakeholders (Clarke, 2004; Letza et al., 2004; Mallin, 2015; Solomon, 2010; Zahra, & Pearce, 1989). Some definitions focus on an operational perspective, which includes the structures, processes and practices of corporate governance while others focus on relationships, stakeholders, financial economics, and societal perspectives (Tricker, 2012). Nonetheless, each definition falls within the 'narrow' agency definition or the broader more inclusive stakeholder definition (Solomon, 2010). The 'narrow' agency definition of corporate governance is based on a traditional economics and finance perspective which restricts corporate governance as a nexus of relationship between a firm and its owners, i.e. shareholders (Jensen, & Meckling, 1976). Conversely, the broader more inclusive 'stakeholder' definition views corporate governance as a set of relationships between the firm, its shareholders and a range of other stakeholders that have a vested interest in the firm (Mallin, 2012; OCED, 2004, 2015).

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One of the earliest definitions of corporate governance is contained in the UK Cadbury Report (1992). It defines corporate governance as the *"system by which firms are directed and controlled"*. This definition comes from an operational agency perspective whereby the board of directors are responsible for the governance of firms whereas shareholders are assumed to fulfil their role of appointing the directors and the auditors, and to ensure that they are satisfied appropriate governance structures are in place. Shleifer and Vishny (1997) state "*corporate governance deals with ways in which suppliers of finance to corporations assure themselves of getting a return on their investments*" (p. 737). This definition assumes that the main objective of the firm is wealth maximization i.e. to maximise the returns of debt holders and shareholders. Defining corporate governance from an agency perspective is based on an economic and finance perspective found in agency theory, which emphasises the separation of ownership and control as posited by Berle and Means (1932). It advocates for the use of corporate governance mechanisms that will curtail the residual control power held by managers (agents) and align the divergence of interests between the owners of the firm (the principal) and the managers (agents) via control (i.e. incentives) and monitoring (i.e. board of directors) (Jensen & Meckling, 1976).

From the above, it is clear that these shareholder centric definitions perceive the internal feature of the board as being accountable to its shareholders, subject to national laws and regulations in place. There is increasing realisation that corporate governance is affected by other relationships among participants in the governance system, also known as stakeholders. It is posited that these stakeholders play an important role in contributing to the long-term success and performance of the corporation (Organisation for Economic Co-operation and Development-OECD, 2004). Stakeholders have a vested interest in the firm as they are affected by its success or demise (Letza et al., 2004; Solomon, 2010). Thus there has been a significant shift in corporate governance theory, whereby the inclusion of stakeholder interests continues to be advocated for on a national and international level ( Akinpelu 2012; Letza et al., 2004; OECD, 2004, 2015; The Basel Committee on Banking Supervision, 2006, 2010; The Hampel Report, 1998). As stated in the Hampel Report (1998) good corporate governance ensures that stakeholders with relevant interest in a firm's business are fully taken into account. There have been a significant number of definitions of corporate governance from a stakeholders' perspective. For example, Weimer and Pape (1999) define corporate governance as *"a system…country-specific framework of legal, institutional and cultural factors shaping the patterns of influence that stakeholders (e.g. managers, employees, shareholders, creditors, customers, suppliers and the government) exert on managerial decision-making" (p. 152).*

The OECD (1999, 2004) strengthens the operational perspective by including the relationship among various participants. It also takes a wider relationship perspective by including stakeholders in the category of those that have rights and responsibilities within firms. The OECD (1999, 2004) defines corporate governance as *"The system by which business corporations are directed and controlled…The corporate governance structure specifies the distribution of rights*

*and responsibilities among different participants in the corporation, such as the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs...by doing this, provides the mechanisms through which the company objectives are set and the means of attaining those objectives and monitoring performance" (p. 2).* This definition of corporate governance was subsequently advocated by Sir Adrian Cadbury (2000), when he stated *"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The corporate governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as possible the interest of individuals, corporations and society."*

Such perspective sets corporate governance at a high level of abstraction. It is a societal perspective as it includes all the stakeholders involved with the firm, including the contractual stakeholders, such as shareholders, managers, and other employees, suppliers, customers, consumers, bankers, but also other non-contractual stakeholders external to the company whose interest could be affected by corporate behaviour including local, national, and international societal interests. Such a perspective can raise interesting philosophical issues about the relationships between the individual, corporations and the state. Solomon (2010) advocates Sir Adrian Cadbury's (2000) societal definition of corporate governance that encompasses accountability and social responsibility frameworks. Solomon (2010) defines corporate governance as *"The system of checks and balances, both internal and external to the company, which ensures that companies discharge their accountability to all stakeholders and act in a socially responsible way in all areas of their business activities" (p. 6).* The Basel Committee on Banking Supervision 'Principles for enhancing corporate governance' (2006, 2010) endorses the definition proposed by the OECD (2004), stating that corporate governance involves *"A set of relationships between a company's management, its board, its shareholders and other stakeholders...and provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined" (p. 11).*

In Nigeria there is also recognition of the inclusion of stakeholder interests in achieving effective corporate governance. The Securities Exchange Commission (SEC) and the Central Bank of Nigeria (CBN) adopt a wider stakeholder definition of corporate governance. The CBN Code of Corporate Governance (2006) defines corporate governance as "[a] *system of managing the affairs of the corporations with a view to increasing shareholder value and meeting the expectations of other stakeholders" (p. 1).*

The study seeks to examine the perception of stakeholders on the importance of corporate governance in the Nigerian banking sector. This study is of significant importance given the lack of adequate investigation on corporate governance particularly in relation to the Banking sector. In particular the study seeks to examine:

- The perception of stakeholders on the definition of corporate governance, familiarity with developments in corporate governance codes both on a national and international level
- The importance of corporate governance to the Nigerian banking sector.

*Following the introductory section, the paper progresses with a review of international development in corporate governance. In addition, the review provides useful information on* the legal regulatory environment and its impact on corporate governance and corporate governance codes for Nigerian listed banks. Following the literature review the paper provides the methodological consideration informing the research. The findings of the study are presented in five main parts. The first part of the findings contains the findings in relation to the definition of corporate governance among the four stakeholder groups. The second part presents findings in relation to the stakeholder's familiarity with corporate governance codes and international development. The third part focuses on the importance of corporate governance to banks and the economic environment in Nigeria. The fourth parts presents findings in relation to current codes and practices of corporate governance in the Nigerian banking sector. The final part of the analysis focuses on the relevance of international development of corporate governance in the Nigerian banking sector.

## 2 International Development in Corporate Governance

The most recent financial crisis has brought to the fore international debates on the efficacy of existing corporate governance standards and practices (Erkens, Hung, & Pedro Matos, 2012; Mustafa, Othman, & Perumal, 2012; Olayiwola, 2010; Solomon, 2010). The attention given stems from the need to ensure essential lessons are learnt and future scandals are possibly circumvented. In a bid to ensure good governance, various countries have devised strategies to ensure transparency and accountability of business practices not only as a means of inculcating investor confidence but also as a way of further strengthening their legal systems and democratic governance (CIPE, 2012). There is now consensus amongst various national and international bodies, such as the OECD, that this can only be achieved if there is greater transparency and accountability within a nation's corporate governance framework (BCBS, 2006; 2010; CIPE, 2012; OECD, 1999, 2004, 2010, 2015). Furthermore, globalisation has ushered in an era where the traditional dimensions of corporate governance defined within local laws, regulations and national priorities are becoming increasingly challenged by circumstances and events having international impact (CACG, 1999). There is also realisation that existing national legal, institutional and regulatory frameworks are inadequate to cater for challenges. Consequently national governments and international institutions are actively working on devising initiatives to ensure quality of corporate governance practices is adopted. This has led to the emergence of collaborative

efforts at regional and international levels to converge corporate governance rules that will ensure an acceptable international minimum standard.

One of the fundamental principles of corporate governance at an international level is the OECD "Principles of Corporate Governance" (OECD, 1999, 2004). The OECD principles were developed with the sole intention to assist both member states of the OECD and non-member states in their efforts to evaluate and improve the legal, institutional and regulatory framework for corporate governance in their countries (OECD, 2004). The OECD principles has also been implemented to provide guidance and suggestions for stock exchanges, investors, corporations, and other parties that have a role in the process of developing good corporate governance (OECD, 2004). The OECD Principles have become *"a living instrument offering non-binding standards and good practices as well as guidance on implementation, which can be adapted to the specific circumstances of individual countries and regions"* (OECD, 2004, p. 4). It has become an international benchmark for policy makers, investors, corporations and other stakeholders worldwide as it has advanced the corporate governance agenda and provided specific guidance for legislative and regulatory initiatives in both OECD and non-OECD countries. In recent times the OECD principles have fostered the development of culture of values for professional and ethical behaviour on which well-functioning markets depend. For example, the Financial Stability Board designated the OECD Principles as one of twelve key standards for sound financial systems (Financial Stability Board, 2012). Furthermore, these revised Principles reinforce the OECD's contribution and commitment to strengthen the fabric of corporate governance around the world. Nonetheless, the OECD (2004) recognises that these Principles will not eradicate criminal activity, but it does acknowledge that such activities will be made more difficult if rules and regulations are adopted in accordance with the Principles (OECD, 2004, p. 4).

The Commonwealth Association for Corporate Governance (CACG) also issued the 'Principles for Corporate Governance in the Commonwealth' (1999) for members of the Commonwealth. The CACG Guidelines were based on the OECD Principles (1999) but with greater emphasis on addressing the corporate governance issues of firms in developing countries (CACG, 1999). Furthermore, the Economic Commission for Africa issued its 'Guidelines for Enhancing Good Economic and Corporate Governance in Africa' (2002) which provides a framework of best practice and enforcement mechanisms that can be adopted and adapted by African countries to attain reputable and beneficial systems of good economic and corporate governance practices. However, as the OECD Principles (1999, 2004) focused on publicly traded financial and non-financial companies, there was a need to provide international benchmarks for the banking sector. The BCBS issued a set of guidelines called 'Enhancing corporate governance for banking organisations' in September 1999 to assist banking supervisors and banks in promoting the adoption and implementation of sound corporate governance practices by banking organisations (BCBS, 1999; as revised in 2006, 2010). The BCBS also issued 'Core Principles for Effective Banking Supervision' and 'Core Principles Methodology'

(2006; updated in 2012) which stipulates the minimum standard for sound prudential regulation and supervision of banks and banking system.

Irrespective of these international principles of corporate governance, various international bodies, such as the OECD and the Basel Committee on Banking Supervision agree that these principles are not intended as a substitute for government, semi-government or private sector initiatives to develop more detailed best practice in corporate governance. As the BCBS (2006) states that their "*guidance is not intended to establish a new regulatory framework layered on top of existing national legislation or codes, but is rather intended to assist banking organisations in enhancing their corporate governance frameworks, and to assist supervisors in assessing the quality of those frameworks. The implementation... should be proportionate to the size, complexity structure, economic significance and risk profile of the bank and the group (if any) to which it belongs. The application of corporate governance standards in any jurisdiction will depend on relevant laws, regulations, codes and supervisory expectations*" (p. 2).

In addition, various countries have adopted national corporate governance codes to complement company law legislations, beginning with the Cadbury Report (1992) in the United Kingdom. In the Nigerian banking sector, the CBN and Securities Exchange Commission (SEC) have developed codes of corporate governance. The CBN as the apex regulator of the money market issued a mandatory code of corporate governance called the 'Code of Corporate Governance Post Consolidation' (2006) and the 'Prudential Guidelines for Deposit Money Banks in Nigeria' (2010). In the review to strengthen governance practices, eliminate perceived ambiguities in and align the 2006 code with current realities and global best practice, the CBN published a revised draft 'Code of Corporate Governance for Banks in Nigeria' (2012). Furthermore, SEC as the apex regulator of the capital markets in Nigeria issued the 'comply or explain' 'Code of Corporate Governance for Public Companies in Nigeria' (2003) and 'Code for Shareholder's Association'. The SEC Code (2003) has been revised in 2011, so as to ensure the highest standards of transparency, accountability and good corporate governance without unduly inhibiting enterprise and innovation.

The importance of the implementation of revised corporate governance codes and standards, at international, regional and country level, stems from its increasing use as a signal of strength or weakness in the global competition for direct and portfolio investments (BCBS, 2010; ROSC, 2004; ROSC Nigeria, 2011). In recent times, the World Bank and IMF have attached considerable importance to corporate governance in all aspects of their operations. They explicitly take corporate governance into account in country and project assessments. Using the OECD principles as benchmarks, they now assess countries as part of the Financial Sector Assessment Program (FSAP) and the Report on the Observance of Standards and Codes (ROSC) (OECD, 2004). The Group has partnered with others to launch the Global Corporate Governance Forum for the dissemination of best practices, fostering academic research and facilitating reform especially in emerging and developing economies.

In the aftermath of the financial and economic crisis there has been a call for greater use of stringent regulatory measures, over self-regulating codes and standards, to be implemented to boost investor confidence and prevent further crises (Adegbite, Amaeshi, & Nakajima, 2012; OECD, 2015; OECD Steering Group on Corporate Governance, 2010; Proimos, 2005). The crisis has opened the old debate about the costs and benefits of regulation as opposed to market mechanisms (OECD Steering Group on Corporate Governance, 2010). For example, in past financial scandals the UK and the US adopted different approaches. The US opting for the more rigid rule based corporate governance system "in guise of" the Sarbanes-Oxley Act 2002. The UK, on the other hand, promotes soft-law and voluntary compliance in fostering effectual corporate governance in the form of "comply or explain" (Adegbite et al., 2012; Mallin, 2015; Nordberg, 2011). However, there have also been instances of regulatory failure even in the most regulated sectors and in the most developed countries. Thus, there is a need to exert caution in devising and implementing corporate governance strategies, as there is no one-size fits all approach (OECD, 2004). Furthermore, there is a need to ensure a balance is struck between corporate governance strategies and the need to maintain competitive advantage and not impede a firm's productivity or prevent management from achieving and maintaining their first responsibility of wealth maximisation and enhancing the long-term prosperity of a company (The Hampel Report, 1998; Clarke, 2004).

## 3 The Legal Regulatory Environment and Its Impact on Corporate Governance

Domestic and foreign portfolio investors are more confident in investing in capital markets which operates within a stable legal and financial system. A survey by Koke (1999) carried out to assess the criteria upon which institutional investors and fund managers base their investment destinations found that the most important criteria for investment, amongst other factors, is the stability of the legal and financial system. Garcia and Liu (1999) found that a regulatory environment that encourages mandatory disclosure of reliable information about firms may enhance investor participation. Klapper and Love (2002) report that firms in countries with weak legal systems have on average lower governance rankings. In addition, they find that good governance is positively correlated with market valuation and operating performance, which implies a positive association between the effectiveness of the regulatory environment and the performance of firms. Murunda (2006) investigates the relationship between corporate governance failures and financial distress in Zimbabwe's banking sector. He found poor corporate governance practices in sectors with lax regulatory authorities and where the board of directors failed to adapt to the demands of a changing competitive environment.

In addition, although rules exist in many jurisdictions to protect minority shareholders and shareholder derivative suits, these are rarely used. For example, in Liberia, a popular international corporate domicile, the Associations Law provides for shareholder derivative suits. Yet no case has been brought before the Liberian courts invoking the provision under the statutes (Cooper, 2007). Consequently, there is a need for a viable regulatory framework in order to foster effective and sound corporate governance practices (Otobo, 1997). This can only be achieved if there is a legislative enactment or decree that establishes a regulatory agency, indicating its functions including its enforcement powers. In addition, the regulatory process is expected to consist of setting the rules or standards, monitoring compliance and enforcement. The regulatory challenges related to capital adequacy standards, auditing and accounting standards and regulations governing business practices is ever more present in the banking sector (Otobo, 1997).

Cooper (2007) opines that inadequate administrative systems compounded by heavy bureaucracies stifle corporate development and governance in many African countries. Furthermore the African Development Bank (2007) notes that institutions that are intended to provide checks and balances within the system (including prosecuting systems) are generally under-resourced and lack requisite skills, infrastructure and independence. Kauffmann, Kraay, and Mastruzzi (2009) note that many African countries are characterised by an ineffective enforcement of laws and regulations, highly bureaucratic systems, low regulatory quality and relatively high levels of corruption. Although many of these countries are currently undertaking economic, political and institutional reforms, they are still perceived as having weak legal systems and highly bureaucratic and corrupt governments, low levels of voice accountability, and poor quality regulations and public services (Kauffmann et al., 2009). For many African countries, the main challenges are to reduce registries, establish and integrate registries for secured transactions, strengthen and attract competent human resources, improve regulatory oversight, elevate more African firms to the level where they can obtain internationally recognised credit ratings, improve the legal and judicial frameworks, and develop effective compliance mechanisms.

Research shows that the most typical method for ensuring corporate governance reforms in most countries is through the invocation of corporate governance codes which supplement existing law (Adekoya, 2011), yet out of the fifty-five recognised African countries by the African Union and United Nations, only ten countries have established a corporate governance code (i.e. Algeria, Egypt, Ghana, Kenya, Malawi, Mauritius, Morocco, Nigeria, South Africa and Tunisia). While the first corporate governance code was introduced by South Africa in 1994 with the King I Report (1994; as revised by the King II, 2002; King III, 2009), evidence shows that Nigeria has been the most active, establishing and revising governance codes in 2003, 2006, 2008 and 2011. Ghana and Malawi introduced corporate governance codes in 2010. Mauritius also followed the trend in 2012 by introducing its governance code with a revision planned for 2014 (European Corporate Governance Institute, 2014). These codes contain a collection of best practices aimed at improving the quality of corporate governance in these countries. The codes are

seen as complements to support failing institutional settings, such as property rights and the legal protection of debt and equity holders. However, the contents of the codes are based on similar codes established by developed economies, as well as on generally accepted practices endorsed by international organisations such as the OECD (Adegbite, & Amaechi, 2010). Munisi, Hermes, and Randoy (2014) assert that the problem with the codes is that they do not particularly complement the institutional and/or cultural settings of the African countries that establish them. Adegbite and Amaechi (2010) argue that caution needs to be exerted when countries seek to adopt practices to improve their respective governance systems. Consequently, prescribing corporate governance ideologies and systems which are more suited to cope with the peculiar challenges of developed economies may not be deemed fit to improve governance systems in developing economies (Adegbite & Amaechi, 2010; Lincoln, Adedoyin, & Croad, 2015).

## 4 Corporate Governance Codes for Nigerian Listed Banks

The introduction of codes, which supplement existing corporate laws, is the most common instrument for ensuring corporate governance reforms in many countries around the world. In Nigeria, the CBN and the SEC have established codes of corporate governance as instruments for governing and managing firms, and safeguarding against corruption, mismanagement and environmental abuse. These codes have been invoked to promote corporate transparency and accountability as well as economic growth and social development (Adekoya, 2011; Okeahalam & Akinboade, 2003). The initial SEC Code (2003) is a principle-based mechanism in form of 'comply or explain'. The consolidation of the banking industry however necessitated a review of the existing code for the Nigerian banks in anticipation that additional corporate governance challenges (i.e. board and management squabbles) would arise from the integration of processes, information technology, corporate culture and management. Furthermore, it was anticipated that the emergence of mega banks in the consolidation era was bound to task the skills of Boards and Managements in improving shareholder values and balancing stakeholder interests in a competitive environment (CBN Code, 2006a, 2006b). Consequently, the CBN in its role as the apex regulator developed the mandatory Code of Corporate Governance for Banks in Nigeria Post Consolidation (2006) to compliment the earlier SEC Code and enhance the effectiveness of the banking industry. Despite the mandatory code devised by the CBN in 2006, the banking sector witnessed yet another financial crisis in 2008. SEC concluded that weak corporate governance was responsible for the scandals in the financial sector (SEC, 2011).

In September 2008, SEC set up a committee chaired by Mr M.B. Mahmoud to carry out a comprehensive review of the corporate governance codes. The rationale stems from increasing need to address inherent weaknesses and improve mechanisms for its enforceability. The review resulted in the introduction of the current Code of Corporate Governance for Public Companies in Nigeria devised in 2011.

The Code is voluntary based on comply or explain. The spirit of the Code (2011) seeks to ensure the highest standards of transparency, accountability and good corporate governance, without unduly inhibiting enterprise and innovation. Furthermore the CBN released a draft Code of Corporate Governance for Banks in 2012. According to the CBN the proposed code seeks to strengthen governance practices, eliminate perceived ambiguities, and align the code with current realities and global best practices. Some of the recommendations proposed include a maximum 10 year tenure for CEO in two periods, at least three committees namely the risk management committee, governance and nominations committee, audit committee which have to be different from the statutory audit committee required by CAMA (1990), members of the governance and nominations committee can be a combination of executive and non-executive directors except when both committees are combined. All industry-specific corporate governance codes in Nigeria (including the CBN Code, 2006) are compulsorily applicable to the firms operating in their respective sectors. The SEC Code (2011) however is not industry-specific and in the event that there is a conflict between its provisions and those of any of the industry-specific corporate governance codes, the code with the stricter provision prevails (Ofo, 2014). Ofo (2014) posits that this is a nebulous provision as it is not always easy to determine a stricter provision when a conflict arises. Consequently, the Federal Government initiated the Financial Reporting Council of Nigeria (FRCN) Steering Committee tasked with the mandate to develop a mandatory centralised national Code of Corporate Governance applicable to public firms (Ofo, 2014). The national code is expected to unify existing codes of corporate governance promoted by primary regulators (i.e. the CBN and SEC). The initiation of the Committee is in accordance with Section 119 (C) of the Financial Reporting Council of Nigeria Act (FRCN, 2011), which empowers the FRCN as the only statutory body responsible for the development of the code of corporate governance in both public and private sectors of the Nigerian economy. The Steering Committee members include representatives from SEC, the National Pension Commission, National Insurance Commission, Nigerian Communication Commission, Accountant General of the Federation, NDIC, CBN, Head of Service of the Federation, CAC, Association of Professional Bodies of Nigeria, Institute of Chartered Secretaries and Administrators of Nigeria, Institute of Directors, Igbinedion University, Guaranty Trust Bank Plc, KPMG, Andrew Russell Consulting, and two individuals representing women (FRCN, 2011). As the CBN Code of Corporate Governance (2012) is a draft code and the National Code of Corporate Governance by the FRCN is yet to be released, it was not used to highlight aspects of corporate governance; rather the provisions of the CBN Code (2006) and SEC Code (2011) is used. Recognising that provisions in the current codes applicable to publicly listed banks may conflict, the SEC Code (2011) expressly states that in situations where a conflict arises between the code and the provisions of any other code in relation to a company covered by the two codes, the code that makes a stricter provision shall apply.

The SEC Code (2011) also contains express provisions relating to the firm's relationship with other stakeholders. It states that firms should pay attention to the

interest of their stakeholders such as depositors, distributors, regulatory authorities, the host community and the general Nigerian public. Listed firms are expected to demonstrate sensitivity to Nigeria's social and cultural diversity and are expected to promote strategic national interests as well as national ethos and values without compromising global aspiration (SEC Code, 2011). To ensure that the interests of stakeholders have been considered by firms, boards are required by SEC to annually report on the nature and extent of its social, ethical, safety, health and environmental policies and practices. To foster stakeholder inclusion in the banking sector and further enhance customer protection, in 2010 the CBN established the Consumer and Financial Protection Division to provide a platform through which consumers can seek redress and are educated to detect money laundering, combat financial terrorism, and enhance general awareness. The CBN Code (2006) and SEC Code (2011) state that banks should also establish 'whistle blowing' procedures that encourage (including by assurance of Confidentiality) all stakeholders (e.g. employees, customers, suppliers, shareholders, and the general public) to anonymously report any unethical activity/breach of the corporate governance code using among others a special email or hotline to both the bank and the CBN. To ensure that this is carried out, the CBN Code (2006) requires the chief compliance office to submit monthly returns to the CBN on all whistle-blowing reports and corporate governance related breaches. However, as Bakre (2007) posits whistle-blowers often become the victim of oppression instead of being protected and rewarded for their patriotic acts in Nigeria.

The most recent Corporate Governance Code is the National Code of Corporate Governance 2016. The National Code of Corporate Governance applies to all public companies whether listed or not, all private companies that are holding companies or subsidiaries of public companies and all other companies other those stated above, but excludes those companies that routinely file returns only with the Corporate Affairs Commission and the Federal Inland Revenue Services and Small Private companies. Compliance with the provisions of this Code is mandatory (FRCN Corporate Governance Code, 2016). The spirit of the FRCN Code (2016) seeks to ensure the highest standards of transparency, accountability and good corporate governance, without unduly inhibiting enterprise and innovation. The proposed code seeks to strengthen governance practices, eliminate perceived ambiguities, and align the code with current realities and global best practices. Some of the recommendations proposed include managing director and chief executive officer prevented from becoming chairman of the same company. The FRCN Code (2016) allows for very exceptional circumstance for this to occur, but imposes a 10-year cool off period. The FRCN Code (2016) also imposes an obligation for at least four committees namely the remuneration committee, risk management committee, governance and nominations committee, audit committee which have to be different from the statutory audit committee required by CAMA (1990), members of the governance and nominations committee can be a combination of executive and non-executive directors except when both committees are combined.

It remains to be seen if the wide reaching FRCN Code (2016) achieves its stated objectives. Despite these efforts, Nigeria continues to record a poor business and investment climate, as shown by the Nigeria's World Bank Doing Business ranking of 2015 which shows Nigeria in 170th out of 189 countries, down from its position of 138th in 2013 (OECD, 2015). As this study shows, Nigeria does not face shortfalls in terms of substantive legal protections. The problem, which often arises, is a lack of clarity and disjointed strategies adopted by the Nigerian government. According to the OECD (2015), the Nigerian policy formulation process is itself in need of streamlining and there is a need to improve the implementation of existing regulatory framework through strengthening and rationalising various implementing institutions.

## 5 Research Design and Methodology

The study utilised a mixed method approach to data collection involving the use of semi-structured interviews and questionnaire survey with various stakeholders in the Nigerian banking sector. To ensure reliability, the questionnaire and semi-structured interview questions were based on sound theoretical underpinning derived from the corporate governance and accountability literature. The semi-structured interviews and questionnaire surveys were carried out in Lagos State. Three main banks were selected for the study namely for a variety of reasons. First, based on the International Monetary Fund's (IMF, 2008) categorisation of the Nigerian commercial banking sector, the three banks are one of the first generation banks and the largest traditional banks. In addition, the three banks selected are ranked as one of the top 1000 banks in the world. Furthermore the annual report on the world's most leading brands issued by Brand Finance (2013) confirmed the choice of the study banks, as numerous regional and international accolades recognise that these study banks are one of the top three banks in the Nigerian banking sector.

The study adopted the survey technique through the use of a self-administered questionnaire in collecting data. A survey can be defined as a predetermined list of question devised by the researcher for participants in a given study. Bryman and Bell (2011) define a survey as *"A cross-sectional design in relation to which data collected predominantly by questionnaire or by structured interview in order to collect a body of quantitative or quantifiable data in connection with two or more variables, which are then examined to detect patterns of association"* (p. 54). This method allows for the collection of data on a large scale and from participants in dispersed geographical locations. The questionnaire uses a combination of open-ended, closed-ended and Likert scale questions. The questionnaire was piloted to unearth potential weaknesses, ambiguities, inadequacies and problems in all aspects of the research design and structure so that appropriate corrections could be made before the fieldwork. Additionally, the pilot study was conducted to assess the time and cost implications.

The study utilised bank branches as the avenue for distribution of the questionnaires. In light of dispersed geographical locations of the study bank branches across Nigeria and time and financial constraints a multi-stage sampling procedure involving purposive sampling and convenience sampling was adopted for all respondent groups under study in ensuring representativeness of the sample population. Eti-Osa and Ikeja local governments were selected as the research locations in light of the total number of branch clusters. In addition, Eti-Osa and Ikeja are part of the main local governments in Lagos and the division of bank branches in the two local governments is more proportionate when compared to other local government areas.

The sample size for each stakeholder groups was 460 making a total sample size of 1840. This sample size is in line with the framework put forward by Saunders, Lewis, and Thornhill (2012) and Sekaran (2003). To ensure the smooth running of the data collection process the researcher approached the branch managers of the 113 branches of study banks. The initial contact involved an introduction of the researcher and the importance of the study. The initial introduction was essential for a variety of reasons, first taking into account the cultural setting of Nigeria, the researcher recognised that access and cooperation of banking employees as well as access to other stakeholder groups such as customers and depositors was dependent on the branch manager's co-operation. Access was granted by the branch managers. In some cases access to the branch managers was based on personal contacts and recommendations. From a total of 1840 questionnaires distributed, 1664 were returned, thereby yielding a high response rate of 90% (Table 1).

Data obtained from the questionnaire was analysed using the Statistical Package for Social Sciences (SPSS 20.0 for Windows). Kruskal-Wallis and Mann-Whitney non-parametric tests were used as a significant portion of the questions posed in the questionnaire are ordinal measurements. The Kruskal-Wallis test was used to test the differences between all four respondent groups while the Mann-Whitney was used to test the differences between each respondent group pairing. The Cronbach's Alpha test was used to statistically test the internal consistency of various parts of the questionnaire. The Cronbach Alpha coefficient for all respondents groups for 136 items in this study is 0.886. As the internal reliability value is above 0.80, the study has a satisfactory level of internal consistency (Bryman & Bell, 2011)

A total of 16 semi-structured interviews were carried out, representing 4 interviews with each stakeholder group i.e. 4 bank managers, 4 regulators, 4 shareholders

**Table 1** Distribution of stakeholder groups by Chosen local government areas

| | Eti-Osa | | Ikeja | | Total | |
|---|---|---|---|---|---|---|
| Stakeholder groups | Response rate | % | Response rate | % | Response rate | % |
| Customers | 206 | 49.3 | 212 | 50.7 | 418 | 100 |
| Depositors | 219 | 47.7 | 240 | 52.3 | 459 | 100 |
| Shareholders | 204 | 51.0 | 196 | 49.0 | 400 | 100 |
| Employees | 172 | 44.4 | 215 | 55.6 | 387 | 100 |
| Total | 801 | 48.1 | 863 | 51.9 | 1664 | 100 |

and 4 reporting accountants (i.e. accounting and auditing firms). The selection of cases chosen for this part of the study is based on the role and functions of these stakeholder groups in corporate governance in Nigeria. Purposive non-probability sampling was adopted to identify appropriate participants for the semi-structured interviews. Snowball sampling was also adopted as an ancillary sampling technique to derive access to other interviewees. In arranging the interviews, initial contact by telephone was made with the interviewees to arrange a convenient time and place. The interview protocols were sent to the interviewees prior to the main interviews in order to aid their preparation (Bryman, & Bell, 2007). The interviewees were guaranteed anonymity and confidentially that their names will be excluded from the study and in future presentations or publications. This is because the participants in the study include top ranking officials in the Nigerian banking sector. During the empirical fieldwork for the semi-structured interviews no leading questions were posed to the respondents to avoid bias (Sewell, 2008). Furthermore, to increase the validity of the interviews conducted, the interviews were tape.

## 6 Analysis of Finding

The aim in this part is to present findings on corporate governance and its importance to the Nigerian banking sector. Mean scores and standard deviations are used to identify and provide descriptive variations in the responses provided. Kruskal-Wallis and Mann-Whitney non-parametric tests were also used to test the differences between all four respondent groups and between each respondent group pairing.

### *6.1 Corporate Governance*

The section explores the definition of corporate governance among the four stakeholder groups. The stakeholders were asked to provide response to six definitions of corporate governance on a 5 point Likert-scale 1 = Strongly Disagree, 2 = Disagree, 3 = Neither Agree nor Disagree, 4 = Agree and 5 = Strongly Agree. The results obtained shows that the stakeholders were in agreement with the definitions of corporate governance proposed in the questionnaire. Table 2 illustrates the mean of each stakeholder group against the definitions of corporate governance.

The result shows that all the stakeholders have a preference for definition A i.e. “a system by which banks are directed and controlled”. Customers obtained the highest mean score for definition B “Corporate governance is a mechanisms that organise the relationship between banks and its shareholders” and employees and customers obtained a high mean score for definition C “Corporate governance is a mechanism that organise the relationships between the owners, the managers and the board of directors”. The result also shows that employees obtained the highest

**Table 2** Distribution, mean and standard deviation figures for stakeholders by the definition of corporate governance

| Corporate Governance refers to... | N | Mean | Standard deviation |
|---|---|---|---|
| The system by which banks are directed and controlled | 1648 | 4.38 | .87 |
| Mechanisms that organise the relationship between banks and its shareholders | 1646 | 3.93 | 1.03 |
| Mechanism that organise the relationships between the owners, the managers and the board of directors | 1639 | 3.93 | 1.06 |
| Mechanisms that organise the relationships between the bank's management, its board, its shareholders and other stakeholders, who are affected by, or who affect the bank's decisions and activities | 1645 | 4.03 | 1.02 |
| A country-specific framework of legal, institutional and cultural factors shaping the patterns of influence that stakeholders exert on managerial decision-making | 1641 | 3.99 | 1.04 |
| A system of checks and balances, both internal and external to the bank, which ensures that the bank discharges its accountability to all stakeholders | 1644 | 4.18 | .94 |

mean score for definitions D "Corporate governance is a mechanisms that organise the relationships between the bank's management, its boards, its shareholders and other stakeholders who are affected by, or who affect the bank's decisions" while depositors obtained a high score for definition E "Corporate governance is a country-specific framework of legal, institutional and cultural factors shaping the patterns of influence that stakeholders exert on managerial decision-making". Depositors also obtained the highest mean score for definition F "Corporate governance is a system of checks and balances, both internal and external to the bank, which ensures that banks discharge their accountability to all stakeholders".

The result of the Kruskal-Wallis (K-W) Test in Table 3 reveals that there are differences in relation to the definition of corporate governance. The P-Value shows that definition A which presents corporate governance from a narrow agency perspective was very significant (.00). Definitions D, E, F which presents corporate governance from a wider stakeholder perspective were all also found to be statistically significant with a K-W P-Value of (.01), (.00) and (.00) respectively. As the K-W P-Values for Definitions A, D, E and F were less than .05 the null hypothesis is rejected, thus the differences in opinions were more pronounced across stakeholder groups and is likely to hold in the general population. The K-W P-Values reveal that Definitions B and C are not likely to represent the wider population stakeholder sample as the observed significance levels for both definitions is higher than the .05 confidence level.

In order to identify further differences between the stakeholder groups, the Mann-Whitney (M-W) test was conducted between each pair of stakeholders and the results reveal that there was statistical variation in the responses provided for all Definitions and all stakeholder pairings. In the agency theoretical definitions A, B, and C, the M-W P-Values reveal remarkable significance for all stakeholder groups

**Table 3** Group means, Kruskal-Wallis (K-W) and Mann-Whitney test for the definitions of corporate governance

| Corporate governance refers to... | Group means | | | | K-W P-value | M-W P-values | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | E | S | C | D | | E-S | E-C | E-D | S-C | S-D | C-D |
| A | 4.28 | 4.16 | 4.34 | 4.69 | .00* | 00* | .74 | .00* | .00* | .00* | .00* |
| B | 3.97 | 3.95 | 4.00 | 3.82 | .30 | .18 | .66 | .40 | .08 | .84 | .18 |
| C | 4.00 | 3.95 | 4.01 | 3.80 | .10 | .08 | .90 | .07 | .10 | .70 | .07 |
| D | 4.18 | 3.98 | 4.05 | 3.91 | .01* | .00* | .06 | .05* | .10 | .27 | .74 |
| E | 3.97 | 3.93 | 3.94 | 4.09 | .00* | .15 | .46 | .01* | .50 | .00* | .00* |
| F | 4.15 | 3.96 | 4.15 | 4.42 | .00* | .00* | .66 | .00* | .00* | .00* | .00* |

NB: *The significance is important as the value is less than .05. The Monte Carlo significance confidence figures were obtained from the K-W Test and the two-tailed Monte-Carlo significance confidence figures were obtained from the M-W Test

pairing apart from the "Employees and Customers" in only definition A. The M-W P-Values reveal that the responses provided by the stakeholder group pairing "Employees and Shareholders", "Employees and Depositors", "Shareholders and Customers", "Shareholders and Depositors" and "Customers and Depositors" in definition A are statistically significant. However, the M-W P-Values reveal that the stakeholder group pairing "Shareholders and Depositors" have the highest variance of responses with depositors having a slightly stronger belief in definition A in comparison to shareholders.

Furthermore, as depicted in Table 3 the M-W P-Values also reveal that there was statistical significance in the responses provided by the entire stakeholder group pairing for the stakeholder theoretical definitions D, E and F apart from the "Employees and Customers". In definition D the responses provided by the stakeholder group pairing "Employees and Shareholders" and "Employees and Depositors" are statistically significant. In definition E the responses provided by the stakeholder group pairing "Employees and Depositors, "Shareholders and Depositors" and "Customers and Depositors" show that there is statistically variation in the responses provided with depositors exhibiting a stronger belief in this definition in comparison to other stakeholder groups. In definition F the answers provided by the stakeholder group pairing "Employees and Shareholders", "Employees and Depositors", "Shareholders and Customers", "Shareholders and Depositors" and "Customers and Depositors" demonstrate that there is statistical significance in the answers provided with depositors having a stronger confidence in this definition of corporate governance in comparison to other stakeholder groups. Consequently the only stakeholder group pairing that was found to have provided statistically significant answers in all stakeholder theoretical definitions D, E and F was the "Employees and Depositors" group pairing with employees having a slightly stronger belief in definition D in comparison to depositors, and depositors having a stronger belief in definitions E and F in comparison to employees.

## 7 Familiarity with National Corporate Governance Codes and International Developments

The questionnaire survey sought to investigate the awareness of stakeholders on national and international developments in corporate governance codes. 54.2% of the stakeholders stated that they were familiar with national codes of corporate governance 38.9% stated that they had no awareness of national governance codes. 47.6% stated that they were familiar with international developments in corporate governance codes compared with 45.4% who stated that they were not familiar with international development in corporate governance. Table 4 shows the mean value of 1.58 which suggests that the stakeholders are familiar with the Nigerian codes of corporate governance. The result of the group mean shows that depositors were more familiar with the Nigerian corporate governance code with a mean value of 1.70, followed by employees with a mean value of 1.63. Customers and shareholders obtained the lowest group mean value with 1.51 and 1.49 respectively. The finding also shows a mean value of 1.51 in relation to international developments in corporate governance. The group mean value in Table 5 in relation to international development in corporate governance again shows that depositors and employees were more familiar with international developments with a group mean figure of 1.62 and 1.55 respectively. The result shows that the stakeholders with the lowest mean value were customers with a mean value of 1.44 and shareholders with a mean value of 1.42.

The K-W Test in Table 5 reveals variation in the responses provided by all groups regarding their familiarity with national codes and international developments in corporate governance. In both questions asking the familiarity of participants with national codes and international developments in corporate governance,

**Table 4** Distribution, mean and standard deviation figures for stakeholders by familiarity with corporate governance

| National and International codes of corporate governance | N | Mean | Standard deviation |
|---|---|---|---|
| Are you familiar with National codes of corporate governance applicable to Nigerian banks | 1550 | 1.58 | .49 |
| Are you familiar with international developments in corporate governance | 1547 | 1.51 | .50 |

**Table 5** Group means, Kruskal-Wallis (K-W) and Mann-Whitney test on familiarity with corporate governance

| | Group means | | | | | M-W P-Values | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Codes | E | S | C | D | K-W P-Value | E-S | E-C | E-D | S-C | S-D | C-D |
| National codes | 1.63 | 1.49 | 1.51 | 1.70 | .00* | .00* | .00* | .02* | .32 | .00* | .00* |
| International developments | 1.55 | 1.42 | 1.44 | 1.62 | .00* | .00* | .00* | .03* | .30 | .00* | .00* |

the M-W P-Values reveal statistical significance in the responses provided by all stakeholder groups pairing apart from the "Shareholders and Customers". The M-W P-Values in the first statement reveal that the "Employees and Shareholders", "Employees and Customers", "Employees and Depositor", "Shareholders and Depositor" and "Customers and Depositors" stakeholder groups pairing provided statistically significant responses, with depositors being more proverbial in national codes in comparison to all other stakeholder groups. In addition, the M-W P-Values reveal that in second statement, the "Employees and Shareholders", "Employees and Customers", "Shareholders and Depositors" and "Customers and Depositors" stakeholder groups pairing provided statistically significant responses with depositors being more proverbial in international developments in comparison to employees, shareholders and customers. However the highest statistical variation in responses provided for both questions was between the stakeholders pair "Shareholders and Depositors" with depositors being more aware of national codes and international developments of corporate governance in comparison to shareholders.

## 8 The Importance of Corporate Governance to Banks and the Economic Environment in Nigeria

Most stakeholders overwhelmingly agree that corporate governance is important for Nigerian banks. The result shows that a cumulative 94.4% of stakeholders either strongly agree/agree with the statement. In addition, a cumulative 93.4% of the stakeholders strongly agree/agree that corporate governance is important for attracting foreign investment to the banking sector and the Nigerian economy as a whole. Table 6 shows a mean value of 4.53 in relation to the importance of corporate governance and a mean value of 4.48 in relation to the role of corporate governance in attracting foreign investments in the banking sector and the overall Nigerian economy.

The group mean in Table 7 reveals that depositors had a slightly stronger belief in both statements than any other stakeholder group. Employees had the second highest belief in the importance of good corporate governance for the sector and for attracting foreign investment in the sector and the overall economy with a mean score of 4.50 and 4.57 respectively followed by customers and shareholders.

The result of the P-value of the K-W test is very significant (.00) for both questions. The M-W test shows variation in the responses provided by the stakeholders for both statements. The M-W P-Value reveals that in the question asking participants to rate how important they perceive corporate governance is to the Nigerian banking sector, "Employees and Depositors", "Shareholders and Depositors" and "Customers and Depositors" stakeholder group pairing provided statistically significant responses with depositors providing a slightly stronger belief in the importance of corporate governance. In relation to the question asking participants to rate whether they recognise good corporate governance is important for

**Table 6** Distribution of stakeholders by the importance of corporate governance

| Importance of corporate governance | N | Mean | Standard deviation |
|---|---|---|---|
| Corporate governance is important | 1651 | 4.53 | .66 |
| Good governance is important for attracting foreign investment… | 1649 | 4.48 | .65 |

**Table 7** Group means, Kruskal-Wallis and Mann-Whitney test by the importance of corporate governance

| Importance of corporate governance | Group means | | | | K-W P-value | M-W P-values | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | E | S | C | D | | E-S | E-C | E-D | S-C | S-D | C-D |
| Corporate governance is important | 4.50 | 4.45 | 4.47 | 4.67 | .00* | .29 | .58 | .00* | .47 | .00* | .00* |
| Good governance is important for attracting foreign investment… | 4.57 | 4.32 | 4.45 | 4.58 | .00* | .00* | .00* | .88 | .02* | .00* | .00* |

attracting foreign investment in the Nigerian sector and the national economic environment, all stakeholder groups pairing provided statistically significant responses apart from the "Employees and Depositors" group pair. However in this second statement, the employees and depositors agree slightly more that good corporate governance is important for attracting foreign investors to the sector and the economy in comparison to shareholders and customers. The findings also indicate that many of the stakeholders agree that corporate governance is important for Nigerian banks and that good corporate governance is important for attracting foreign investment in the Nigerian banking sector and the Nigerian economy as a whole. Some of the stakeholders in the study stated that:

> Corporate governance is very important in the Nigerian banking sector as it enhances efficiency, accountability and development of the sector if allowed to operate unhindered (Shareholder).

> Financial institutions being a backbone of a nation's economy needs efficient and effective corporate governance to support the foundation of the economy (Employee).

> Good corporate governance practices in the Nigerian banking system in general have a direct impact on the economy (Shareholder).

> Corporate governance is one of the most crucial and critical issues in the financial industry across the globe. Failure of the industry in the past has made it imperative to promote good corporate governance (Employee).

> Corporate governance mechanisms and controls are designed to reduce the inefficiencies that arise from moral hazard and adverse selection. So I think that good governance in our banking sector is good as it helps in fighting corruption and inadequacies (Customer).

> Corporate governance promotes good governance and careful running of the bank. It also gives room for accountability and the thorough revelation of the personal integrity (Depositor).

## 9 Current Codes and Practices of Corporate Governance in the Nigerian Banking Sector

Over half the stakeholders representing a cumulative 66.7% strongly agree/agree that the mandatory consolidation of the banking sector by the CBN in 2006 has improved corporate governance practices in Nigeria. 11.3% stated that they neither agree nor disagree and 12.4% and 9.6% stated that they disagree/strongly disagree respectively. A cumulative percent 57.5% of stakeholders strongly agree/agree that the corporate governance practices are satisfactory. 14.1% stated that they neither agree not disagree, 17.9 stated that they disagree and 10.6 stated that they strongly disagree. In relation to the statement investigating whether "the codes of corporate governance applicable to Nigerian banks are adequate and effective in ensuring good corporate governance practices", a cumulative 64.2% of the stakeholders strongly agree/agree with the statement. While a cumulative 14.3% strongly disagree/disagree that the applicable governance codes were suitable, 21.5% stated that they neither agree nor disagree with the statement. The stakeholders were asked whether there is a culture of compliance with corporate governance codes, an overwhelming majority of stakeholders representing a cumulative 74.6% strongly agree/agree with the statement.

Table 8 shows a mean value 3.64 in relation to whether mandatory consolidation has improved corporate governance practices, 3.41 with regards whether corporate governance practices of Nigerian banks are satisfactory, 3.71 in relation to the

**Table 8** Distribution, mean and standard deviation figures for the current practices of corporate governance

| Statements | N | Mean | Standard deviation |
|---|---|---|---|
| The mandatory consolidation of banks by the CBN in 2006 has improved corporate governance practices | 1635 | 3.64 | 1.28 |
| The corporate governance practices of Nigerian banks are satisfactory | 1647 | 3.41 | 1.30 |
| The codes of corporate governance applicable to Nigerian banks are adequate in ensuring the practice of good corporate governance | 1643 | 3.71 | 1.09 |
| There is a culture of compliance with corporate governance rules and regulations by Nigerian banks | 1638 | 3.93 | .97 |

adequacy of applicable codes and 3.93 in relation to the level of compliance of these codes by Nigerian banks.

The group mean reveals that all stakeholders generally agreed with all four statements however some stakeholder groups agreed with the statement more than others. The K-W P-Value in Table 9 reveals that there was some disparity in the responses provided by the stakeholders for all three statements. The test result in relation to the question investigating whether the mandatory consolidation by the CBN in 2006 has improved corporate governance practices in Nigeria shows that shareholders agree more with the statement compared to other stakeholder groups. In relation to the question on corporate governance practices shareholders had the strongest belief that Nigerian banks practice satisfactory governance followed by employees, customers and depositors. For example one of the shareholders stated:

> Corporate governance practices in the Nigerian banking sector have improved tremendously over the last few years and there are possibilities for improvements in the coming years. We are more confident in the Nigerian banking sector.

While shareholders had the highest number of positive responses for the statement gauging the satisfaction of stakeholders on corporate governance practices of Nigerian banks, depositors had more responses indicating their dissatisfaction. Some of the depositors had this to say:

> The corporate governance practices should be satisfactory but it is not. There is a need to strengthen corporate governance practices in banks. Let there be over hauling in the system.
>
> The corporate governance practices of Nigerian banks are quite poor in comparison to the international arena. The practices of most banks need to change as this is the root cause of the lack of confidence in the system. Corporate governance practices should ensure professionalism in the banking practices in Nigeria but I am not sure that professionalism at the top levels of the sector is at satisfactory levels.

The finding shows that employees and shareholders had the highest mean value in relation to the question on the adequacy and effectiveness of corporate governance codes in Nigeria with a mean value of 3.85, followed by depositors and customers. In the words of one of the employees "*the ideal etiquette of the banking profession is contained in the comprehensive guideline issued by the Central Bank*". The results of the K-W test also confirms that depositor agree more in with the question investigating the culture of compliance by Nigerian banks to applicable codes when compared to other stakeholders.

The M-W Test reveals statistical significance in the responses provided by "Employees and Depositors", "Shareholders and Depositors" and "Customers and Depositors" on whether 'the mandatory consolidation of banks by the CBN in 2006 has improved corporate governance practices'. This means that the null hypothesis is rejected as the significance levels for these stakeholder group pairs indicate that the results derived did not occur by chance and is representative of the greater population. In the questions asking participants to rate the impact of the mandatory

**Table 9** Group means, Kruskal-Wallis (K-W) and Mann-Whitney test for the current practices of corporate governance

| | Group means | | | | K-W P-Value | M-W P-values | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Familiarity | E | S | C | D | | E-S | E-C | E-D | S-C | S-D | C-D |
| The mandatory consolidation of banks by the CBN in 2006 has improved corporate governance practices | 3.85 | 3.89 | 3.82 | 3.09 | .00* | 0.35 | .36 | .00* | .99 | .00* | .00* |
| The corporate governance practices of Nigerian banks are satisfactory | 3.52 | 3.65 | 3.49 | 3.05 | .00* | .35 | .95 | .00* | .31 | .00* | .00* |
| The codes of corporate governance applicable to Nigerian banks are adequate in ensuring the practice of good corporate governance | 3.85 | 3.85 | 3.54 | 3.62 | .00* | .60 | .00* | .01* | .00* | .02* | .21 |
| There is a culture of compliance with corporate governance rules and regulations by Nigerian banks | 3.78 | 3.90 | 3.87 | 4.11 | .00* | .37 | .14 | .00* | .44 | .00* | .01* |

*Significance less than .05

banking consolidation and their satisfaction with the practices of corporate governance, the M-W P-Values reveal that the answers provided by the stakeholder groups pairing "Employees and Depositors", "Shareholders and Depositors" and "Customers and Depositors" are statistically significant with shareholders demonstrating the stronger agreement with both statements and depositors providing the weaker response in the form of neither agree nor disagree. In relation to the question asking participants whether the applicable codes are adequate and effective, the M-W P-Values reveal that the responses provided by the stakeholder group pairing "Employees and Customers", "Employees and Depositors", "Shareholders and Customers" and "Shareholders and Depositors" are statistically significant with employees and shareholders equally providing the stronger agreement with the statement and customers providing the weaker response to the statement. In relation to the question asking participants whether Nigerian banks comply with the codes of corporate governance, the M-W P-Values reveal that the answers provided by the stakeholder group pairing "Employees and Depositors", "Shareholder and Depositors" and "Customers and Depositors" are statistically significant with depositors displaying the most confidence in this statement and employees providing the weaker response to this statement. Some of the stakeholders stated:

> Poor corporate governance is one of the factors of financial distress in Nigeria. Some Nigerian banks comply with codes of corporate governance on paper. Superficial! The level of corporate governance should be raised in order to enable effective redefining restructuring and expanding into areas of change (employee).

> Nigerian banks should comply with rules and regulations that govern them. They should strictly follow the rules of corporate governance so that rights of stakeholders would be adequately protected (customer).

## 10 The Relevance of International Developments of Corporate Governance in the Nigerian Banking Sector

66.6% of the stakeholders strongly agree/agree that international guidelines are relevant for the Nigerian banking sector. 56.8% either strongly agree/agree that international guidelines can be transposed without modelling them to fit the environment in developing countries including Nigeria. A cumulative 29.9% of stakeholders however strongly disagree/disagree with this statement. Some of the stakeholders stated that:

> International codes of corporate governance developed by the west can be transposed and are relevant to the Nigerian banking sector as they will facilitate the enhancement of corporate governance practices in Nigeria. For example it will ensure that Nigerian banks

ensure that they invest in entrepreneurs in the right way and not in the adverse way they carry it out at the moment.

The continuous implementation of international codes of corporate governance will have positive effects in Nigeria as it will ensure an improvement in the performance and services of banks and it will foster healthy competition within the banking sector which in turn will improve Nigeria's overall GDP.

International guidelines of corporate governance are not relevant to the banking sector in Nigeria as we have our own peculiar circumstances.

The results obtained from the K-W Test reveal significant differences in the responses provided by each stakeholder group. For both statements shareholders agreed strongly that international guidelines are relevant to the Nigerian banking sector and that these international guidelines can be implemented in the sector (including other developing countries) without a need to localise them to fit the applicable country-context (Table 10).

The result of the M-W P-Values highlighted in Table 11 below show that for the first statement, the stakeholder groups pairing "Employees and Customers", "Employees and Depositors", "Shareholders and Customers" and "Shareholders and Depositors" provided statistically significant responses. In the second statement the stakeholder groups pairing "Employees and Depositors", "Shareholders and Customers" and "Shareholders and Depositors" provided statistically significant answers. However the M-W Test reveals the highest variation of responses was between the stakeholder groups pairing "Shareholders and Customers" and "Shareholders and Depositors" for both statements. This means that in comparison to shareholders, the customer and depositor participants were less enthusiastic about the relevance of international guidelines and were also less enthusiastic about transposing international guidelines without adapting them to fit specific country contexts.

**Table 10** Distribution, mean and standard deviation figures for stakeholders by relevance of international guidelines

| Statements | N | Mean | Standard deviation |
|---|---|---|---|
| International guidelines of corporate governance that have been developed by the western world are relevant to the Nigerian banking sector | 1644 | 3.68 | 1.21 |
| International guidelines can be adopted by developing countries (including Nigeria) without the need to adapt them to the individual circumstances of these countries | 1643 | 3.39 | 1.33 |

**Table 11** Group means, Kruskal-Wallis (K-W) and Mann-Whitney test by the relevance of International guidelines

| Statements | Group mean | | | | K-W P-value | M-W P-values | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | E | S | C | D | | E-S | E-C | E-D | S-C | S-D | C-D |
| International guidelines of corporate governance that have been developed by the western world are relevant to the Nigerian banking sector | 3.79 | 3.90 | 3.61 | 3.48 | .00* | .83 | .01* | .02* | .00* | .00* | .75 |
| International guidelines can be adopted by developing countries (including Nigeria) without the need to adapt them to the individual circumstances of these countries | 3.46 | 3.63 | 3.35 | 3.14 | .00* | .19 | .18 | .02* | .01* | .00* | .12 |

*Significance less than .05

## 11 Conclusion

There is growing consensus that the competiveness of firms will be better enhanced through the presence of an effective governance system perceived to promote fairness, disclosure, transparency, accountability and social responsibility. There is a general agreement among academics, researchers and government agencies in countries around the world that such governance systems help to provide a degree of confidence, integrity, stability, investment and sustained economic growth, which is necessary for the proper functioning of a market economy. Each country encounters specific challenges in their effort to aptly device corporate governance strategies. The strategy, which might prove suitable in one country, may not be suitable in another. Whilst recognising that 'one size does not fit all' investors and various stakeholder groups are converging on the basic characteristics of good corporate governance. To a large extent our study helps confirm the growing focus of corporate governance from a shareholder centric to a more stakeholder centric definition of corporate governance, increasing awareness of developments

in corporate governance codes both on a national and international level and the importance of corporate governance to the Nigerian banking sector. Furthermore while many of the stakeholders agree that international guidelines are relevant for the Nigerian banking sector, some stakeholders had reservations about transposing international guidelines directly into the Nigerian banking sector without a need to localise them to fit the applicable country-context. Such reservations are not surprising as while there are some similarities between corporate governance strategies adopted by different countries, developing capital markets need to continue to intensify their corporate governance effort and err on the side of caution in attempting to transport Western corporate governance strategies. The corporate governance strategy of a nation ought to be shaped largely by prevalent legal regulatory infrastructure as well as socio-cultural norms and practices, political and economic climate, and the ethical environment of business conduct.

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# Part III
# Developing New Tools

# Investigating the Concept of Socially Responsible Executive Pay

**Ihar Sahakiants**

## 1 Introduction

Recently, along with the trend toward mounting executive rewards, especially the proportion of long-term incentives in directors' total compensation (Milkovich, Newman, & Gerhart, 2014), there has been increased criticism that CEO pay fails to achieve its intended effects on performance (Bebchuk & Fried, 2006, 2010), and that it can even contribute to behaviours leading to corporate scandals (Coffee, 2005; Sahakiants, 2015). For instance, Bebchuk and Fried (2010, p. 1922) stated in this respect that "pay arrangements have rewarded executives for short-term results that do not necessarily reflect long-term performance and that may in fact be generated at the expense of long-term value". The literature on CEO pay has often discussed ways in which to improve the ethical or social responsibility aspects of executive rewards, including radical suggestions to amend CEO compensation from an ethical standpoint that include limitations, or caps, on top managers' pay (Perel, 2003). The recent Swiss popular vote against excessive executive compensation, including subscription bonuses, or the so-called 'golden hellos', and the soaring severance payments for top managers ('golden parachutes'), can be interpreted as a manifestation of the incompatibility of such reward schemes with the prevailing social norms in certain societies (Rost & Weibel, 2013; Sahakiants & Festing, 2014). The above discussions and political actions underscore the necessity to maintain the socially responsible character of CEO pay and to align top managers' rewards not only with the interests of the shareholders, but also with the interests of all stakeholder groups—in line with the notion of corporate social responsibility (CSR). This approach can be characterised as socially responsible executive compensation, which is based on a combination of both effectiveness and

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ethical objectives (Simmons, 2003) when designing respective human resource (HR) practices. However, as noted by Berrone and Gomez-Mejia (2009b), "the academic community has largely neglected the link between social issues and managerial pay" (p. 961), which is reflected in the relatively low number of studies related to this aspect of executive compensation.

Although recent studies analysing the link between financial incentives provided to CEOs and CSR (Cai, Jo, & Pan, 2011; Jian & Lee, 2015; Mahoney & Thorne, 2005, 2006; McGuire, Dow, & Argheyd, 2003; Rekker, Benson, & Faff, 2014) have provided in many cases contradictory results, the necessity to design executive pay based on CSR-related targets is supported by the evidence of the positive impact of social responsibility on financial performance provided by Orlitzky, Schmidt, and Rynes (2003) and the primary role of CEOs in promoting corporate social responsibility (Godos-Díez, Fernández-Gago, & Martínez-Campillo, 2011).

This book chapter aims at investigating the concept of socially responsible executive pay. It begins with a review of the current literature dedicated to the link between CEO compensation and different aspects of CSR. Secondly, I discuss ways to design socially responsible executive compensation based on the considerations of the standard principal-agent theory (Eisenhardt, 1989; Jensen & Meckling, 1976), which represents a frequently used conceptual lens through which to analyse CEO pay in general, and the application of the balanced scorecard (BSC) approach (Kaplan & Norton, 1992) to measuring performance. Any discussion of socially responsible pay would be incomplete without a consideration of cross-national differences, which in this chapter are highlighted by referring to the neo-institutional theory (DiMaggio & Powell, 1983). Finally, recommendations for future investigations to close the currently existent research gaps are outlined in the conclusions section.

## 2 Investigating the Link Between CSR and Executive Pay

Over the last two decades, there have been growing numbers of studies examining the link between CEO pay and CSR. A number of such investigations concentrate on the individual compensation levels of executives and analyse the relationship between those levels and various aspects related to CSR initiatives in respective companies, by applying different assumptions used to explain such a link. For instance, Cai et al. (2011) assume that "CEOs of socially responsible firms will take relatively lower pay than those of socially irresponsible firms" and will "also refrain or reduce controversial pay practices, such as generous severance pay" (p. 160) and other compensation elements. The results of their analysis support the following contention: a significant negative relationship between the lagged CSR composite index (based on dimensions such as community, environment, diversity, employee relations and product) and CEO pay (both cash and total compensation). In their investigation of similar aspects of socially responsible behaviour of firms, namely employment relations, diversity and environmental issues, Rekker et al. (2014) also

found that there is a negative association between executive pay and CSR. One of the assumptions underlying their study is that "more intrinsically motivated CEOs will engage in more CSR activity" (Rekker et al., 2014, p. 85). Thus, the above studies regard the readiness of CEOs to accept lower pay as a manifestation of social responsibility, which is among other things driven by personal attitudes of managers to ethical behaviour.

A slightly different approach was taken by Jian and Lee (2015), who, in their analysis of the link between total executive pay levels and CSR investments, differentiated between "normal" and "abnormal" CSR. Normal CSR is defined as relating to "the optimal level of CSR investment that potentially increases shareholders' value," whereas abnormal CSR is assumed to be "related to excessive CSR investment that can potentially destroy shareholders' value" (Jian & Lee, 2015, p. 48). Here, by including corporate governance measures such as percentage of independent directors on the board, board ownership and institutional ownership in the equation, the authors found that in firms with stronger governance there is a stronger negative association between total CEO pay levels and abnormal CSR investment. Hence, in this case, it is suggested that the negative link between CEO pay and CSR is not affected by the personal characteristics and attitudes of top managers; rather, it is moderated by corporate governance configurations.

However, the study by Callan and Thomas (2011) showed a significant positive influence of CEO pay on corporate social performance, which can be seen as a contradictory result to the findings described above relating to a negative association between executive compensation and CSR. Similarly contradictory results were delivered by a number of other studies analysing the link between financial incentives provided to executives and different aspects of CSR. For instance, Mahoney and Thorne (2005) found a negative association between executive long-term compensation and CSR weakness, i.e. negative aspects of corporate social responsibility. These findings, however, contradict the results of the study by McGuire et al. (2003), who found that CEO salary and long-term incentives are positively related to weak CSR. In their more recent paper, Mahoney and Thorne (2006) identified different relationships between various elements of pay and CEO compensation in Canadian companies, ranging from a positive association between salary and CSR weakness to a positive relationship between stock options and CSR strength, i.e. positive aspects such as environmental planning and community charities.

Furthermore, Berrone and Gomez-Mejia (2009a) showed that there is a positive relationship between CEO pay and environmental performance in polluting industries, irrespective of the existence of environmental compensation policies and board committees responsible for environmental matters. However, Coombs and Gilley (2005) found a negative effect of several dimensions of stakeholder management, such as community, diversity, environmental and product performance, on CEO salaries and a positive effect of employee performance on bonuses. No significant effect of stakeholder management on stock options or total CEO compensation could be identified. In their study, based on a US-American sample of electronics industry companies, Russo and Harrison (2005) found a marginally

significant negative relationship between toxic emissions levels and the existence of a link between plant managers' compensation and environmental performance. Stanwick and Stanwick (2001) found a significant negative relationship between CEO pay and environmental reputation, which the authors measured by using the revised *Fortune* Corporate Reputation Index.

In summary, not only do the above studies deliver contradictory results, but there are also a number of practical questions which cannot be answered definitively by applying the evidence provided by those investigations. The main one, however, is the question on how to design CEO pay to achieve simultaneously the desired level of CSR and financial performance. If we assume the positive effect of CSR on the financial performance of companies (Orlitzky et al., 2003), and the possibility of the simultaneous management of social, environmental and financial performance (Epstein, Buhovac, & Yuthas, 2015), the main focus of investigation would be changed to the issue of performance measurement, appraisal and compensation schemes applied. Indeed, the negative relationship between CEO pay and CSR could be explained not only by the readiness of managers to avoid socially contested compensation practices, or their preference for intrinsic rewards, but also by their poorer performance or by inefficient pay-for-performance systems. For instance, with respect to the latter argument, Baker et al. (1988) state: "Managers respond to their lack of incentives by taking uneconomic actions that could be interpreted as being equitable and socially responsible" (p. 614).

Taking into consideration the above arguments, the question of administering socially responsible compensation and, first of all, defining the measures of desired performance, seems to be of primary importance. Here, executive compensation is regarded within the framework of relationships between stockowners and other stakeholder groups, on the one hand, and professional managers on the other. In the subsequent sections of this book chapter, I discuss the issue of social performance management, by referring to the standard principal-agent theory and by outlining the ways of practically implementing the respective systems, as well as the impact of national institutional contexts on the configurations of socially responsible executive pay.

## 3 Socially Responsible Executive Pay and Principal-Agent Relationships

Currently, the public discussion related to excessive executive pay is rooted in the trend toward an increasing share of pay-for-performance in total CEO pay (Sahakiants, Festing, & Perkins, 2016). For instance, Milkovich et al. (2014) show that the proportion of the respective reward types, especially long-term incentives, in the overall compensation of US-American executives has grown rapidly in the last few decades and constitutes a major part of their income. This explosive interest, and the prevalent use of pay-for-performance, is supported by

the seminal work of Jensen and Meckling (1976) describing the agency problems in the relationships between stockholders (as principals) and managers (as agents), which can be mitigated by providing performance-related incentives such as stock options or restricted stock (for an overview cf. Murphy, 1999). These incentive schemes are regarded within the positivist stream of principle-agent theory as mechanisms that "coalign managerial behaviors with owner preferences" (Eisenhardt, 1989, p. 68). In line with the above considerations, and in order to answer criticism related to excessive executive compensation, Jensen and Murphy (1990) argue that it is not the level of CEO pay but the establishment of a true link to performance that has to be in the focus of discussions. It is suggested that "[m]ore aggressive pay-for-performance systems (and a higher probability of dismissal for poor performance) would produce sharply lower compensation for less talented managers," while "more able and more motivated executives... would, on average, perform better and earn higher levels of pay" (Jensen & Murphy, 1990, p. 139). This argument on the frequently missing link between pay and performance and the necessity to establish such a link in order to ensure the effectiveness of executive rewards echoes with the earlier work of Baker et al. (1988), cited above, which established that CSR activities can be related to uneconomic decisions resulting from the lack of incentives.

But would it be correct to state that the application of the shareholder-oriented approach related to the arguments of the principal-agent theory contradicts the philosophy of CSR? As the very idea of CSR underscores the "responsibility [of businesses] to society and a broader set of stakeholders beyond [their] shareholders" (Heli, Li, Takeuchi, & George, 2016, p. 534), some scholars believe that tension exists between the shareholder and stakeholder orientation. For instance, Dalton and Daily (2001) state that "[s]takeholder theory... stands in stark contrast to the basic tenets of agency theory" (p. 92). However, recently, there have been intensive discussions on the need to recognise stakeholders in the latter theoretical approach (Shankman, 1999). In an attempt to unite both theories, Hill and Jones (1992) propose a modification of the principal-agent theory which they denote as "stakeholder-agency theory." This theoretical approach "encompasses the implicit and explicit contractual relationships between *all* stakeholders" (Hill & Jones, 1992, p. 132, emphasis in the original) and is characterised by Mitchell, Weaver, Agle, Bailey and Carlson (2016) as "a useful framework for articulating how corporations can embody multiple objectives even within a contractual view of corporations" (p. 264).

Considering the above arguments, I propose that the incorporation of the stakeholder theory's assumptions in the analysis of principal-agent relationships between the shareholders (principals) responsible for setting up executive director (agent) incentives may well be in line with the traditional efficiency logic underlying such interactions. Indeed, in their analysis of the relationship between different CEO compensation structures and corporate social performance (CSP), Deckop, Merriman, and Gupta (2006) found a positive association between the long-term focus of executive pay and CSP, which the authors regarded as a demonstration of "the relevance of agency theory in predicting management pursuit of CSP" (p. 340).

By developing further the idea of applying principal-agent theory to explaining socially responsible executive pay, it could be assumed that shareholders as principals can also be interested in promoting CSR in their companies and would thus be inclined to use long-term incentives as a means of aligning their interests with those of agents, i.e. CEOs.

The question as to why shareholders would be interested in promoting CSR-related activities can be answered by referring to the widespread understanding of socially responsible business outlined by Carroll (1991), who presents CSR as a multi-layered framework with economic responsibilities towards stockholders as its foundation, followed by responsibilities related to legal compliance, ethical and, finally, philanthropic responsibilities. Here, even CEO compensation based on financial performance targets would also constitute one of the elements of socially responsible pay in pursuit of the main purpose of business as defined by Milton Friedman, namely to "increase its profits" (Friedman, 1970, p. 32). Moreover, based on the above-mentioned evidence on the positive impact of social responsibility on financial performance, provided by Orlitzky et al. (2003), the link of CEO pay to CSR-related targets (for a discussion cf. Berrone & Gomez-Mejia, 2009b) may equally serve shareholders and other major stakeholder groups. In particular, Orlitzky et al. (2003) propose that their analysis "rejects the idea that CSP is necessarily inconsistent with shareholder wealth maximization... [and shows that] organizational effectiveness may be a broad concept encompassing both financial and social performance" (p. 424). Furthermore, as shown by Hong, Li, and Minor (2015), linking CEO pay to CSR leads to the improved social performance of firms, whereby companies with stronger corporate governance are more inclined to provide their CEOs with incentives for promoting CSR.

Thus, it seems that it is not the incompatibility of CSR initiatives with shareholder-oriented performance as such but the behaviour of executives incongruent with the interests of shareholders which constitutes the problem related to value-decreasing CSR activities. For instance, Barnea and Rubin (2010) assume that there is a conflict between company shareholders with respect to CSR-related strategies, and in this regard they posit the self-serving behaviour of insider shareholders which manifests itself in promoting over-investment in CSR "for their private benefit to the extent that doing so improves their reputations as good global citizens and has a 'warm-glow' effect" (p. 71). Similarly, Donaldson and Preston (1995, p. 87) argue: "It is feared by some that a shift from the traditional shareowner orientation to a stakeholder orientation will make it more difficult to detect and discipline self-serving behavior by managers, who may always claim to be serving some broad set of stakeholder interests while they increase their powers and emoluments". Still, while Barnea and Rubin (2010) assume that CSR may reduce firm value, they also recognise that "an increase in CSR expenditure may be consistent with firm value maximization if it is a response to changes in stakeholders' preferences" (p. 71).

Consequently, a crucial question related to the design and implementation of socially responsible pay, aligned with the interests of shareholders and other

stakeholder groups, is an effective performance management system based on relevant CSR measures, as discussed in the following subchapter.

## 4 Socially Responsible Executive Compensation and Performance Management

The issue of measuring CSP and CSR has been discussed extensively in the literature (cf. for an overview Wood, 2010). To address the problem of related performance measures, Searcy (2012) proposes concentrating on the notion of sustainability performance measurement system (SPMS), which is defined as "a system of indicators that provides a corporation with information needed to help in the short and long-term management, controlling, planning, and performance of the economic, environmental, and social activities undertaken by the corporation" (p. 240).

In practice, however, although linking CEO pay to CSR-related objectives seems to be quite commonplace (Hong et al., 2015; Jian & Lee, 2015), a recent survey by KPMG (2013) shows that there is still only a small proportion of companies that establish such a link in a clear manner.

Overall, there is evidence on the increased use of CSR reporting by enterprises (Einwiller, Ruppel, & Schnauber, 2016), in compliance with international standards such as UN Global Compact (UNGC) or Global Reporting Initiative (GRI). While Vigneau, Humphreys, and Moon (2015) show that CSR reporting in the case of GRI is not only seen as a source of legitimacy, but also—among other things—as a performance assessment tool, the evidence on using respective reporting standards as bases for key performance indicators (KPIs) for determining executive pay is still rare. One of the exceptions is the analysis of Australian companies conducted by Klettner, Clarke, and Boersma (2014), who provide evidence on the use of financial incentives for executives to promote CSR. For instance, the authors show that the majority of those companies in their sample that published GRI statements reported on compliance with guideline 4.5 of the third version of the Sustainability Reporting Guidelines. This guideline concerns the disclosure of the "linkage between compensation for members of the highest governance body, senior managers, and executives (including departure arrangements), and the organization's performance (including social and environmental performance)" (Global Reporting Initiative, 2011, p. 23). Furthermore, Klettner et al. (2014) found that the majority of Australian companies that were analysed by the authors used non-financial performance measures within executive remuneration schemes, including sustainability indicators such as community, environment, consumers, employees and safety.

Since, as discussed above, the successful implementation of socially responsible CEO pay is largely dependent on the quality of executive performance management, primary importance should be attributed to measuring and evaluating the

performance of top managers. In their case studies dedicated to the use of KPIs for sustainability performance, Adams and Frost (2008) provide evidence on the use of CSR and sustainability-related indicators for performance measurement, by applying the balanced scorecard technique, which was developed by Kaplan and Norton (1992) and is considered as one of the "most significant developments in management accounting" (Atkinson et al., 1997, p. 94) of the last few decades. The balanced scorecard incorporates the stakeholder model by combining four major sets of measures related to financial, customer and internal business processes as well as innovation and learning indicators (Kaplan & Norton, 1992; Ulrich, 1997). A way to link the respective metrics to executive compensation is to use a set of weighted KPIs related to different balanced scorecard measures (Kaplan & Norton, 1996). For instance, in such a case, 70% of target executive incentives could be linked to financial measures, such as revenue, return on investment or earnings per share, while the remaining 30 per cent could be linked to residual non-financial measures such as customer or employee satisfaction.

The increased attention to CSR and related sustainability issues over the last years has stimulated a discussion on the so-called "sustainability balanced scorecard", which "explicitly integrat[es] relevant environmental, social and ethical goals" (Hansen & Schaltegger, 2016, p. 194). Figge, Hahn, Schaltegger, and Wagner (2002) suggest three ways of integrating environmental and social dimensions into a balanced scorecard. The first option is to incorporate the respective aspects into four standard groups of measures, for instance by including metrics related to environmentally sustainable business processes. Secondly, an additional set of measures linked to environmental or social issues could be introduced, and finally, an environmental/social scorecard could be developed which extends the modified balanced scorecard discussed with respect to the previous two options.

However, irrespective of which approaches to designing a sustainability balanced scorecard are used, the main potential problem areas related to linking traditional balanced scorecard performance measures to compensation would also apply in this case. For instance, the most crucial questions that should be answered by companies in this respect were formulated by Kaplan and Norton (1996) as follows: "[D]oes the company have the right measures on the scorecard? Does it have valid and reliable data for the selected measures? Could unintended or unexpected consequences arise from the way the targets for the measures are achieved?" (p. 81).

Moreover, the implementation of a sustainability balanced scorecard as a performance measurement tool is very likely to be subject to similar criticism as the traditional balanced scorecard, which, according to Jensen (2010), "fails to provide… a clear linkage (and a rationale for that linkage) between the performance measures and the corporate system of rewards and punishments" (p. 40). An effective solution to increasing the effectiveness of balanced scorecards, including the sustainability scorecard, is to pay special attention to the strength of non-financial performance measures, i.e. their relationship with future profitability (O'Connell & O'Sullivan, 2014). This can be achieved by analysing the association of the respective performance metrics with specific financial performance

indicators in the past periods and primarily using those non-financial measures to determine CEO compensation that show high degrees of strength.

## 5 International Aspects of Implementing Socially Responsible Pay

An analysis of socially responsible executive pay would be incomplete without a consideration of international differences in the country-specific contexts of CSR and rewards. Building on the considerations of the national business systems approach coined by Whitley (1992, 1994), Matten and Moon (2008) posit that variations in the local institutional contexts result in either implicit or explicit forms of corporate social responsibility. The authors propose that organisations in liberal market economies such as the USA are subject to less institutional pressures to promote implicit CSR, which is composed of "values, norms and rules that result in (mandatory and customary) requirements for corporations to address stakeholder issues" (Matten & Moon, 2008, p. 409), than in many coordinated market economies in Europe. Instead, US-American enterprises engage in explicit CSR practices that "normally consist of voluntary programs and strategies by corporations that combine social and business value and address issues perceived as being part of the social responsibility of the company" (Matten & Moon, 2008, p. 409).

Furthermore, in a similar vein to the call of Filatotchev and Allcock (2010) on the necessity to adopt a contingency approach to the analysis of the national specifics of executive compensation, Bruce, Buck, and Main (2005) showed in their example of executive pay configurations in the UK and Germany the value of the institutional approach, which is instrumental in analysing the relevant differences in corporate governance configurations and thus contributes to the understanding of specific local agency relationships and contexts.

Given the importance of both the principal-agent theory and the stakeholder approach to analysing socially responsible executive pay, as discussed above, it is also necessary to acknowledge their limitations when considered from an international perspective (see, for instance, Jansson, 2005; Sahakiants & Festing, 2016, for discussions of the stakeholder model and the agency theory in international settings). For instance, the existence of principal-principal (as opposed to principal-agent) problems in emerging economies has been increasingly discussed in the academic literature (Dharwadkar, George, & Brandes, 2000; Li & Qian, 2013; Young, Peng, Ahlstrom, Bruton, & Jiang, 2008). These problems are related to the conflicts between majority and minority shareholders in weak governance contexts characterised by a low level of protection of minority shareholders' rights and concentrated ownership.

Moreover, some authors (cf. Donaldson & Preston, 1995, for example) underscore the variations between different institutional contexts with respect to the salience of different stakeholder groups. For instance, given the strong collective

bargaining in Europe, employees have more influence there than the same stakeholder group in the USA.

Although, as has been mentioned above, information on the use of concrete CSR-related measures for executive compensation is still scarce, the existing evidence suggests that the specifics of applying the respective metrics, and the propensity of companies for establishing explicitly a link between CSP and CEO rewards, are dependent on the particular country contexts. For instance, in their analysis of the corporate reports of large German companies for 2003 and/or 2004, Székely and Knirsch (2005) show that the studied corporations used a large variety of indicators, including economic, environmental and social metrics. Specifically related to executive compensation, or incentives provided to members of the management board in this country (in German: *Vorstand*, i.e. the executive body within the two-tier corporate governance system in Germany), is the discussion on the impact of the Act on the Appropriateness of Directors' Compensation (in German: *Gesetz zur Angemessenheit der Vorstandsvergütung [VorstAG]*) adopted by the German Parliament in 2009 (Wilke, Priessner, Schmid, Schütze, & Wolff, 2011). This law, which was conceived as a means to safeguard against false incentives potentially leading to corporate governance failures, introduced a number of changes in the German Stock Corporation Act (stipulated in Paragraph 87) calling for principles governing the appropriateness of pay provided to management board members of German stock corporations (Kling, 2012). One of the requirements of the Act reads as follows: "The remuneration system of listed companies shall be aimed at the company's sustainable development" (Norton Rose Fullbright LLP, 2013, p. 37). Wilke et al. (2011) analysed the impact of the above-mentioned Act on compensation design in leading German corporations, and they found that besides the frequently used notion of sustainability related to long-term orientation, the analysed enterprises used a number of additional indicators as targets for executive compensation, such as customer or employee satisfaction as well as environmental and corporate social performance (e.g. by applying measures based on a corporate responsibility [CR] index).

The above example, showing the importance of legislation on the implementation of socially responsible executive pay based on the integration of CSR or sustainability-related metrics into performance measurement systems, underscores the importance of the mechanisms of institutional isomorphism described by DiMaggio and Powell (1983). According to this approach, organisations become increasingly isomorphic, i.e. resembling each other, due to *coercive mechanisms* (e.g. laws similar to the Act on the Appropriateness of Directors' Compensation in Germany), *normative forces* (for instance, increased GRI reporting promoted by professionalising responsible organisational members) or *mimetic drivers*, based on the inclination of enterprises to imitate more successful companies, especially in situations of high uncertainty. Overall, this perspective emphasises the importance of achieving legitimacy, which is defined as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions" (Suchman, 1995, p. 574). For instance, Hansen and Schaltegger (2016) propose

that "[p]erformance measurement and management tools such as the BSC are used to meet societal expectations and achieve legitimacy" (p. 202). Similarly, Callan and Thomas (2014) state that "to achieve legitimacy, the firm must be actively committed to socially responsible objectives and do so in a way that is apparent to stakeholders" (p. 210).

Still, on the global level, the coercive mechanism of isomorphic change related to different regulatory contexts across countries can result in various ways of using CSR-related performance measures or the involvement of different stakeholders in designing executive pay. Different configurations of say-on-pay in various countries, i.e. shareholders voting on executive compensation, which is widely seen as a means to remedy excessive reward (Mangen & Magnan, 2012), are good examples of differences mainly fostered by national regulations (for an overview cf. e.g. Thomson Reuters, 2014). For instance, Lieder and Fischer (2011) describe the differences in say-on-pay legislation in the USA, UK, Switzerland and Germany and underscore, first of all, the traditional role of the German supervisory board (in German: *Aufsichtsrat*) within the two-tier board system in overseeing the activities of management board members. The authors state that for this reason "it makes sense to have an optional say-on-pay vote as a collateral corporate governance feature in Germany. To the contrary, a mandatory shareholder vote (at least as regards the compensation of the board) appears to be more important in a corporate structure built around a one tier board" (Lieder & Fischer, 2011, p. 377).

## 6 Conclusion

Recent discussions on the drawbacks of executive compensation related to corporate scandals (Coffee, 2005) and the latest financial crisis (Bebchuk, 2010) underline the importance of making CEO pay socially responsible. This call has been reinforced by the growing importance of CSR and the associated notion of sustainable development for business (Callan & Thomas, 2014). To date, a significant amount of evidence has highlighted that CSR-related performance indicators are increasingly used by companies while designing incentive schemes for top managers. However, available information about the specific use and effectiveness of using such metrics is still scarce. Moreover, more academic research on the link between CEO pay and CSR is necessary, to validate and confirm the frequently contradictory results of studies which have been conducted on this topic so far.

It can be expected that the importance of socially responsible executive compensation will further grow, which would constitute a practical challenge to companies implementing the respective schemes, first of all, in view of designing effective performance management and incentive systems. Here, evidence on the effectiveness of adopting sustainability balanced scorecards, and the positive effect of socially responsible CEO pay schemes on overall company performance, could build strong business cases showing the benefits of CSR and sustainability. Furthermore, such evidence has to be supported by academic research concentrating,

for instance, on the integration of the stakeholder approach and the principal-agent theory. In this case, further investigations into issues such as goal congruence between shareholders, other stakeholder groups and managers and the use of financial incentives to mitigate possible CSR-related agency problems are necessary. Another challenging topic for scientific inquiry is the examination of the determinants driving the implementation of socially responsible executive pay: analyses of developments in regulatory contexts or social norms could shed additional light on the mechanisms of institutional isomorphism discussed above and inform both policymakers and business leaders about the potential effects of the respective factors. For instance, it would be interesting to investigate how Directive 2014/95/EU of the European Parliament and of the Council, related to the disclosure of non-financial information by certain large companies in the European Union, including CSR-related aspects, which has to be translated into national law until December 6, 2016 and complied with starting in 2017, would affect the implementation of and reporting on socially responsible CEO pay in the region.

Ultimately, socially responsible executive pay is a promising research topic with the potential to contribute not only to developing economic, behavioural and organisational theories, but also to the overall understanding of the role of CSR in business success. Hopefully, socially responsible compensation will be a viable solution for improving the widely criticised—and in many cases dysfunctional—pay provided to corporate managers.

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# Integrated Reporting: State of the Art and Future Perspectives

Maria Roszkowska-Menkes

## 1 Introduction

Companies today operate in a changing and complex business environment, facing challenges related to expectations of increasingly powerful stakeholders. Businesses are pressured to take responsibility on economic, social and environmental impact of their operations and to focus on sustainability and accountability (Frias-Aceituno et al., 2014). Companies' ability to grow and to improve continuously is determined to large extent by their social competences, ethical responsibility and environmental contributions. The growing awareness on the role of business in society results in greater demand among investors and other stakeholders for transparent corporate reporting that could give a true picture and overall picture of companies' performance (Clayton, Rogerson, & Rampedi, 2015; Dragu, & Tiron-Tudor, 2013; Eccles, Ioannou, & Serafeim, 2011).

Traditional financial reporting cannot satisfy this demand, as it does not reflect the intangible capitals, such as environmental, social, intellectual and relational capital influencing firm's value creation process (Adams & Simnett, 2011). In response, sustainability (or corporate social responsibility—CSR, as these terms are often used interchangeably[1]) reporting has proliferated as the main communication tool with stakeholders, enabling to present results of business activities related to society and natural environment. Although being already well-established practice among large and medium-sized companies (EY & GRI, 2014), CSR reporting has been commonly criticized by academics and business practitioners.

[1]For the purpose of this study the relation between these two terms has been defined in accordance to ISO 26000 standard that describes CSR as a business contribution to sustainable development (ISO, 2013).

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Hypocrisy, box-ticking exercise, window-dressing and glossy product of self-admiration (Atkins, Atkins, Thomson, & Maroung, 2015; Fleming & Jones, 2013; Porter & Kramer, 2006; van Bommel, 2014)—these are just some of the unflattering attributes often used to describe corporate social and environmental disclosure efforts. CSR reporting often give thoroughly biased, one-sided, not complete or even no account of events, which reflect negatively on the reporting company (Flower, 2015; Lewis, 2011). Most sustainability reports are usually documents distinct from the annual report and there is no integration or correspondence between sustainability issues, financial data and core business strategy (Clayton et al., 2015), and as such they fail to provide stakeholders with information on interdependencies between various areas of company's operations. This results in the sustainability reports remaining isolated from the organization as a whole (Brown-Liburd & Zamora, 2015) and "merely exacerbating the already overwhelming amount of disclosure provided without adding any further insight" (Adams & Simnett, 2011).

With traditional annual reports being not sufficient to evaluate the ability of company's value creation (Doni & Gasperini, 2015) and CSR reports being primarily positive in nature comes investors' and other stakeholders' increasing demand for integrated reporting (IR) of social and environmental information. The topic of integrated reporting has come under serious scrutiny lately, as it is hoped to move sustainability from the business periphery to its mainstream. Most of the discussions focus on the need to regulate this field and explore how it will contribute to the improvement of organizations' reporting performance. Although integrated reporting is still in the development stages and there is no commonly accepted model to guide such reporting (Lodhia, 2015), more than 600 companies around the world have already implemented this form of disclosure (GRI, 2016). Academic research in this field is starting to expand[2] and provide regulators and managers with valuable insights to foster further development of policy and practice (Villiers, Rinaldi, & Unerman, 2014). Given the growing number of companies interested in integration of financial and non-financial data, and increasing amount of studies on integrated reporting the aim of this paper is to explore the limits in our understanding of this concept.

In so doing, the study seeks to critically analyze existing literature on integrated reporting. The study aims to provide an understanding of the term and provide theoretical justification and benefits of this form of disclosue. In addition, the study seeks to identify the audience of integrated reporting and the reporting entities and to explore regulations, frameworks and tools for integrated reporting.

[2]Based on the number of research papers on integrated reporting included in Thomas Reuters Web of Science database (search for publications that had "integrated reporting" in the topic field was conducted on February 9, 2016).

In achieving the aim, the study seeks to address four basic questions:

1. WHAT is integrated reporting?
2. WHY should companies report in an integrated way?
3. WHO reads integrated reports and who prepares them?
4. HOW integrated reporting should be implemented?

The paper is organized as follows. The next four sections present results of the literature review concerning each of the formulated research questions. Final remarks with emphasis on challenges for further development of IR and opportunities for future studies are presented in conclusion section.

## 2 Integrated Reporting: What Do We know Already?

### *2.1 What?*

#### 2.1.1 What Is the Common Understanding of Integrated Reporting?

The concept of integrated reporting has developed gradually in time, starting with an assumption that organization in order to be successful in the long run needs CSR strategy (Oprisor, 2015). Growing number of researchers argue that social responsibility, if integrated with core business strategy, stimulates innovation and supports continuous flow of competitive advantages (Kanter, 1999; Nidumolu, Prahalad, & Rangaswami, 2009; Porter & Kramer, 2011). Some authors argue that CSR, especially if it is based on stakeholder management and linked to the core business strategy, enables firm to develop rare, hard to imitate and valued by customers resources, such as ethical awareness, ability to manage social and environmental issues (Husted & Allen, 2007; Litz, 1996), enhanced reputation and more productive employees (McWilliams & Siegel, 2011), and relational resources (i.a. external knowledge and complementary resources) (Dyer & Singh, 1998). "CSR and competitiveness are not opposed but rather link in a synergic relationship" (Perrini, Pogutz, & Tencani, 2006, p. 6). Addressing societal needs and harms not only allows companies to minimize internal costs and operational risks, but also broadens search for new business opportunities (Porter & Kramer, 2011). Thus, reporting in order to reflect all of the firm's value drivers need to include both financial and non-financial information (Doni & Gasperini, 2015).

The first attempt to integrate these two types of disclosure was the Elkington's (1997) triple bottom line (TBL) concept (or three pillars theory—People, Planet, Profit). TBL adds to the traditional, economic bottom line two other balance sheets focusing on the conservation of social, natural and economic capitals, giving them equal importance. It has been designed to encourage organizations to take into consideration the whole impact of their operations. TBL has become a major sustainability accounting approach, most commonly chosen by companies reporting according to Global Reporting Initiative (GRI) guidelines (Robins,

2006), that is internationally the most prominent and most widely used guidelines for non-financial data disclosure (Clayton et al., 2015). The framework, however, by using three separate bottom lines, fails to track interconnections between the various types of capitals and is more focused on disclosing decreases in these capitals rather than on value creation (Adams, 2015a). Additionally, as the GRI standards became more complex and started to cover a broad range of social, environmental and governance issues, sustainability reports compiled in accordance with them also became more complex, lengthy and detailed, hindering identification of linkages between different policies and practices (Villiers et al., 2014).

The most recent significant global development in the area of integrated reporting is the formation of the International Integrated Reporting Council (IIRC), coalition of regulators, investors, companies, standard setters, accountants and NGOs. In its framework (International IR Framework) published in 2013 IIRC defines integrated report as “a concise communication about how an organization’s strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term” (IIRC, 2013a p. 7). The framework demonstrates a reorientation of the focus of corporate reporting from short-term, backward-looking financial information to forward-looking, connected and strategic information that discusses an organization’s ability to generate value over time (Adams & Simnett, 2011). Although its primary purpose is to present this information to providers of financial capital and to enable a more efficient allocation of capital, it is also intended to benefit other stakeholders, who have interest in the organization’s ability to create value. “In essence, integrated reporting is a hybrid practice that spans between the different worlds of financial reporting and sustainability reporting. It aims to provide a ‘true and fair’ view of firm value and thereby attempts to account for sustainability” (van Bommel, 2014, quotation marks original).

Integrated reporting is poised to be an evolution of mainstream reporting, and represents an opportunity for improving transparency, governance and decision making for organizations of all types (Adams & Simnett, 2011; Eccles & Krzus, 2010). Burritt (2012) argues that “if integrated reporting is both required and successfully adopted throughout the world (...) environmental performance accountability (...) would no longer be a subservient supplement to the main financial accounts and reports in the way that environmental and sustainability reporting have emerged until now” (Burritt, 2012).

While the final product of integrated reporting is the report, it is not its ultimate goal, but rather a mean to managing and creating value (Demartini & Paolini, 2013). The framework aims to shift the corporate thinking from short-term focus on financial gains and cost cutting towards long-term, future-oriented, business-model and value-based approach to running a company (Adams, 2015b; Ballou, Casey, Grenier, & Heitger, 2012; Beattie & Smith, 2013; Eccles & Krzus, 2010). It encourages managers to base their strategic decisions on criteria that include a full range of value drivers. In this way it aligns notions of profit maximization with wider goals of financial stability and sustainable development (Adams, 2015b).

The IIRC's concept is built around the notion of value that is generated from six categories of capital, not necessarily owned by the company: financial, manufactured, intellectual, human, social and relationship, and natural (IIRC, 2013a). Since financial providers are the target audience of integrated reporting, the framework focuses on value created for the organization, acknowledging however, that the organization's ability to create shareholder value depends to a large extent on its ability to create value for other stakeholders (Freeman, 1999). Thus, the materiality of a particular social or environmental issue and its inclusion in the report (as this depends on whether the issue is material or not) is determined by its impact on the organization's value.

### 2.1.2 What Is the Criticism of Integrated Reporting?

The IIRC's framework has attracted a range of criticism mainly related to its business case framing, one-sided approach to assessing and reporting on sustainability issues and serving the interests of financial capital providers far more than wider public (Brown & Dillard, 2014). Atkins et al. (2015) acknowledge that, integrated reporting does not satisfy the needs of broad stakeholder groups, as it suffers from lack of integration between financial and non-financial metrics. The authors call for monetizing the costs of climate change and integrate them with IFRS-based profits.

Flower (2015) suggests that the final framework has failed to introduce the key ideas initially presented by IIRC: (1) introduction of single corporate report (IIRC, 2011) (2) creation of a globally accepted framework for sustainability reporting (IIRC, 2010). Firstly the integrated report was supposed to be an organization's primary report, replacing rather than adding to existing requirements. This original proposal has been dropped, as it is incompatible with the principle of conciseness, one of the guiding principles of the framework (Villiers et al., 2014). While Adams (2015b) argues that replacing annual report as the foundation for accountability with integrated report might still be IIRC's long-term goal, finding formats of reporting that would enable to present all necessary data without creating an information overload becomes a crucial issue. Daub and Karlsson (2006) try to address this challenge with their streamlined reporting model that introduces well-designed and interesting traditional paper 'activity reports' that disclose mostly qualitative information and that make reference to the detailed quantitative section published online.

Secondly the IIRC's concept is accused of abandoning sustainability. As being constructed around notion of "value to investors" and not "value to society", it privileges a neoliberal pragmatics (Thomson, 2015). It guides companies to address only those social and environmental effects of business operations that have material impact on their ability to create value. Although IIRC recognizes the existence of stakeholders other than investors, in doing so it takes an instrumental approach to stakeholders that are viewed solely as means to profit maximization (Flower, 2015). Business case logics and "doing well by doing good" approach to

CSR that have dominated discussion on integrated reporting only preserve power asymmetries between shareholders and other stakeholders hindering authentic dialogue and participation (Brown & Dillard, 2014). Since stakeholder engagement is strongly consensus-oriented, less powerful constituencies are highly vulnerable to co-option when they engage in business-dominated fora.

Unsustainability of IR is also related to trade-offs between different categories of capital. On the one hand and, as argued by Flower (2015), the framework's user might assume that, since such trade-offs are permitted, it is possible to off-set a decline in natural capital by an increase in financial capital, what indeed seems, at least, controversial. On the other hand, however, this study would argue that such extreme situation is rather unlikely to occur. Taking into account long-term perspective, which in fact is promoted by IIRC, degradation of natural capital for short-term financial gains, in long run results in decline in social and relationship and possibly human capital, leading to decrease in organization's value.

## *2.2 Why?*

### 2.2.1 Why Should Companies Implement Integrated Reporting? Theoretical Justification

There are several theoretical justifications of integrated reporting mentioned in the literature. Firstly—stakeholder theory that assumes that firm is a constellation of cooperative and competitive interests possessing intrinsic value (Donaldson & Preston, 1995) and, thus, managers must formulate and implement strategies, which satisfy all and only those groups who have a legitimate stake in the company's operations (Freeman & McVea, 2001). There are three different approaches to stakeholder theory (Donaldson & Preston, 1995, see also Jones & Wicks, 1999): (1) descriptive—used to describe and explain specific corporate characteristics and behavior; (2) normative—used to define the objective of the firm and identify moral and philosophical guidelines for its management; based on the idea that stakeholders' interests are of intrinsic value or, in other words, that managers should include stakeholders' interests, since this it the right thing to do; (3) instrumental—used to examine connections between stakeholders management and achieving firm's strategic goals; based on the assumption that to maximize shareholder value over an uncertain time frame, managers ought to pay attention to key stakeholder relationships (Freeman, 1999).

The stakeholder model, especially in its normative variant (Flower, 2015), implies creating value for all stakeholders. According to stakeholders-agency theory managers are accountable for their actions not only to shareholders, but also to other stakeholders (Hill & Jones, 1992). Within this perspective integrated reporting is a stakeholders control mechanism and should include information material to the impacts on environment and society as a whole (van Bommel, 2014). Additionally it is supposed to serve as a stakeholder dialogue and

engagement tool, enabling participation of stakeholding publics in organization's decision-making process.

Stakeholder theory justification is reinforced by legitimacy theory (Magnaghi & Aprile, 2014) and its fundamental idea that there is a 'social contract' between a company and the society in which it operates (Deegan, 2002; Patten, 1991). Legitimacy theory assumes that organizations continually seek to ensure that they operate within the bounds and norms of their respective societies. The disclosure of social and environmental information through integrated reports legitimizes the role of the firm within society.

In the language of institutional theory the legitimization may also be reached in the process of isomorphism and the coercive, mimetic and normative efforts. Even if the company has no marginal return from sustainability practices and integrated reporting, it might still decide to engage in these activities as a result of regulation or social pressure, creating differences among countries produced by the demand for sustainability (Fernandez-Feijoo, Romero, & Ruiz, 2015, Nazari, Herremans, & Warsame, 2015). The companies' ability to survive and to grow is determined to large extent by how well they conform to rules, norms and belief systems prevalent in their operating environment (Wild & van Staden, 2013). In the absence of coercion, which is the case of integrated reporting, this conformity is driven by the need to comply with wider industry norms, to influence stakeholder perceptions and to gain legitimacy.

Additionally the theory of political costs suggests that integrated reporting might lead to the reduction of political costs, such as taxes and fees, help company to obtain certain benefits from the government and justify their profits (Frias-Aceituno et al., 2014).

The final theoretical justification for integrated reporting is provided by shareholder theory that assumes that the firm's main objective is to maximize shareholder's value. In its "extreme" form shareholder model negates the very idea of business people having any other social responsibilities then their fiduciary duty to maximize shareholder wealth, while obeying the law and basic canons of ethics (Doane, 2005; Friedman, 1970; Karnani, 2011a, 2011b; Sternberg, 1999). Thus any corporate activities focused on social or environmental issues are viewed as example of agency problem– managers misusing resources of the principals and acting in their own rather then shareholders' best interest (Friedman, 1970; Sternberg, 2000).

Its "enlightened" version, strongly influenced by instrumental premises of stakeholder theory (Freeman, 1999), assumes however that there is growing number of social and environmental factors that influence firm's ability to create value in the long term, and they should be addressed by the managers in their strategies and reporting. From this perspective the role of integrated reporting is to provide information on different interdependencies between social, environmental and economic aspects of business operations and to provide more accurate (than traditional financial reporting) picture of company's value drivers (Adams & Simnett, 2011). In this way it supports decision making of investors, especially those with long-term investing perspective, and enables shareholders to supervise

managerial actions, reducing, in result, agency costs (Frias-Aceituno, Rodriguez-Ariza, & Garcia-Sanchez, 2014).

An integrated report is also, in line with the signalling theory, a signal conveyed to the market in order to reduce information asymmetries, optimize financing costs and increase the value of the firm. Companies would publish and integrated report in order to distinguish themselves from the competition, to increase investors' confidence and to raise capital at the lowest possible cost (Frias-Aceituno et al., 2014). This form of disclosure may be an important tool of building competitive advantage, particularly in the growing socially responsible investment market.

According to Eccles et al. (2011) integrated reporting represents the reconciliation of shareholder and stakeholder theory. It combines these two approaches "in order to balance the opportunities of incorporating benefits from both producers and users of accounting information" (Dragu & Tiron-Tudor, 2014). This view is not shared, however, by the whole academic community. Some researchers (Atkins et al., 2015; Brown & Dillard, 2014; Flower, 2015; Thomson, 2015) argue that integrated reporting, as conceived by the IIRC, is based on instrumental stakeholder theory and exhibits a strong shareholder bias, not paying enough attention to interests of other stakeholders. Furthermore, it does not address the decision-making and accountability needs of interest groups such as consumers, employees, suppliers, local communities, NGOs, governments, developing countries and future generations (Brown & Dillard, 2014). Van Bommel (2014) suggests that integrated reporting combines the disparate domains of industrial, market, civic and green order of worth. Consequently it can be conceptualized as "a constellation of various valuation logics that must be reconciled to attain a state of legitimacy" (van Bommel, 2014). However reaching a shared compromise is increasingly problematic. The dialogue between the actors in the integrated reporting field seems to be strongly influenced by the accountants and investors (Reuter & Messner, 2015), who are accused of giving privilege to market/industrial worth without searching for a common interest.

### 2.2.2 Why Should Companies Implement Integrated Reporting? Benefits of IR

The literature mentions various benefits of integrated reporting such as enhanced reputation, effective decisions and capital allocation, interest from shareholders, profit increases, future orientation, stakeholder engagement, retaining customers and employees, effective risk (including regulatory risk) management (Dragu & Tiron-Tudor, 2014, Eccles & Krzus, 2010; Frias-Aceituno et al., 2014, Higgins et al., 2014; IIRC, 2013a). However, as shown below, empirical studies on this matter do not provide consistent results.

The reasons why companies voluntarily adopt IR reflect a combination of strategic drivers and institutional expectations (Clayton et al., 2015; Higgins et al., 2014; Lodhia, 2015). The first are related to communication with stakeholders (shareholders and broader constituents). In managers' opinion integrated reporting

is about "storytelling", i.e., explaining to stakeholders the company's overall strategy and, in this way, increasing their satisfaction (Higgins et al., 2014). Some companies view integrated reporting as communications tool that overcomes financial and sustainability reporting weaknesses and enables them to articulate their business model, strategy, governance and operational performance (Lodhia, 2015). However, in many instances integrated reporting does not give stakeholders any possibility of engagement or providing feedback information (Higgins et al., 2014). The second group of reasons emerges from the institutional environment and is connected with internal (from the CEO) and external (from reporting movement) pressures faced by reporting managers. Companies decide to introduce integrated reporting in order to meet expectations, but do not necessarily appreciate its value (Higgins et al., 2014). For some organizations integrated reporting is more a compliance exercise rather than a communication exercise and thus prove to be a distraction from substantive corporate sustainability (Clayton et al., 2015).

Majority of early adopters of IR report increased understanding of value creation in long-term and improvements in decision-making that are largely attributed to changes in management information (IIRC & Black Sun, 2015). Other research (Higgins et al., 2014; Stubbs & Higgins, 2014), however, argue that reporting managers do not have the agency or the responsibility to bring fundamental changes. Instead of delivering radical change to reporting processes, IR stimulates merely incremental changes to processes and structures that previously supported sustainability reporting (Stubbs & Higgins, 2014). "While the organizational changes promised through IR are reasonable (and noble), the arguments and rationality associated with it falls on not deaf, but constrained, ears" (Higgins et al., 2014). Although Ballou et al. (2012) find that integrated reporting is correlated with strategic orientation of sustainability initiatives, there is no evidence on the direction of the causation between these two variables. In fact Lodhia (2015) reveals that existing ethical values and business structures that enable integrated thinking within the organization are the drivers of integrated reporting and not other way round.

Regarding the benefits in terms of shareholders interest some empirical studies (Eccles et al., 2011; Serafeim, 2014) confirm that investors are increasingly interested in environmental, social and governance performance metrics and policies when making investment decisions and that they consider sustainable information disclosed in an integrated report as more reliable and relevant. More than half of organizations from the IIRC Pilot Programme find that this new approach to reporting helps to build stronger relationships and better understanding with institutional investors and analysts (IIRC & Black Sun, 2015). However, other companies, including those operating in U.S., Canada, China, India and Korea, "remain skeptical about the importance of sustainability in their strategies, to some extent exacerbated by the short-term nature of their capital markets" (Eccles & Serafeim, 2011, pp. 80–81).

## 2.3 *Who?*

### 2.3.1 Who Is the Audience of Integrated Reporting?

The discussion in previous sections has shown that there is no consensus in the literature regarding the audience of integrated reporting. On the one hand the proponents of business-case framing argue that the role of IR is to improve the quality of information available to providers of financial capital. As previously mentioned investors are increasingly searching for sustainability information and believe that integrating reporting increases reliability of such information (Eccles et al., 2011; Serafeim, 2014). However, as Resenburg and Botha (2014) reveal, in South Africa (one of the leading countries in terms of integrated reporting implementation) very few stakeholders use integrated reports as their main source of financial and investment information, and they are viewed as additional information. As integrated reports are perceived as too complex, annual financial reports are still the mainstay for the corporate financial data.

On the other hand, a number of authors, critical towards the IIRC's concept, call for more stakeholder-oriented approach that would enable real dialogue and engagement. Dumitru, Gușe, Feleagă, Mangiuc, and Feldioreanu (2015) prove that the annual (integrated) report is often used as a marketing tool targeted at customers, especially with respect to the section about value creation. Furthermore, some organizations prioritize disclosures for non-financial stakeholder groups such as customers or do not disclose any specific shareholder value information at all. Higgins et al. (2014) argue that although, as the experience of some early adopters of the framework shows, companies address their integrated reports also to other stakeholders, this is rather one-way communication.

### 2.3.2 Who Is the Reporting Entity?

As financial capital providers are the main audience of integrated reports, large, publicly listed companies that face significant market pressure to attract external funding are definitely among pioneers in integrated reporting. Frias-Aceituno, Rodriguez-Ariza, and Garcia-Sanchez (2013, 2014) prove that there is a positive relation between corporate size and the integration of corporate information. Authors argue that larger companies operating in environments characterized by significant social inequalities are more visible in the market and raise considerable stakeholder's interest. In result they tend to implement broader, more objective and more comparable information practices. This added dimension enables them to generate added value and an enhanced social and environmental impact. Furthermore, they have greater resources for compilation of the information.

Other company's characteristics influencing likelihood of integrated reporting include Frias-Aceituno et al. (2014):

- profitability—most profitable companies are those investing most resources to the development of integrated reporting, in order to make their actions better known to the public. In this way, according to agency theory, managers seek for personal advantages such as ensuring the stability of their position and increasing their level of remuneration. Additional integrated reporting enables to justify firm's profits and decrease political costs;
- industry concentration—firms in less competitive industries, in order to preserve the abnormal profits, tend to disclose less information relevant to decision taking than that concerning intangible assets or standardized reporting. Integrated reporting provides strategic information on diverse current and future dimensions of business behavior that could be used by competitors. Thus, it increases proprietary costs.

On behalf of institutional theory Dragu and Tiron-Tudor (2013) prove that political, economic, and cultural factors maintain small influence of 8.1% upon the disclosure of IR elements and principles. Corporations from countries with civil law political system and strong economy tend to report in integrated manner. Surprisingly it has been observed that there is negative relation between national corporate responsibility index exerting cultural pressure and integrated reporting.

Garcia-Sanchez, Rodriguez-Ariza, and Frias-Aceituno (2013) investigates the influence of cultural system representing values of local stakeholders on integrated information disclosure. Authors provide empirical evidence that firms operating in countries with similar cultural systems adopt homogeneous patterns of behavior regarding integrated reporting. Specifically, companies located in collectivist and feminist countries, i.e. societies characterised by concern for the public good, present a greater commitment to sustainability and good governance, and thus show greater interest in integrated reporting. What is interesting, neither power distance nor long-term orientation were found to be determining factors. This suggests that the implementation of integrated reporting does not arise from more regulation or stratification of power. It is also not attractive for societies oriented towards long-term perspective. One might draw conclusion from this observation that the IR framework is not perceived to have potential to initiate change in the organization mindset towards future orientation, as it is hoped by IIRC.

The International IR Framework has been written primarily in the context of private sector, for-profit companies of any size, but, as IIRC (2013a, p. 4) states, it can be also applied, adapted as necessary, by public sector and not-for-profit organizations. Lodhia (2015) explores the transition to integrated reporting by a customer-owned mutual bank and presents evidence that despite the lack of external market pressure, a customer-owned business context actually provides the necessary foundations for such transition. Author suggests that the public sector could similarly benefit from integrated reporting. Veltri and Silvestri (2015) explore for example implementation of this form of disclosure in public university. Adams and Simnett (2011) argue that IR provides a unique opportunity for the NGO sector to engage in detailed and effective reporting. Since NGOs are increasingly building complex and partner relations with public and private sector, they are

expected to adopt strategic thinking and business-like models of operations, and to satisfy financial capital providers' demands for greater transparency and better performance and value measurement frameworks. Integrated reports, by bringing together the most material elements of all forms of reporting, and illustrating the link between them, may reduce regulatory reporting burden on the limited resources of NGOs. Various not-for-profit organizations can also benefit from a change toward flexible and long-term oriented reporting framework that IIRC is trying to introduce. Integrated reporting enables to combine both qualitative and quantitative elements over a variety of time frames and is adaptable to new forms of social impact measurement. "Essentially, the elements of the IIRC draft framework provide the opportunity for these various sectors to differentiate themselves from other organizations and clearly tell their 'story'." (Lodhia, 2015).

### 2.3.3 Who, Within the Organization, Is Involved Integrated Reporting?

There are several groups, whose involvement in disclosure of integrated information has been mentioned in the literature. Firstly Ballou et al. (2012) note that although accountants are rarely involved in sustainability initiatives, their expertise in risk identification and measurement, financial reporting and independent assurance can be crucial for successful implementation of integrated reporting and thinking.

Secondly Huggins, Simnett, and Hargovan (2015) discuss the role of board in integrated reporting and whether they should acknowledge their responsibility for this process. On the one hand sign-off of those charged with governance (TCWG) on integrated reports would enhance the reliability, credibility and accountability of such documents. Frias-Aceituno et al. (2013) state that the board is responsible for safeguarding the interests of different stakeholders and plays an important role in implementing policies of stakeholder engagement and achieving holistic corporate transparency. It has been shown that larger boards, containing directors with greater experience and broader diversity of backgrounds, positively promote integrated reporting regardless corporate governance systems in particular countries (Frias-Aceituno et al. 2013).

On the other hand the involvement of TCWG in integrated reporting generate in some jurisdictions (e.g. in Australia) directors' concerns about personal liability exposure, particularly for forward-looking statements that subsequently prove to be unfounded (Huggins et al., 2015). Therefore the development of a legal safe harbor for directors, but also for auditors providing assurance of information disclosed in IR, is desired. Thirdly Meintjes and Grobler (2014) draw attention to the role of public relations professionals in corporate governance and integrated reporting. Since stakeholders' demand for open communication and information sharing is currently not being met by companies, PR that focuses on building dialogue-based relationships with stakeholders can be regarded as the 'missing link' in corporate governance. Moreover PR officers with their experience with annual reports may prove to play essential role in preparing integrated reports.

Finally, results of Lodhia's (2015) case study show that top management support is crucial in the transition process to integrated reporting. They have to acknowledge the organizational ethical values and formulate strategies to meet their goals. They need to 'set the tone from top' through their governance. Additionally, in situation when economic, social and environmental issues are embedded across the organization, which is actually a result of integrated thinking, all staff is involved in and share responsibility for producing integrated report. Many companies implementing integrated reporting change their approaches to work across departments (IIRC, 2013b).

## *2.4 How?*

### 2.4.1 How Should Integrated Reporting Be Regulated?

There is no consensus among academics on how integrated reporting (and non-financial information reporting in general) should be regulated. On the one hand the IIRC (2013a) promotes integrated reporting as a voluntary disclosure practice and does not impose any specific obligations on companies using its framework. The organization presents principle-based approach, including a small number of, general requirements and providing no indicators in order to ensure flexibility of the framework. As Daub and Karlsson (2006) prove, there is no 'one-size-fits-all' solution on how to prepare a report and therefore companies need to find their individualized strategy in accordance to their characteristics and stakeholders expectations. Principle-based approach, although understandable in relation to CSR strategies that are highly company specific, hinders comparability (Zicari, 2014) (which paradoxically is one of the principle of the IIRC's framework). It also creates danger that some managers will use the discretion offered by the IIRC to not report on matters that they prefer to keep secret (Flower, 2015).

On the other hand there is increasing regulatory interest in integrated reporting. South Africa became the first jurisdiction to mandate this form of disclosure in 2010. The driver for this was the King Code of Governance Principles for South Africa 2009 (King III) becoming a requirement for entities listed on the Johannesburg Securities Exchange. King III recommends that organizations should adopt integrated reporting on an 'apply or explain' basis. New mandatory reporting rules in Europe (Directive 2014/95/EU) and stock exchange listing rules in, inter alia, Singapore, Kuala Lumpur and Copenhagen also require companies to disclose non-financial information (still not necessarily integrated with financial information). However Brown and Dillard (2014) suggest that overcoming shortcomings of the dominating accounting model is not just the matter of introduction of mandatory IR. With no fundamental rethink of accounting theory, policy and practice mandatory non-financial disclosure will only institutionalize business case logic in social and environmental reporting.

### 2.4.2 How Should Integrated Reporting Be Implemented?

Researchers propose various frameworks and tools for integrated reporting. The IIRC's framework (IIRC, 2013a, pp. 16–23) provides seven guiding principles underpinning preparation and defining the content and form of an integrated report:

1. Strategic focus and future orientation—an integrated report should provide insight into the organization's strategy, how it creates value and how it effects particular capitals;
2. Connectivity of information—an integrated report should present the holistic picture of the company's value creation process;
3. Stakeholder relationships—an integrated report should provide information on how and to what extent the organization understands, takes into account and responds to their legitimate needs and interests;
4. Materiality—an integrated report should disclose information about matters that substantively affect the organization's ability to create value over the short, medium and long term;
5. Conciseness—an integrated report should be concise;
6. Reliability and completeness—an integrated report should include all material matters, both positive and negative;
7. Consistency and comparability—the information in an integrated report should be presented in a consistent way, enabling comparison with other organizations.

The content of the integrated report, according to IIRC's template (IIRC, 2013a, pp. 24–32), should include eight elements:

1. Organizational overview and external environment;
2. Governance structure and how it supports organization's ability to create value in different time perspectives;
3. Organization's business model;
4. Risks and opportunities affecting the organization's ability to create value and how the organization is dealing with them;
5. Future-oriented information regarding strategy and resource allocation;
6. Performance related to strategic objectives and impact on the capitals;
7. Outlook, i.e. challenges and uncertainties that the organization is likely to face and their potential implications for its business model and future performance;
8. Basis of preparation and presentation of the report's content.

However, as being principle-based, the IIRC's framework does not provide companies with any specific tools for non-financial and financial data integrated disclosure. Some researches have already undertaken some effort in order to fill this gap. Basing on the case study of a company operating in the field of electronics and defense, Demartini and Paolini (2013) establish relationships between business performance, intellectual capital (IC) and CSR indicators, and present a model of IC-CSR management. Haller and van Staden (2014) argue that "value added statement" (VAS) has the potential to serve as a practical and effective reporting

instrument for integrated reporting. VAS represents the monetary contribution of a company to the wealth of several groups in society and there is strong empirical evidence that it complies with the disclosure needs of the financial capital providers as well as other stakeholders. VAS not only meets the guiding principles of IIRC, but also reports on the monetary effects of different types of capital included in the framework. Rambaud and Richard (2015), basing on a critical analysis of triple bottom line approach, propose another monetary reporting framework, the "Triple Depreciation Line" (TDL). It extends the historical cost accounting, designed for preserving the financial capital, to human and natural capitals.

By monetizing the costs of environmental degradation and social impacts, accounting and finance can address significant environmental and social risks, and encourage integrated thinking within organizations (Atkins et al., 2015). There is some empirical evidence that there is tendency towards quantification among companies adopting integrated reporting (Clayton et al., 2015). However monetary reporting instruments cannot capture information that is not measurable in monetary terms and, as IIRC (2013a, p. 17) states, "both qualitative and quantitative information are necessary for an integrated report to properly represent the organization's ability to create value as each provides context for the other."

Brown and Dillard (2014) warn that monetization strategies may just reinforce business-as-usual framings and instead propose dialogic/polylogic accounting approach based on eight general principles (Brown, 2009):

1. Recognizing a diversity of ideological orientations;
2. Avoiding monetary reductionism;
3. Being open about the contestability of calculations;
4. Enabling access for non-experts;
5. Ensuring effective participatory processes;
6. Being attentive to power relations;
7. Recognizing the transformative potential of dialogic accounting;
8. Resisting new forms of monologism.

Dialogic/polylogic accounting, by including diverse socio-political perspectives in integrated reporting, increases transparency around decision making in controversial areas. It recognizes diverse range of goals and values including, i.a., efficiency, economic growth, sustainable livelihoods, labor rights, fair trade, cultural identity, and social justice. This requires, however, multi-way learning and effective engagement processes. In order to achieve that authors (Brown & Dillard, 2014) propose experimentation with diverse forms of calculative and narrative accountings such as counter-accountings, testimony, interactive online technologies and visual methods.

Another issue related to implementing integrated reports is its assurance. Literature delivers strong evidence that assured CSR reporting enhances a firm's reputation and credibility, and is associated with lower cost of equity capital, analyst forecast errors and forecast dispersion (Brown-Liburd & Zamora, 2015). Similarly, integrating reporting assurance is viewed as a fundament mechanism enhancing credibility and reliability (IIRC, 2014). Empirical studies reveal that transition to

integrated reporting is accompanied by an increase in assurance of non-financial information (Clayton et al., 2015; Sierra-García, Zorio-Grima, & García-Benau, 2015). However, the results concerning the relations between integrated reporting and the likelihood of having social and environmental data assured are still mixed (see Fernandez-Feijoo et al., 2015). Oprisor (2015) argues that a high level of IR assurance is difficult to obtain because of the lack of audit regulations and KPIs, and possible high costs of such audits. Other challenges relate to the time frame of integrated reports, namely assuring future-oriented information (see also Huggins et al., 2015). To address these challenges IIRC (2014) encourages discussion concerning development of specific assurance standards. Villiers et al. (2014) suggest that assurance service providers may have to combine IR with existing regulations on annual reports, but there may also be a need to change auditing standards.

## 3 Discussion

### *3.1 Business-Case vs. Sustainability-Case*

The results of the literature review reveal that research on integrated reporting has been developed in two opposite streams: business-case (BC) and sustainability (SD). "For some, integrated reporting is a 'potent tool' to mainstream sustainability in companies and capital markets, while for others (. . .) International Integrated Reporting Council's (IIRC's) proposals are 'a masterpiece of obfuscation and avoidance of any recognition of the prior 40 years of research and experimentation' that (. . .) threaten to push us 'even further away from any plausible possibility that sustainability might be seriously embraced by any element of business and politics'" (Brown & Dillard, 2014, quotation marks original). Table 1 summarizes the main differences between the streams in respect to the four formulated research questions.

One of the biggest challenges in the development of integrated reporting is to find compromise in between business-case and sustainability model of integrated reporting. The ongoing debate over what exactly should constitute the value and what should be disclosed in integrated report reflects the lack of consensus in the literature regarding the definition of corporate social responsibility (or business sustainability). Classical understanding of CSR has been constructed around notions such as voluntarism, social altruism and profit sacrificing (Horrigan, 2010, pp. 34–35). Within this altruistic approach CSR is defined as "situations where the firm goes beyond compliance and engages in actions that appear to further some social good, beyond the interests of the firm and that which is required by law" (McWilliams, Siegel, & Wright, 2006). However, over the last decade or so there has been a growing number of authors convinced that CSR should play strategic role in business (Husted & Allen, 2007; Vilanova, Lozano, & Arenas,

**Table 1** Comparison of business-case and sustainability research stream on integrated reporting

| Stream/ Question | What? | Why? | Who? | How? |
|---|---|---|---|---|
| BC | Disclosure of all information reflecting the organization's ability to create value for itself over time | Theoretical justification: shareholder, instrumental stakeholder, agency, signaling and public costs theory<br>Benefits: focus on business benefits | Audience: Capital providers<br>Stakeholders—one-way communications | Principle-based approach, ensuring flexibility<br>Monetary and narrative instruments—need for instruments<br>Assurance—need for standards |
| SD | Disclosure of all information reflecting the organization's ability to create values for the society as a whole over time | Theoretical justification: normative stakeholder, stakeholders-agency, legitimacy and institutional theory<br>Benefits: focus on social benefits in form of higher transparency of corporate actions and genuine sustainability; business benefits not considered—"the right thing to do" approach | Audience: Stakeholders—dialogue and engagement | Rather standard-based and regulatory approach, but after fundamental change in the accounting theory<br>Dialogic/polylogic accounting using both monetary and narrative instruments—need for instruments<br>Assurance do not guarantee credibility |

2008). Lantos (2002) argue that altruistic CSR is paradoxically unethical, since by having negative influence on corporate performance (Baron 2001) it infringes shareholders rights. Purely altruistic approach leads to making CSR a marginal concept framed in opposition to shareholder value generation (Freeman & McVea 2001; Horrigan 2010, p.35; Porter & Kramer 2011).

Strategic CSR bases on the "win-win" assumption about business-society relations, and so does the IIRC's framework. The latter provides no guidance for situations, where win-win solution cannot be reached. While this study would argue that it is managers' fiduciary and moral duty towards shareholders to integrate social and environmental programs into core business strategy in a way that enables creation of shared value (or in other words mutual benefits), the problem arises when there is a conflict of interests. It would be interesting to investigate when such conflicts occur, how companies deal with them and how they address them in integrated reports. One might assume that since integrated reporting, as hoped by its proponents, changes managerial decision-making process and shifts it towards

long-term, business-model perspective, companies implementing IR would see these kind of challenges as an opportunity for innovation.

Adams and Whelan (2009) suggest that moving from business case for sustainability to what Thomson (2015) calls "sustainability case for business" is idealistic and wishful thinking. However, instrumental stakeholder theory (or strategic CSR) does not provide excuse for unethical corporate behavior, and integrated reporting standards should clearly reflect that, by obliging companies to disclose information on all of their social and environmental impacts and not only those, which they consider to influence their value creation ability. Business case framing of sustainability and integrated reporting should acknowledge the need for creating partner relations with stakeholders based on dialogue and participation. Stakeholders armed with information and communication technologies do not remain passive audience, they are increasingly interested in firms' activities and global social problems. They easily get access to and willingly share information on these activities, take up collective actions, and expect to be engaged in various business operations (see for example Shirky, 2008; Tapscott, 2009, Tapscott & Ticoll, 2003; Shirky). Thus building good relationships with these modern stakeholders is not just the matter of risk management, but also creation of new business and innovation opportunities.[3] What is more, since there are no standards for integrated reporting, dialogue with stakeholders seems to be the only way for organization to determine what and how to report. Future qualitative studies could focus on searching for best practices of stakeholder engagement through integrated reporting and developing tools for such engagement.

### *3.2 Limitation of Present Research and Future Directions*

There is little empirical evidence on who is the IR's audience and what is the stakeholders' attitude to this form of reporting. Future research could explore not only to whom companies address their integrated reports, but also how different groups of stakeholders benefit from integrated reporting; whether they are interested in reading such reports; how they asses the credibility of disclosed information; what information they would like to be provided with and in what form.

There is still lack of clarity on how economic issues will be integrated with social, ethical and environmental matters (Lodhia, 2015). Thus, development of standards and KPIs for integrated reporting and its assurance is strongly encouraged. On the one hand, standards are desirable, since they enable comparisons between firms, provide a transparent picture of the organization's activities and provide guidance for preparers about what should be reported and how. On the other hand, exactly who should develop the standards, and what they should be in

[3]There is much evidence in the literature on the crucial role of various stakeholder groups in innovation proces (see for example: Ayuso et al., 2011; Holmes & Smart, 2009; Luo & Du, 2014).

order to be meaningful for the company and its unique business model is unclear (Higgins et al., 2014). Such standardization should include different types of reporting organizations, e.g. those in the public and non-government sectors. It is important that, in order to achieve high level of credibility, they should also be developed in cooperation between regulators, practitioners, academics from various disciplines and civil society groups.

Finally, still not much is known about the success factors for IR implementation and further empirical research may provide some insight on this matter. As studies deliver mixed results concerning business benefits of integrated reporting, it would be interesting to investigate what are the external and internal factors influencing organization's ability to benefit from this new approach to accounting, especially in relation to the delivery of organizational changes, interest from investors and stakeholders satisfaction. What is more there is little evidence on the risks stemming from IR. Frias-Aceituno et al. (2014) argue that IIRC's requirement for disclosure of forward-looking information can be problematic as speculation and commercial sensitivity risks could arise. Further studies might focus on identification of other risks and ways to avoid them.

## 4 Conclusion

Over the last 5 years integrated reporting has attracted increasing attention of both academics and business practitioners. It provides a broader explanation of firm performance than the traditional disclosure approach, describing the company's dependence on various resources and its relationship with stakeholders. As such it offers a fundamental progress of adopting and operationalizing the concepts of CSR and sustainability in business practice. Research in the field of integrated reporting is dynamically growing but still remains limited, leaving many questions unanswered.

This paper examines the current state of art of the integrated reporting. It focuses on the understanding of the term, its criticism, its theoretical justification and benefits stemming out from its implementation. The analysis concentrates also on the actors engaged in the process of integrated reporting and frameworks defining its application in organizations.

The results of the study indicate that the understanding of the drivers of integrated reporting has been developed in two opposite streams: business-case and sustainability. The first, addressed to shareholders, is constructed around shareholder value and business benefits of sustainability. It is determined by the "doing well by doing good" and "win-win" approach to the relationship between business and society. The second stream has its origins in normative stakeholder theory and suggests that integrated reporting should serve as a stakeholders control mechanism. It goes beyond profit maximization and shareholder value, focusing on social benefits and value for all stakeholders. Due to the lack of consensus in the literature over integrated reporting, further research is needed, in particularly on the benefits

of this practice for both companies and their stakeholders, success factors for IR, standards of integrated reporting with special focus on the disclosure of negative result, and finally tools for integration of financial and non-financial data.

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# Integrated Reporting in Nigeria: The Present and Future

**Sunday Chukwunedu Okaro and Gloria Ogochukwu Okafor**

## 1 Introduction

Corporate governance aims at promoting corporate transparency and accountability. It has as its goal the enhancement of the directors' fiduciary duties and their ethical conduct in directing the affairs of a corporation, (Adekoya, 2011). The agency theory emphasizes the need for the protection of shareholders for the simple reason that they are the core financiers of businesses and can only be expected to play this role effectively if they are assured that corporate managers have their interests at heart (Mangena & Tauringana, 2007). It is therefore not surprising that the bedrock of corporate governance legislation in Nigeria, The Company and Allied Matters Act (CAMA) of 1990, made elaborate provisions for the protection of shareholders' rights. These include provisions for annual audits, powers of annual general meeting to sanction erring Directors, mechanism for effective oversight of the audit function, convening of annual and extra ordinary general meeting, mechanism and structure for prudent management of shareholders assets. Some others are ability to transfer ownership and enforcement rights, measures for secure shareholder share registration, shareholder voting and proxy rights and minority shareholders' rights (Oyejide & Soyibo, 2001). Nigeria has witnessed a plethora of corporate governance codes all aimed at holding the managers of corporate resources accountable to the shareholders and to a lesser extent other stakeholders. These include the Nigerian Security and Exchange Commission (SEC) codes of 2003 and 2011, The mandatory Central Bank of Nigeria (CBN) code of 2006 for all licensed banks in Nigeria post consolidation, the Pension Commission (PENCOM) 2008 code for licensed Pension operators in Nigeria, the 2009 Insurance Industry (NAICOM) code for insurance companies and the

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Nigerian telecommunication code of 2014. As can be seen, many of the codes are industry specific. In 2011, the Financial Reporting Council of Nigeria (FRCN) was established by the government of Nigeria to drive financial reporting and corporate governance in Nigeria. As part of its mandate to bring corporate governance and financial reporting practices in tandem with international best practices, the council has announced a plan to come out with one unified mandatory corporate governance code for all companies operating in Nigeria.

More broadly corporate governance comprises the legal infrastructure such as corporate law, securities law, accounting rules, regulations, enforcement mechanism, business ethics and the operating environment that instigate sound economic performance. The principles around which businesses are expected to operate hover around five key areas. These are shareholders rights, interest of stakeholders, roles and responsibility of the board, integrity and ethical behavior and disclosure and transparency. Corporate governance speaks to these principles (Otudeko, 2011). Reporting no doubt is an essential and integral part of Corporate Governance. The responsibility for good and effective reporting lies on the shoulders of the directors. Regulators, auditors and other stakeholders have the responsibility to ensure that directors live up to expectation. The paradigm shift to stakeholders' rights also means that financial reporting format which characterized shareholder emphasizes in corporate governance must give way to a more robust reporting format that takes care of the interests of all stakeholders and the organization itself. Nigeria has need for both foreign domestic investment and portfolio investments to drive her economy especially in the light of dwindling oil revenue. Globally, the emphasis is on socially responsible and environmentally friendly investments. A picture of the triple bottom line approach of listed Nigerian companies to business has become paramount if they will have access to a plethora of investment opportunities that abound internationally. Integrated reporting (IR) is increasingly being adopted globally as the reporting format that best portrays this paradigm shift. This chapter will explore the current position of Nigeria in respect of IR, state some of the guiding principles of IR, point out the prospects and challenges of IR reporting in Nigeria and attempt a prognosis of the future of IR in Nigeria.

## 2 Underlying Theories of Information Disclosure

Several theories have been developed on why firms should disclose voluntary information and the need to provide a detailed financial report by those entrusted with the management of a company's affairs. These theories include the proprietary theory, institutional theory, political economy theory, resource dependency theory, stakeholders' theory, the agency theory and legitimacy theory (Damagum & Chima, 2013). However, for the purposes of this study we shall highlight the agency theory, the stakeholders' theory and the legitimacy theory as being very relevant to our discourse.

## 3 Agency Theory

Agency theory was the predominant theory of corporate governance and emerged as a result of separation of ownership and control in business between shareholders and directors. The theory is concerned with aligning the interest of the shareholders with that of the management. The assumption is that there is a misalignment of interest between shareholders as principals and the directors as agents. The problem is exacerbated as a result of information asymmetry as the directors have more privileged information about the company than the shareholders (Yahaya, 2013a). According to agency theory, the principal can limit divergence from his/her interests by appropriate incentives for the agent and by incurring monitoring costs such as auditing designed to limit opportunistic action by the agent. This theory is, however, not without its critics. There is the difficulty of measuring utility as utility maximization assumption by directors is at the base of the theory. The self-interest assumption has also been assailed on the ground that it fails to take cognizance of the fact that agents are often constrained in their activities by competitive market assumptions (Tauringana & Chong, 2004). Perhaps the most strident criticism of this theory is its narrow focus of shareholders as the dominant stakeholders' group worthy of attention from corporate managers in terms of information provision and transparent and accountable governance.

## 4 The Stakeholder Theory

The shift in emphasis from shareholder to stakeholder perspective in corporate governance has been described as a paradigm one (Haruna, 2012). Stakeholder theory is underpinned by the notion that stakeholders are important to the organizational performance and require explicit consideration in corporate strategy formulation (Nkundabanyanga, Ahiauzu, Kisakye, & Ntayi, 2013). Stakeholder theory highlights the interplay and communication between an organization and its stakeholders. Stakeholders are identified by reference to the extent to which the organization believes the interplay with each group needs to be managed in order to further the interests of the organization. The implication of the theory is that organizations should put additional emphasis on the opportunity offered by stakeholder analysis because the interest of the organization can be enhanced by an interactive and symmetrical two-way communication with its stakeholders (Qian, Burrit, & Monroe, 2011). Stakeholder theory views organizations as a system that accommodates not only the interest of the owners but also the interests of other groups within the environment in which the organization operates. These stakeholders include employees, creditors, suppliers and local communities. Such stakeholders should be considered in the process of strategic decision-making (Yahaya, 2013b).

## 5 Legitimacy Theory

Organisations will do whatever they regard as necessary in order to preserve their image of a legitimate business with legitimate aims and methods of achieving it. Legitimacy is assumed to be influenced by disclosures of information and not singly by (undisclosed) changes in corporate actions (Odia & Imagbe, 2015). While legitimacy theory discusses the expectations of society in general, stakeholder theory provides a more refined resolution by referring to different stakeholder groups within society. The argument underlying legitimacy theory is that organisations can only survive within the framework of societal norms and values. Based on legitimacy theory, the social and environmental disclosures are a means used by the company to influence the public policy process (Aburaya, 2012).

## 6 Integrated Reporting (IR)

At present, there is no generally acceptable definition of IR. The International Integrated Reporting Council (IIRC), however, describes integrated reporting as something that “brings together material information about an organisation’s strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates”. The IR model is expected to bring together the diverse but currently disconnected strands of reporting into coherent, integrated whole and demonstrate an organisation’s ability to create value now and in the future (Okwuosa, 2015). The focus of IR is to demonstrate the stewardship responsibility of corporate leadership to all categories of “capital employed”. Integrated reporting is a blend of two essential backgrounds of corporate disclosures, specifically, financial reporting and sustainability reporting. With financial reporting the firm serves as a connection of the relationship amongst direct stakeholders whose primary responsibilities include the maximization of shareholders’ wealth. While sustainability reporting broaden the concept of IR, it is premised on the notion that the firm is a community of interdependent stakeholders bound together through a value creation process, with a commitment to long-term equitable value creation (Tijani, Gboyega, & Kayode, 2013).

The main objective of IR can therefore be said to be the convergence of reporting architecture that builds upon the assimilation of knowledge, issues and metrics which derives from the enthusiasm of the society and economic dynamics. It becomes imperative that in order to achieve this objective, financial reporting and sustainability reporting must be integrated. Deriving from this, IR will affect all stakeholders in the following ways:

(1) IR will reflect and communicate the full value creation process within the organization
(2) IR will integrate all capitals along organisation’s full value chain.

(3) IR will offer principle- based approach for greater focus on unique factors in clear understandable language.
(4) IR will provide greater transparency covering broader range of issues disclosing the positive with the negative and helping to build superior trust.
(5) IR is future oriented, responsive, concise, reliable and thus will promote consolidation of reporting practices (Umoren, Udo, & George, 2015).

## 7 Drivers of IR

Integrated reporting is, in fact, an outgrowth of the view that today's corporate reporting will not meet the evolving information needs of stakeholders in the global capital markets. This view is buttressed by the following facts:

(1) There have been major changes in the way business is conducted, how business creates value and the context in which they operate.
(2) These changes are interdependent and reflect trends in globalization, heightened expectations of corporate transparency and accountability, resource scarcity and environmental concerns among others.
(3) Some stakeholders are asking companies to provide clear information about emerging external drivers(e.g. political, social and environmental ) affecting their businesses, their approach to governance and managing risk and how their business models work.

Thus there is a growing demand for a broader information set (Neiland, 2013).

In the alternative, the forces that drive IR can be classified into three broad classes. The first is regulatory force. This refers to the various laws, legislation, government policies and rules formulated to drive the preparation of integrated reports. IR has become a reporting requirement in France and South Africa. The second force is market force as shareholders, employees, customers, government, potential investors and other stakeholders are being increasingly interested in how a company creates value and how this can be sustained in the future. The third driving force is the institutionalization of a body, The International Integrated Reporting Committee (IIRC) directly responsible for promoting, coordinating and collaborating with other organizations to develop Integrated Reporting (Babajide, Imoleayo, & Uwalomwa, 2015).

## 8 The Integrated Reporting Framework

In 2013, the Integrated Reporting Council (IIRC) released a framework for integrated reporting. This was after a 3-month global consultations and trials in 25 countries. The framework establishes principles and concepts that govern the overall content of an integrated report (ACCA, 2015). An integrated report should

make the allocation of capital more efficient and productive through improvements in the quality of information available to providers of financial capital; identify and communicate the full range of financial and non-financial factors that materially affect the ability of an organization to create value over the short, medium and long-term; recognise the importance of a broad range of capitals (financial, manufactured, intellectual, human, social and relationship and natural) to a thorough understanding of the organisation's business model; and focus on the core concept of the business model to support integrated thinking and decision-making with a view to sustainable value creation (CGMA, 2014).

The following are supposed to be depicted in an integrated report:

(1) Organizational Overview and External Environment: What does the organization do and what are the circumstances under which it operates?
(2) Governance: How does the organization's governance structure support its ability to create value in the short, medium and long term?
(3) Business Model**:** What is the organization's business model?
(4) Risks and Opportunities**:** What are the specific risks and opportunities that affect the organization's ability to create value over the short, medium and long term, and how is the organization dealing with them?
(5) Strategy and Resource Allocation: Where does the organization want to go and how does it intend to get there?
(6) Performance: To what extent has the organization achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?
(7) Outlook: What challenges and uncertainties is the organization likely to encounter in pursuing its strategy, and what are the potential implications for its business model and future performance?
(8) Basis of presentation: How does the organization determine what matters to include in the integrated report and how are such matters quantified or evaluated (Lipunga, 2015)

The IR framework is principle based and the following principles guide the preparation of IR:

(1) Strategic focus and future orientation: An integrated report should provide insight into the organization's strategy, and how it relates to the organization's ability to create value in the short, medium and long term, and to its use of and effects on the capitals
(2) Connectivity of information: An integrated report should show a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organization's ability to create value over time.
(3) Stakeholder relationships: An integrated report should provide insight into the nature and quality of the organization's relationships with its key stakeholders including how and to what extent the organization understands, takes into account and responds to their legitimate needs and interests

(4) Materiality: An integrated report should disclose information about matters that substantively affect the organization's ability to create value over the short, medium and long term
(5) Conciseness: An integrated report should be concise.
(6) Reliability and completeness: An integrated report should include all material matters, both positive and negative, in a balanced way and without material error
(7) Consistency and comparability: The information in an integrated report should be presented: (a) on a basis that is consistent over time; and (b) in a way that enables comparison with other organizations to the extent it is material to the organization 'sown ability to create value over time (IIRC, 2013).

## 9 Benefits of Integrated Reporting

A lot of benefits have been claimed for IR from the perception of various stakeholders. According to the Chartered Association of Certified Accountants such benefits include:

(a) It benefits all stakeholders interested in a company's ability to create value Such stakeholders include employees, customers, suppliers, business partners, local communities, legislators, regulators and policy makers.
(b) Providers of financial capital can have a significant effect on the capital allocation.
(c) Makes up for the weakness of historic financial report which though useful for compliance purpose may not provide meaningful information regarding business value.
(d) It obviates the need for users to consult company's forecast and projections as in formation provided has a forward looking focus.
(e) Many companies have come to realize the benefits of showing a fuller picture of their performance and a more holistic view of their organization.
(f) Unwittingly it is creating the next generation of annual reports as it enables stakeholders to make a more informed assessment of the organization and its prospects
(g) The principled nature of the report gives organisations' the free hand to set out their reports rather than be subjected to a check list approach.
(h) It gives a base to explain what creates the underlying value in the business and gives an insight into how management takes care of this value
(i) The report is not mutually exclusive as other reports may still be produced by as deemed fit by the company.
(j) It throws light into the company's resources and relationships known as capitals and the link between the capitals and external environment in creating value.
(k) Additionally the resulting framework will be attractive to companies who wish to develop their narrative reporting around the business model to explain how the business has been developed.

(l) Also the framework is a good tool for companies trying to shift their focus from annual financial performance to long-term shareholder value creation (ACCA, 2015).

## 9.1 *Triple Bottom Line (TBL) or Sustainability Reporting (SR): The Nigerian Experience*

Triple Bottom Line is used interchangeably with sustainability reporting (SR) and Corporate Social Responsibility (CSR) (Abd-Mutalib, Jamil, & Wan-Hussin, 2014).

TBL was coined by John Elkington in 1994 and was designed to alert the business minded of the necessity to factor in non-market valuations (i.e. integrate natural capital to the business models). According to Elkington, there were seven areas that needed significant paradigm shifts to accomplish greater environ and social awareness, which included markets, values, access to information (transparency), life cycle technology, partnerships (public/private, corporate/non-profit), time scale of decisions and corporate governance (Haruna, 2012). The global reporting index (GRI) emphasizes two major economic indicators namely: flow of capital among different stakeholders and main economic impacts of the organization throughout society. It is therefore vitally important that apart from the financial accounts, the organization must also report its contribution to the larger economic system through direct/indirect value created and distributed.

The social performance indicators of the GRI guidelines (2002) are structured as follows:

(1) Labour practices and decent work (employment, labour/management relations, health and safety, training and education, diversity and opportunity)
(2) Human rights strategy and management, non-discrimination, freedom of association and collective bargaining, child labour, disciplinary practices, security practices and indigenous rights)
(3) Society (Community, bribery and corruption, political contributions, competition and pricing)
(4) Product responsibility (customers' health and safety, products and services, advertising and respect for privacy (GRI, 2002)

The GRI remains the most widely used voluntary reporting framework and in the absence of regulatory requirements plays an important role in improving consistency in sustainability reporting and the quality of disclosure (KPMG, 2013). It should be noted that the basic G2 framework has since given rise to G3 and now G4 guideline. G4 urges businesses to disclose grey areas in any category of their businesses in a financial year coded as DMA (Disclosure on Management Approach). In the G4 reporting standard information there are 44 aspects including procurement practices in the economic category, equal remuneration for women

and men in the labour category, and two aspects: screening and assessment and remediation in four categories (Environment, labour, Human Rights and Society). Nigeria's performance in respect of the guidelines has been described as dismal at only two percent compared to about ninety eight percent for South Africa, (Ademigbuji, 2014).

Nigerian Accountants are reported to be negative on the level of rigour and transparency that currently goes into the preparation of TBL reports in Nigeria. Consequently, Nigerian investors do not rely on such reports for investment decision-making. Nigerian customers also do not regard such reports as indicative of an organisation's impact on society (Ogbodo, 2015). However, some Nigerian stakeholders are upbeat that right implementation of TBL in organisations will have a salutary effect on sustainability reporting in the country, (Onyali, 2014).

## 10 Current State of Sustainability Reporting in Nigeria: A Literature Search

A critical issue that has aggressively confronted today's business in Nigeria is that of sustainability as stakeholders are becoming more demanding. Environmental degradation in the Niger- Delta region of Nigeria has resulted in youth unrest in the region. This has added to the strident calls for sustainability reporting in Nigeria. However, sustainability disclosure in Nigeria is still voluntary. The Financial Reporting Council (FRC) of Nigeria is yet to come up with a standard or recommendation on sustainability reporting. The United States of America has such a standard (SASB) (Oba & Ibikunle, 2013). In terms of sustainability reporting in Nigerian banks, a 2012 survey of 12 publicly quoted Nigerian banks using content analysis revealed that Nigerian Banks were involved mostly in the social aspect of sustainability reporting and that firm characteristics like size and profitability did not affect the disclosure practices of such banks (Michael & Oluseye, 2014). A similar study in the Oil and Gas sector of the Nigerian economy revealed that the major oil and gas companies sampled had arbitrary and incompatible sustainability reporting indicators (Asaolu, Agboola, Ayoola, & Salawu, 2011). In a related development, a study by Nzewi, Nzewi, and Okereoti (2013) examined the social reporting practices of 30 companies randomly selected from 237 non-bank companies quoted in the Nigerian stock exchange in 2013. Findings from this study show that the reporting emphasis of the companies is on social intervention in education, employee development, welfare, health and sports development; none of the sampled companies disclosed its means of assessing its social contributions (an indication of the rudimentary stage of social responsibility accounting among Nigerian companies); and there were significant differences in accounting and reporting of social activities among the companies.

Yet another study investigated the report of companies listed in the Nigerian Stock Exchange over a 2 year period-2013–2014. The overall disclosure score of

the companies was found to be 53%; Environmental disclosure was a paltry 7%; Social disclosure score was 66%; and Governance score was 81% (Umoren et al., 2015). The findings on high governance score is corroborated by some other Nigerian studies for example (Society for corporate Governance, 2012).

## 11 Empirical Study on State of Corporate Governance in Nigeria

Our literature search showed that there is indeed no single Nigerian company that has reported under the IIRC framework (Tijani et al., 2013; Umoren et al., 2015). Our empirical study in the course of this work also corroborated this fact. We therefore shifted our empirical study to the present state of sustainability reporting in Nigeria.

Content analysis was conducted on 49 Nigerian companies listed on the Nigeria Stock Exchange out of 185 companies listed. The 49 companies used in this study consists 15 companies in the consumer sector, 16 in financial sector, 8 in the industrial sector, 2 in the health sector, 3 in basic material sector and 5 in the oil and gas sector. In this study not less than 18% of the companies quoted under each sector were sampled for this study and the sampling also depends on the online availability of detailed published financial statement.

Annual reports of these 49 companies were duly analysed to ascertain the extent to which these companies give sustainability reports of their activities. ISO 26000 core social responsibility subjects were the core ingredients that were analysed by this study. There are seven core subjects identified by ISO 26000, they include organisational governance, human rights, labour practices, environment, fair operating practices, consumer issues and community involvement and development.

Under the human right, the study tried to ascertain the extent to which companies report human right risk situations, due diligence, ways of resolving grievances, discriminative and vulnerable groups, civil and political rights, economic, social and cultural rights, fundamental principles and rights at work. Labour practices revealed reporting of employment and employment relationships, conditions of work and social protection, social dialogue, health and safety at work, human development and training in the place of work. Environment involves reports on how the companies prevent pollution, sustain resource use, protect the environment, biodiversity and restoration of natural habitats; It also involves reporting on climate change mitigation and adaptation. Fair operating practices involve reports on anti-corruption practices, responsible political involvement, respect for property rights and promoting social responsibilities in the value chain. Consumer issues involve reports on fair marketing, factual and unbiased information and fair contractual practices, protecting consumers' health and safety, sustainable consumption, consumer service, support, complaint and dispute resolution, consumer data protection and privacy, access to essential services, education and awareness. Finally among

**Table 1** Elements of sustainability reports (SR)

| | Elements of SR disclosed in the annual statement | No of companies | Average % reports |
|---|---|---|---|
| 1 | Organisational governance | 49 (100%) | 100% |
| 2 | Human rights: | | 11.48% |
| A | Due diligence | 13 (26.55%) | |
| B | Human right risk situations | 3 (6.12%) | |
| C | Avoidance of complicity | 1 (2.04%) | |
| D | Resolving grievances | 2 (4.08%) | |
| F | Discriminative and vulnerable groups | 21 (42.86%) | |
| G | Civil and political rights | 3 (6.12%) | |
| H | Economic, social and cultural rights | 1 (2.04%) | |
| I | Fundamental principles and right at work | 1 (2.04%) | |
| 3 | Labour practices | | 65.71% |
| A | Employment and employment relationships | 45 (91.84%) | |
| B | Conditions of work and social protection | 32 (65.31%) | |
| C | Social dialogue | 0 (0%) | |
| D | Health and safety at work | 42 (85.71%) | |
| E | Human development and training in the work place | 42 (85.71%) | |
| 4 | Environment | | 21.43% |
| A | Prevention of pollution | 12 (24.49%) | |
| B | Sustainable resource use | 14 (28.57%) | |
| C | Climate change mitigation and adaptation | 3 (6.12%) | |
| D | Protection of the environment, biodiversity and restoration of natural habitats | 13 (26.53%) | |
| 5 | Fair operating practices | | 5.71% |
| A | Anti corruption | 5 (10.20%) | |
| B | Responsible political involvement | 4 (8.16%) | |
| C | Fair competition | 0 (0%) | |
| D | Promoting social responsibility in the value chain | 5 (10.20%) | |
| E | Respect for property rights | 0 (0%) | |
| 6 | Consumer issues | | 9.33% |
| A | Fair marketing , factual and unbiased information and fair contractual services | 7 (14.29%) | |
| B | Protecting consumers health and safety | 8 (16.33%) | |
| C | Sustainable consumption | 5 (10.20%) | |
| D | Consumer service, support and complaint and dispute resolution | 8 (16.33%) | |
| E | Consumer data protection and privacy | 0 (0%) | |
| F | Access to essential services | 3 (6.12%) | |
| G | Education and awareness | 1 (2.04%) | |
| 7 | Community involvement and development | | 45.48% |
| A | Community involvement | 37 (75.5%) | |
| B | Education and culture | 19 (38.78%) | |
| C | Employment creation and skills | 8 (16.33%) | |

(continued)

**Table 1** (continued)

| | Elements of SR disclosed in the annual statement | No of companies | Average % reports |
|---|---|---|---|
| D | Technology development and access | 11 (22.45%) | |
| E | Wealth and income creation | 8 (16.33%) | |
| F | Health | 38 (77.55%) | |
| G | Social investment | 35 (71.43%) | |

Source: Compilation from Content Analysis of 49 companies (2016)

the core subjects is report on community involvement and development which includes a company's contribution towards the existing community's education and culture; technology development; wealth and income creation; social investment; health and how the entire welfare of the hosting community is always being considered by companies.

Data obtained from the published accounts were analysed using percentages.

Table 1 shows the different areas of sustainability reports and the extent of their disclosure in the annual statement of the 49 companies under review. The content analysis shows that every company under review discloses its organisational structure, strategies and maps by which organisations create sustainable values over time.

Only an average of 11.48% of the sampled financial statements disclosed attributes of human rights in the organisations. Discriminative and vulnerable groups were the most reported among other human right attributes, about 42.88% of the sampled firms reported on it.

An average of 65.71% of companies under review disclosed Labour practices attributes, with employment and employment relationships ranking highest among the other attributes, about 91.84% reported on that. 85.71% reported on both health and safety situations and human development and training at place of work.

An average of 21.43% of the companies reported different attributes of environmental management and protection. Sustainable resource use was the most reported attributes of environmental management with only 28.57% of the companies reporting on that.

Fair operating practices and consumer issues were scarcely disclosed in the financial statements only averages of about 5.71% and 9.33% of the companies reported on them respectively.

45.48% of the companies reported on their community involvement and development with community health as the most disclosed attribute, by 77.55% of the companies; followed by community involvement and social investment disclosed by about 75.5% and 71.43% of the companies respectively.

These SR attributes were not disclosed in the annual reports under a sole subheading but were disclosed under human resources, director's report, chairman's report, employee health and safety and corporate social responsibility.

Findings

(1) Majority of the companies disclose their organisational structure and governance.
(2) The most reported subject of SR among companies apart from organisational governance is the labour practice with employment and employment relationships, health and safety at work and employees development and training as the most reported attributes
(3) Another core subject with attraction is Community involvement and development.
(4) Our findings corroborate our review of literature that IR is yet to be practiced in Nigeria and that sustainability reporting still leaves much to be desired. However, sustainability reporting, though still on the low side, appear to have improved in terms of reporting environmental issues
(5) Environmental disclosure attracted the least attention. Governance issues had the highest disclosure followed by social issues.
(6) Disclosure reporting practices were not stream lined in terms of where they were reported in the annual reports.

## 12 Challenges of Integrated Reporting in Nigeria

Many challenges face the entrenchment of integrated reporting in Nigeria. As our empirical study and literature search have shown no single company, to the best of our knowledge, has reported under the IR framework. Many Nigerian companies are reporting under the GRI sustainability reporting framework. However, only few of such companies have advanced to G4 reporting mode. A situation where there is lack of uniformity in sustainability reporting will not augur well for full blown integrated reporting in Nigeria.

There is also the issue of the readiness of Nigerian regulatory authorities to drive the change process to full blown integrated reporting in Nigeria. For example, the Nigerian regulatory authorities including the Nigerian Accounting profession and the Financial Reporting Council(FRC) have been urged to institute and drive IR in Nigeria (Umoren et al., 2015). The readiness of the Accounting profession in Nigeria to drive the numbers needed for IR has also come into scrutiny. The following roles, amongst others, have been prescribed for Nigerian Accountants desiring to drive integrated reporting:

(1) Internalization of other cost other than financial in core financial statements.
(2) Incorporating sustainability in strategic decision- making by agreeing on the required discounting rate of return
(3) Play a leading role on environmental audit and management through standardized assurance engagement and
(4) Standardization of IR practices (Haruna, 2012).

Perhaps the greatest challenge to the development of IR in Nigeria is the fact that there is no regulatory compulsion for companies in Nigeria to report under the IR

framework. This is in contrast to South Africa, for example, where the King's report makes it mandatory for South African Companies to report under IR framework (Umoren et al., 2015). There is also the issue of Nigerian tertiary institutions upgrading their curricula to reflect the current thinking in integrated reporting and ensure a pool of future accountants that will sustain the IR drive (Babajide et al., 2015). Attitudes, subjective norms and perceived control have been found to have effect on early intention of Nigerian companies to adopt IR (Tijani & Ogundeji, 2014). Lack of awareness among some stakeholders on the benefits of IR is also a factor that has delayed the early enthronement of IR in Nigeria. The Nigerian CAMA' 1990 as amended did not envisage IR and so did not make provisions for its introduction. The Nigerian Corporate governance codes were elaborate on governance issues but thin on environmental and social issues. Thus the legal infrastructure for IR development in Nigeria is deficient.

## 13 The Future of Integrated Reporting in Nigeria

Although no Nigerian company, to the best of our knowledge, has so far reported under the full integrated reporting framework, the prospects for future compliance by Nigerian companies are enormous. For one legislation in Nigeria is fast moving to the mandatory lane. This means that the prospect of IR being made mandatory in the near future is bright indeed. The Financial Reporting Council of Nigeria, for example, is already pushing for a unified mandatory code of corporate governance for all listed companies in the Nigerian stock exchange (Financial Reporting Council, 2015). There is the issue of competition among companies. The desire to have competitive edge over rivals is a factor that will drive Nigerian companies to early adoption of IR. Our literature search, for example, revealed that Etisalat (NIG) is already reporting for sustainability using the G4 index. The company is thus well ahead of its peers in this regard. Some civil society groups are beginning to get interested in good corporate governance in Nigeria. The Nigerian society for corporate governance is a non-profit making organization comprising individual and corporate members and committed to good corporate governance and best practices. Such pressure groups enhance the chances that regulators will eventually listen to the calls to mandate Integrated Reporting in Nigeria. In July 2015, the Nigerian Stock Exchange issued a sustainability roadmap. The highlights are as follows:

(1) Comprehensive sustainability reporting for listed companies
(2) Offering sustainability guidance and training
(3) High level engagement process with listed companies, investors and capital market community.
(4) Introduction of sustainability disclosure guidelines.
(5) Capacity building for relevant stakeholders including listed companies and market operators.

(6) Create awareness of sustainability at the highest levels of the industry.
(7) Synthesise current thinking on sustainability opportunities and challenges in Nigeria.
(8) Initiate discussion on a set of environmental, social and governance (ESG) guidelines for the Nigerian Capital market (Onyema, 2015).

The Nigerian Stock Exchange is a self- regulatory organization for market participants in the exchange.

The force of globalization is also driving adoption of global standards. In 2012, Nigeria joined the comity of Nations that report under International Financial Reporting Standards (IFRS) and International Public Sector Accounting Standards (IPSAS). The challenges of IFRS and IPSAS implementation were enormous but were largely overcome. This gives optimism that the Nigerian business community and other stakeholders will in the same vein overcome the challenges posed by the transition to IR.

## 14 Conclusion

Integrated reporting is non-existent in Nigeria. Sustainability reporting is also at low ebb although the empirical review suggests improvement compared to the not too distant past. The literature search and empirical survey confirm this assertion. Many reasons have been adduced for this unsatisfactory state of affairs. One reason is that Nigerian businesses are more concerned with immediate profitability without regard to socio-environmental consequences. Another reason is that IR is not mandatory in Nigeria. This is in contrast to South Africa that mandates IR adoption. The challenges of IR adoption in Nigeria include lack of awareness by captains of industry on the long term benefits of such a reporting framework to their organisations. There is also the need to beef up the accounting and other skills required to scale up to IR reporting in Nigeria. In particular the measurement issues and the resulting need for the assurance of the reports must be squarely addressed. On the flip side, the recent regulatory actions or pronouncements by both FRC and NSE point to an awakening that IR in Nigeria must be driven by regulation. The forces of globalization and competition have added impetus for change to IR framework. Our prognosis is that Nigerian regulators are set, in the near future, to come out with principle based guidelines that will herald the true practice of IR in Nigeria.

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# Ownership and Liability Decision

**Rute Abreu, Liliane Cristina Segura, Marco Milani, and Fátima David**

## 1 Introduction

The role played by families in management of firms has been studied extensively in various areas of business management (Boubakari & Feudjo, 2010; Dedoussis & Papadaki, 2010; Filatotchev, Lien, & Piess, 2005; McConaughy, 1994; Mosebach, 2007). Many of these researches have been conducted on small and medium firms, since they are, for the most part, private firms with family control (Landstrom & Winberg, 2000; Leavell and Maniam, 2009). Recognition of the rights of family shareholders and the duty of a business to be accountable in this wider context therefore has been largely a relatively recent phenomenon. Deegan (2002) presents an overview of the research trends and opportunities in the area of social and environmental accounting research.

In other studies, the family and managers that are family members have been getting the highlight. In U.S.A., Anderson and Reeb (2003) states that 35% of the 500 largest firms had some form of family influence them. In Brazil, Oro, Beuren, & Hein (2008) found that 253 firms among the top 500, according to *Exame Magazine* in 2005, had the characteristic totally Brazilian shareholder, and from these, 20%, approximately, operated under family interference. Unlike the theory on separation of ownership and control, the authors find an extensive list of firms that have the family control through the Board or the Board of Directors. Among these studies,

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Sirmon, Arregle, Hitt, and Webb (2008) and Zaha, Hayton, Dibrell, and Craig (2008) can be named for their studies of the role played by the family in the strategic decisions of the firm and the family culture on business decisions. Hadani (2007) studied the role of the family and their involvement in enterprise policy, as well as, theories of corporate governance.

Indeed, other studies showed that family business members, almost always, concentrate their wealth in one or a few firms (Agarwal & Nagarajan, 1990; Anderson & Reeb, 2004; Gómez-Mejía, Haynes, Núñes-Nickel, Jacobson, & Moyano-Fuentes, 2007). For example, the pulverized capital, implicit or explicit, in the theoretical framework (Soares & Kloeckner, 2008) is not the dominant form of ownership structure in Brazil (LaPorta, Lopez-de-Silanes, & Shleifer, 1999). The concentration of ownership justifies the need to maintain investment in the firm by owners, regardless of its potential to generate profits or of market growth.

The most part of the studies founded in the literature pointing out to the uniqueness of management in family firms. Landstrom and Winberg (2000) and Gómez-Mejía et al. (2007) attributed the fact of the business owner's keeping the investment to their concern with the loss of control of the business (profile of shareholder and controller). Oro et al. (2008) studied the relationship between capital structure and operating profit seen in several generations of family businesses in Brazil. In these studies they found differences between profitability and capital structure due to several generations of the family owned running businesses. Also, family involvement could be on a continuum due to different degrees of family concentration within family firm (Astrachan & Skanker, 2003; Zaha, 2003). Another example, Segura (2012) showed that there is a significant difference in the indebtedness in Brazilian Public Firms that they were managed by families; Puerto (2010) showed the same, but regard to the value of the firm; and Gómez-Mejía et al. (2007) indicated the socioemotional-wealth.

Since literature is not unanimous about these hypotheses, this research contributes to the identification of the decision on capital. Aiming to the proposed objective, the research was design with a positivist perspective and five-year (2005–2009) period was used to evaluate the trend of capital structure of each firm listed by *Bovespa Stock Exchange* (São Paulo, Brazil). In order to contribute to the accounting literature, as well as, the family firms' research, the authors aim to explore the effect of family ownership on the liability decision.

This research will help managers, which appropriately apply Benford law-based analysis, to identify the effect of family and nonfamily owned firms' with current and noncurrent liability decision, such as:

Hypothesis 1: *effect of family ownership increase current liability decision*
Hypothesis 2: *effect of nonfamily ownership increase current liability decision*
Hypothesis 3: *effect of family ownership increase noncurrent liability decision*
Hypothesis 4: *effect of nonfamily ownership increase noncurrent liability decision*

The remainder of this paper is organized as follows. The second section will make the theoretical development that explores the link between the effect of ownership and liability decision. The third section details from the liability decision

to the digit analysis as the methodology to do the longitudinal exploratory analysis. The fourth section will be dedicated to present the exploratory results from the digit analysis. Finally, the last section summarizes from the exploratory results to the main conclusions that it contributes to the debate of effect of family and non-family owned firms' engagement to current and noncurrent liability decision (Abreu, Segura, Milani, & David, 2014).

## 2 From the Effect of Ownership to Liability Decision

The study of the effect of ownership to liability decision is based on the literature review. In general, Fiegener (2010) and, in particular, Thomsen and Pedersen (1997), because family firms were owned by a family with: (a) two or more members of the same family owners of common shares of the firm, or (b) by holding, or (c) for possessing two or more members in positions of Chief of Executive Office (CEO), Chief Financial Officer (CFO) and Chairman of the Board of Administration (CBA). Family management is a firm whose members of the same family were in positions of CEO, CFO or CBA, regardless of the number of shares belonging to this family. Finally, family control is a firm which there is two or more shareholders that are members of the same family and the sum of the shares of these members are bigger than 50% of total shares. In this category, there is no need for a family member in the management of the firm.

Also, Longenecker et al. (2007: 82) details that family owned business is one in which two or more members of the same family own or manage together or in succession. The firm is recognized as belonging to the family, because it is transmitted from one generation to another. Oro et al. (2008: 3) did a literature review on the main family business classifications and concluded that two characteristics are essential, such as: family's majority stake in the firm and family members in business management. It is now 30 years since Dahl (1972: 18) stated that:

> . . . every large corporation should be thought of as a social enterprise; that is an entity whose existence and decisions can be justified insofar as they serve public or social purposes.

This social accounting aspect of this research, which obviously does not exhaust possible discussions, concerns the effect of the liability decision and the performance due to family and nonfamily ownership of the firm. If, on the one hand, some authors say there is no relationship between level of liability and family control. On the other hand, the literature advocates that the relationship between can consider three points of view: (a) there is a positive effect; (b) there is a negative effect; (c) there is no effect.

Another definition that deserves attention in the literature is the capital structure decisions. Thereafter, Modigliani and Miller (1963) show under what conditions capital structure is irrelevant to the firm. The authors state that there is no optimal

capital structure that increases the firm's value for shareholders in perfect and complete conditions of markets. The study has opened doors for many others, such as Stiglitz (1968) and Myers (1984), who demonstrate that, if some of the restrictions imposed by Modigliani and Miller (1958) are removed, there might be dependence between the increased value of the firm and its capital structure (Modigliani & Miller, 1963).

However, according to Kayo and Famá (1997) they were not conclusive. Along this line, Junaid-ul-haq, Nasir, and Wasimullah (2011) say it is still unclear how, exactly, firms choose their level of indebtedness. Harris and Raviv (1991) presented a study highlighting the Agency Theory, which examines the conflict between separation of ownership and management, treated by Fama and Miller (1972) followed by Jensen and Meckling (1976). In view of the importance of agency's costs—costs that exist because of the conflict between managers and owners—other studies have emerged, such as Stulz (1990), which deals with conflicts between managers and owners; Diamond (1989) and Hirshleifer and Thakor (1993) that examine the conflicts between owners and creditors. These conflicts reflect a number of changes in capital structure, as well as, in the assessment of the firm by its shareholders.

From these works, the authors emphasize the fact that the capital structure might modify the value of the firm, as well as, its financial performance (Jensen, 1986). Thus, it is understood that those who are responsible for decisions regarding capital structure, the managers, influence incisively the way such structure will be constituted. Studies of family businesses have various fields such as: strategy (Sirmon & Hitt, 2003; Sirmon et al., 2008), conflict management (Bornholdt, 2005), organizational behavior and culture (Berson et al., 2005; Kotey & Meredith, 1997), financial and operational decisions (Anderson & Reeb, 2003, 2004; Bertucci, Campos, Pimentel, & Pereira, 2009; Oro et al., 2008). Equally diverse is the classification of what constitutes family business category, which varies according to several authors. Fiegener (2010), for example, notes that the distinction between family-owned and family-run management of the founder does not exist, since they are often used as synonyms for family owned businesses. He warns that many authors even use the classification of family business as that of family involvement in business. Due to these inaccuracies, he claims that many conclusions of existing studies ultimately do not bring the appropriate contribution.

Anderson and Reeb (2003) use the active control and passive control classification for family owned business. On the one hand, active control occurs when a family allocates one of its members in the position of Chief Executive Officer (CEO), resulting in a stronger control of its interests (Barros, 2005; Malmendier & Tate, 2008; Thaler & Barberis, 2003). Passive control, on the other hand, would be just the shareholder of the firm, without exercising power of manager. Rossato Neto & Cavedon (2004: 2) state that there is no exact classification of family owned business. The authors researched the topic and say there are some common features to the disclosed concepts, such as: presence of a second generation in the family business and the involvement of family members in the ownership and/or direction of the business.

**Table 1** Literature review of family ownership and liability decision

| Research | Sample | Results of debt in the family business |
|---|---|---|
| Anderson and Reeb (2003) | Firms | There is no relation |
| Schulze and Dino (2004) | Family firms | Minor |
| López-Garcia and Sánchez-Andújar (2007) | Spanish small firms | Minor |
| Pindado and La Torre (2008) | Spanish familiar small firms | Minor |
| King and Santor (2008) | family and non-family firms | Major |
| Al-Ajmi et al. (2009) | Saudi firms | Minor |
| Leavell and Maniam (2009) | Small firms in Texas | Major |
| Boubakari and Feudjo (2010) | African firms | Minor |
| Andres (2011) | German firms | Major |
| Scarpin et al. (2012) | Brazilian firms | There is no relation |

One line of researchers receive prominence for their research in this direction were Schulze and Dino (2004) who identified in a sample with 1000 observations that family firms tend to have lower leverage. López-Garcia and Sánchez-Andújar (2007) argue that there are differences between the financial decisions of family and non-family firms. They found lower levels of liabilities in firms run by family members than in non-family firms.

Pindado and La Torre (2008) found that managers of family businesses are more averse to risk than those of non-family owned firms. Thereby, the level of debt tends to be lower in family owned firms than in non-family owned firms. Al-Ajmi, Hussain, and Al-Saleh (2009) found in a sample of 53 Saudi Firms, that the capital structure is positively influenced by concentrated ownership of banks and pension funds, but negatively related to family property. Firth (1995) founds high levels of debt in capital firms focused, showing no difference between family business with a concentration of capital and venture capital firms concentrate.

Boubakari and Feudjo (2010) point to the fact that when the manager is a family member or controlling shareholder, the firm tends to avoid debt, a negative relationship between debt and household manager, showing the contribution of the manager beyond the familiar family property. These researches corroborate the latest research of Lee (2011), which identifies low level of leverage in firms that are subsidiaries of family businesses. Opposed to the research described above, other researchers show a positive relationship between level of debt and control and family management. Andres (2011) studied a sample of 264 German Firms and found that family owned firms are more leveraged, resisting to seek financing through the issuance of shares. King and Santor (2008) found greater leverage in Canadian family owned firms, based on an evaluation of 613 family and nonfamily firms. Leavell and Maniam (2009) show that in small businesses in Texas, the owners prefer to increase the liability level to finance their operations, rather than use the equity, thereby increasing the leverage of companies. Table 1 demonstrates

the literature review that has identified the influence of family, family control manager and the founder of the firm in liability decision.

Anderson and Reeb (2003) examined 319 firms, over a period of 6 years and they found no difference between the levels of family or nonfamily corporate debt. Likewise, in Brazil, the study of Scarpin, Almeida, and Machado (2012), with companies listed on the BM & FBovespa, indicate that there is no relationship between family management and debt. There are studies that found a conservative influence of the manager member of a founding family, in relation to its capital structure (Demsetz, 1983; Fama & Jensen, 1983; Shleifer & Vishny, 1997). In this sense, Lee (2011) studied families' subsidiaries and his findings show that they are less indebted. He says the FB seeks greater domestic borrowing in order not to issue capital. Other studies point to the fact that the persistence of the founding family in firm decisions tends to increase the debt and, in many cases, the risk of the company (Anderson & Reeb, 2004; Fiegenbaum & Thomas, 1988). Also, Colot and Croquet (2005) and Boubakari and Feudjo (2010), found that family owned firms are more indebted.

LaPorta et al. (1999) in joint-stock companies in Europe, Latin America, United States and other countries, whose control was exercised by the founding families, concluded there is little empirical evidence on patterns of decision of the owners of large firms. In this study, the authors sought to understand the relationship between ownership and control, unlike the approach of Berle and Means (1932), whose work found total separation of ownership and control in publicly traded companies. LaPorta et al. (1999) show that, at the current stage of the market, many companies still have control related to the founding family. However, LaPorta et al. (1999) did not include Brazilian companies. According Oro et al. (2008), a total of approximately 550 firms listed on the BM&FBovespa, 253 Brazilian firms' controlling interest, and of these, 20% are in the hands of families.

In sum, the theoretical development of this paper allows to understand the link between capital structure decisions under the influence of management and family control and those with professional management. Moreover, Solomons (1974) considered the reasons for measuring objectively the social performance of a business, suggesting that while one reason was to aid rational decision-making, another reason is of a defensive nature. Despite, all the development, the authors are true concern, based on academic research, about the influence of liability decisions.

### *2.1 From Liability Decision to Digit Analysis*

According to the fundamentals established by Popper (1975), the research methodology is hypothetical-deductive. It is characterized by the establishment of hypotheses to be tested through empirical research, namely, the observation of reality. The data used to test the hypotheses was the digital analysis by Benford Law (Maher & Akers, 2002; Wiseman, 2011).

Benford Law, known as Law of Anomalous Numbers or Law of Significant Digits or Newcomb-Benford Law, is a logarithmic distribution useful for detecting abnormal patterns in sets of numbers. The innovative paper, written by Newcomb (1881), contributed to the theoretical explanation of Benford (1938) about the first-digit distribution, which is based on the probability of occurrence of a given first digit expressed by the following formula:

$$P(d) = log_{10}\left(1 + \frac{1}{d}\right);\ d \in \{1; 2; 3; 4; 5; 6; 7; 8; 9\} \quad (1)$$

Thus, the probability of occurrence of a specific number in a data set, whose first digit is 1, is equal to 30.12%, considering $Pe(1) = \log_{10}2 = 0.3012$. Similarly, the probability to find numbers whose first digit is 2, is equal to 17.61%, considering $Pe(2) = \log_{10}(3/2) = 0.1761$. So, until $Pe(9) = \log_{10}(10/9) = 0.0458$. Additionally, Hill (1995) provided a robust mathematical basis for this distribution.

An important property of Benford Law, commented by Pinkham (1961), is the scale invariance, since if a data set is multiplied by a constant factor, the new data set obey to the same law. For example, a shift from dollar-denominated data to data denominated in other currencies does not change the first-digit distribution predicted by Benford Law.

Benford Law, on the one hand, is not applicable to all data sets, such as those related to randomly generated numbers whose probability of occurrence of the digits is the same for the entire set. In addition, dates or pre-defined numbers, such as phone numbers, bank account numbers or nonsequential registries, also fail to satisfy Benford Law. On the other hand, in all other cases when the Benford Law is applicable, the lack of conformity between the observed and expected occurrences suggests, in a preliminary way, abnormalities that should be investigated to know whether the cause is related to contextual factors, unintentional or intentional actions.

Hurlimann (2006) pointed out that by the year 2006 there were 305 papers directly related to Benford Law published in scientific journals, and around 90% of these texts were written after 1990. Most of the papers related to the application of Benford Law in forensic accounting and auditing were published, such as Nigrini and Mittermaier (1997), Durtschi, Hillison, and Pacini (2004), Quick and Wolz (2005), Johnson (2009) and Geyer (2010).

For this research, the design defines the parameters of interest, supporting the general objective of it. The authors identified the target population and sample. In this research, the authors used a quantitative approach to analyze the accounting data of two major groups of firms: family and nonfamily owned business firms listed on *Bovespa Stock Exchang*e (São Paulo, Brazil). So, the research population is classified as discrete and finite. The sample was formed by 282 firms separate by: 188 nonfamily and 94 family owned businesses, for the period 2005 to 2009, in a total of 2.820 observations.

The authors used the electronic database provided by entity that manages the market, in order to collect the accounting data and it is related with two variables: Current and Noncurrent liabilities. Also, the percentage of common and preferred shares, names until the 5th largest shareholder and of the Chairman of the Board, Chief Executive Officer, Chief Financial Officer and Directors were collected from annual report (called IAN), which is required by firms that trade shares on the BM & FBovespa. The data on control and management were obtained in DIVEXT—External Disclosure ITR/DFP/IAN of CVM.

The first digit of the accounting data was identified and organized to know the observed frequency of the specific digit *Po(d)*. Subsequently, the *Po(d)* was compared to the expected probability of the same digit *Pe(d)* predicted by the Benford Law, as described previously in the Eq. (1). The null hypothesis *(H0)* proposes that no statistical significance exists between *Po(d)* and *Pe(d)* as shown in the Eq. (2):

$$H_0 : P_o(d) = P_e(d) \tag{2}$$

The authors used the Z-test to determine whether the differences between the actual and expected proportions are significant, in order to verify the appropriateness of accepting or rejecting *H0* with significance level *(α)* equal to 5% and *Z critical* equal to 1.959. The Eq. (3) presents the Z-test *(Zt)*, where *n* represents the number of observations.

$$Z_t = \frac{|P_o(d) - P_e(d)|}{\sqrt{\frac{P_e(d) * \{1 - P_e(d)\}}{n}}} \tag{3}$$

According to Nigrini and Mittermaier (1997), the correction term $\frac{1}{2n}$ is applied in the Eq. (3) when $\frac{1}{2n} < |P_o(d) - P_e(d)|$, as shown in the Eq. (4).

$$Z_t = \frac{|P_o(d) - P_e(d)| - \frac{1}{2n}}{\sqrt{\frac{P_e(d) * \{1 - P_e(d)\}}{n}}} \tag{4}$$

To test the null hypothesis that the frequency distribution *(Do)* observed in the selected sample was consistent with the Benford Law distribution *(De)*. The authors used the Chi-square *(χ2)* statistical test as showed in Eq. (5), with a significance level *(α)* equal to 5%, degree of freedom *(df)* equal to 8, and the critical value or *χ2critical is* equal to 15.507.

$$\chi 2 = \sum_{d=1}^{9} \frac{(D_o - D_e)^2}{D_e} \tag{5}$$

After the appropriate statistical tests, it was possible to verify the conformity of the observed distributions to those expected and to infer about the presence or

absence of bias, by adopting the Benford Law as a proxy for reliability. The peculiarity lies in the detail that what is analyzed is not the absolute magnitude of the numbers, but the pattern of the digits (Benford, 1938).

## 2.2 *From Digit Analysis to Exploratory Results*

The authors present the empirical results as a digital analysis performed by values of Current and Noncurrent Liabilities from the sample (Titman & Wessels, 1988). The results of the statistical tests detect the presence or lack of bias in sets of numbers using the probability distribution predicted by Benford Law. It is noteworthy that any results of non-compliance to Benford Law not necessarily mean that there are cases of fraud or irregularities, which can only be found by an in-depth audit. By one side, the non-compliance data may be a good indicator of attention and it can help to identify relevant factors influencing the liability decision of the firm. By another side, the compliance to Benford Law is not a guarantee that there are no relevant effects influencing the liability decision of the firm in the data sets, but it represents preliminarily a more favorable situation with absence of bias and increasing the degree of reliability of the analyzed data. The law is based on a peculiar observation that first digits appear more frequently than other in data sets (Durtschi et al. 2004: 17).

Figure 1 shows the observed *(Po)* and expected *(Pe)* first-digit frequencies of numbers obtained from the current liabilities of 188 nonfamily businesses for the period 2005–2009. The authors find a reasonable fit of *Po* to the logarithmic curve *Pe*. Figure 2 presents the observed *(Po)* and expected *(Pe)* first-digits frequencies of the values obtained from the current liabilities of 94 family owned business on the same period. Figure 3 shows the observed *(Po)* and expected *(Pe)* first-digit frequencies of numbers obtained of the noncurrent liabilities of 188 nonfamily owned business for the same period. The authors find a reasonable fit of *Po* to the logarithmic curve *Pe*, but the frequency of the digit '8' is higher than expected for



**Fig. 1** First digit distribution of current liabilities on nonfamily owned business, 2005–2009

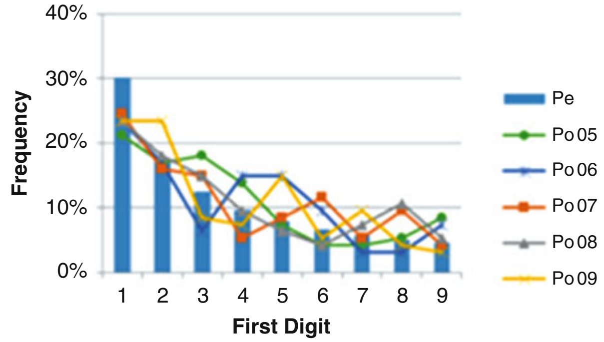


**Fig. 2** First digit distribution of current liabilities on family owned business, 2005–2009

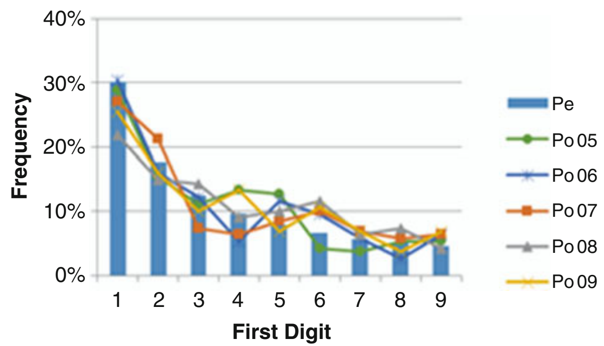


**Fig. 3** First digit distribution of noncurrent liabilities of nonfamily owned business, 2005–2009

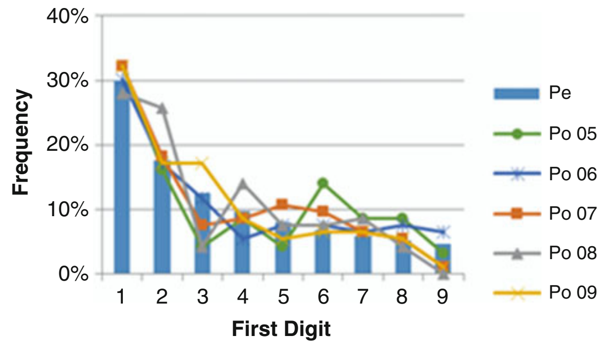


**Fig. 4** First digit distribution of noncurrent liabilities on family owned business, 2005–2009

the biennium. This fact caused a reduction in the frequency of other digits, with emphasis on the digits '5', '6' and '9'. Figure 4 presents the observed *(Po)* and expected *(Pe)* first-digits frequencies of the values of noncurrent liabilities of 94 family owned business for the equal period. In Fig. 4 observes that year of 2009, despite the slight difference for the digits '1' and '2', it is visible the difference found in digits '3', '6' and '9'.

Generally, it is seen that the distribution of observed values does not follow the same distribution predicted by the Benford Law for the analyzed period.

## 2.3 From Exploratory Results to Main Conclusions

Based on Wooldridge (2010), Hair, Anderson, Tatham, and Black (2012) and Greene (2012), Table 2 presents the Z-test results of the current liabilities of 188 nonfamily firms for the period 2005–2009, which verifies if there is a significant difference between the expected *(Pe)* and observed *(Po)* probability of occurrence of a given initial digit *(d)* of the current liabilities on those firms. The null hypothesis *(H0)* shows that there is no significant increase between expected *(Pe)* and observed *(Po)*. After analyzing the frequency of occurrence of *d*, the results indicated that the reference value or *Z critical* is equal to 1.959 and it is higher than *Zt* in all the observations, which allows to accept *H0* and classify the observed data for the period with 'ok' status and this means the absence of bias. Also, Table 2 shows the Chi-square test results, in order to verify whether observed *(Do)* and expected *(De)* data sets have significant differences in the period. The reference value or $\chi 2critical$ is equal to 15,507 and when it is compared to the calculated value $(\chi 2calc)$. Due to $\chi 2critical > \chi 2calc$ in all the 5 years, it is possible to accept the null hypothesis *(Ho)* that there is no significant increase between *Do* and *De*. This result is also expressed in the relation $P\ value > 0.05$. Based on absolute values, the largest difference above the expected frequencies occurred in those numbers initiated by the digit '4' in 2006, but it was not statistically significant for the period. Thus, adopting the digital distribution provided by Benford Law as a proxy for compliance, statistical tests indicated that, preliminarily, there is no bias in the current liabilities data of the nonfamily firms during 2005–2009.

Based on Wooldridge (2010), Hair et al. (2012) and Greene (2012), Table 3 presents the Z-test results of current liabilities of 94 family owned firms for the period 2005–2009. In several observations, the authors may conclude to accept *H0* and classify the observed data for the period with 'ok' status and this means the absence of bias. In 2006 and 2009, the difference between the expected *(Pe)* and observed *(Po)* frequency of first-digit '5' was considered significant. Likewise, the values started in 2008 by the digit '8' also showed a statistically significant difference, as calculated by the Z-test and presented in Table 3 Considering the significance level (α) equal to 5%, the reference value *Zcritical* is equal to 1.959 and lower than *Zt* is equal to 2.123 (years 2006 and 2009) and *Zt* is equal to 1.962 (year 2008). Consequently, an "attention" status was designed to the current liabilities

**Table 2** Z-test and χ2 test of current liabilities on nonfamily owned business, 2005–2009

| | D | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
|---|---|---|---|---|---|---|---|---|---|---|
| Z-test | 2005 | 0.449 | 0.938 | 0.614 | 0.411 | 1.376 | 0.759 | 0.467 | 0.058 | 1.321 |
| | 2006 | 0.015 | 1.311 | 0.029 | 1.849 | −0.064 | 1.043 | 0.467 | 0.379 | 0.036 |
| | 2007 | 0.633 | 0.938 | 1.043 | 0.068 | 1.376 | 1.327 | 0.77 | 0.058 | 0.036 |
| | 2008 | 0.169 | 0.194 | 0.185 | 0.171 | 0.724 | 0.476 | 0.139 | 1.345 | 1.321 |
| | 2009 | 0.478 | 1.311 | 0.244 | 0.411 | 0.589 | 0.375 | 1.074 | 0.586 | 0.036 |
| | 2005 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2006 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2007 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2008 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2009 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| χ2 test | 2005 | 0.255 | 1.042 | 0.6 | 0.382 | 2.473 | 1.015 | 0.559 | 0.137 | 2.631 |
| | 2006 | 0.02 | 1.846 | 0.001 | 3.938 | 0.036 | 1.642 | 0.559 | 0.467 | 0.134 |
| | 2007 | 0.433 | 1.042 | 1.382 | 0.004 | 2.473 | 2.42 | 1.086 | 0.003 | 0.134 |
| | 2008 | 0.073 | 0.119 | 0.14 | 0.152 | 0.896 | 0.538 | 0.185 | 2.635 | 2.631 |
| | 2009 | 0.28 | 1.846 | 0.184 | 0.382 | 0.667 | 0.405 | 1.786 | 0.782 | 0.001 |

initiated by digits '5' and '8' in these years, suggesting that they may contain bias. The *Zt* value of the remaining digits in the period of analysis for the family owned business was less than the *Zcritical*, leading to the acceptance of *H0*. Also, Table 3 shows the Chi-square test results of current liabilities of 94 family owned firms and it allows to accept the null hypothesis *(Ho),* because there is no significant increase between the observed *(Do)* and expected *(De)* data sets of the current liabilities of the family owned business in the period, except in 2006. The reference value or *χ2critical* is equal to 15,507 and lower than the calculated value of *χ2calc* in 2006 that is equal to 17,271, as well as, the *P value* was lower than the significance level of 5%. Based on the χ2 test results, the analyzed data sets in 2006 presented bias.

Based on Wooldridge (2010), Hair et al. (2012) and Greene (2012), Table 4 presents Z-test and Chi-square test results of noncurrent liabilities of 188 nonfamily owned firms, in order to verify whether observed *(Do)* and expected *(De)* data sets have significant differences for the period. The reference value or *χ2critical* is equal to 15,507 and it is compared to the calculated value *(χ2calc)*. Due to *χ2critical* < *χ2calc* in 2008 (16,019), it is possible to reject the null hypothesis *(Ho)* that there is no significant difference between *Do* and *De* in 2008, but the authors can accept *Ho* for 2005, 2006, 2007 and 2009. Given a significance level of 5%, the observed difference in 2008 was statistically significant to reject *H0*, considering both the Z-test and Chi-square test. Thus, adopting the first-digital distribution provided by Benford Law as a proxy for compliance, statistical tests indicated that, preliminarily, there is no bias in 4 years (2005, 2006, 2007 and 2009) and there is bias in the year 2008.

Based on Wooldridge (2010), Hair et al. (2012) and Greene (2012), Table 5 shows the Z-test results of noncurrent liabilities of 94 family owned firms, which allows to conclude that there is no significant difference between the expected *(Pe)*

**Table 3** Z-test and χ2 test of Current liabilities on family owned business, 2005–2009

| | D | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
|---|---|---|---|---|---|---|---|---|---|---|
| Z-test | 2005 | 1.641 | −0.121 | 1.328 | 1.008 | 0.169 | 0.534 | 0.199 | −0.378 | 1.826 |
| | 2006 | 1.191 | −0.121 | 1.48 | 1.356 | 2.123 | 0.704 | 0.64 | 0.378 | 0.839 |
| | 2007 | 0.966 | 0.15 | 0.392 | 1.084 | −0.169 | 1.53 | 0.199 | 1.494 | 0.149 |
| | 2008 | 1.191 | 0.121 | 0.392 | 0.038 | 0.169 | 0.534 | 0.242 | 1.962 | −0.149 |
| | 2009 | 1.191 | 1.204 | 0.856 | 0.387 | 2.123 | 0.121 | 1.125 | −0.09 | 0.149 |
| | 2005 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2006 | ok | ok | ok | ok | attention | ok | ok | ok | ok |
| | 2007 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2008 | ok | ok | ok | ok | ok | ok | ok | attention | ok |
| | 2009 | ok | ok | ok | ok | attention | ok | ok | ok | ok |
| χ2 test | 2005 | 2.433 | 0.018 | 2.352 | 1.662 | 0.026 | 0.836 | 0.386 | 0.008 | 3.181 |
| | 2006 | 1.401 | 0.018 | 2.81 | 2.625 | 5.776 | 1.164 | 1.102 | 0.68 | 1.693 |
| | 2007 | 0.992 | 0.146 | 0.433 | 1.854 | 0.042 | 3.521 | 0.037 | 3.654 | 0.021 |
| | 2008 | 1.401 | 0.012 | 0.433 | 0.001 | 0.28 | 0.836 | 0.44 | 5.606 | 0.114 |
| | 2009 | 1.401 | 1.793 | 1.194 | 0.489 | 5.776 | 0.266 | 2.31 | 0.136 | 0.394 |

**Table 4** Z-test and χ2 test of noncurrent liabilities on nonfamily owned business, 2005–2009

| | D | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
|---|---|---|---|---|---|---|---|---|---|---|
| Z-test | 2005 | 0.253 | 0.595 | 0.328 | 1.425 | 2.192 | 1.046 | 0.906 | 0.127 | 0.139 |
| | 2006 | 0.065 | 0.403 | 0.108 | 1.78 | 1.651 | 1.288 | 0.03 | 1.197 | 0.837 |
| | 2007 | 0.73 | 1.129 | 1.872 | 1.287 | 0.031 | 1.58 | 0.342 | 0.127 | 0.837 |
| | 2008 | 2.32 | 0.786 | 0.554 | 0.054 | 0.841 | 2.455 | 0.03 | 1.12 | −0.139 |
| | 2009 | 1.207 | 0.403 | 0.769 | 1.425 | 0.239 | 1.872 | 0.342 | 0.535 | 1.535 |
| | 2005 | ok | ok | ok | ok | attention | ok | ok | ok | ok |
| | 2006 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2007 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2008 | attention | ok | ok | ok | ok | attention | ok | ok | ok |
| | 2009 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| χ2 test | 2005 | 0.119 | 0.509 | 0.264 | 2.524 | 5.58 | 1.671 | 1.397 | 0.015 | 0.227 |
| | 2006 | 0.003 | 0.291 | 0.01 | 3.708 | 3.4 | 2.329 | 0.001 | 2.216 | 1.342 |
| | 2007 | 0.553 | 1.436 | 3.833 | 2.123 | 0.083 | 3.269 | 0.404 | 0.199 | 1.342 |
| | 2008 | 4.297 | 0.787 | 0.525 | 0.082 | 1.137 | 7.041 | 0.11 | 1.998 | 0.042 |
| | 2009 | 1.305 | 0.291 | 0.858 | 2.524 | 0.239 | 4.367 | 0.404 | 0.712 | 2.248 |

**Table 5** Z-test and $\chi 2$ test of noncurrent liabilities on family owned business, 2005–2009

| | D | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
|---|---|---|---|---|---|---|---|---|---|---|
| Z-test | 2005 | 0.227 | 0.102 | 2.076 | 0.004 | 0.908 | 2.396 | 0.713 | 1.056 | 0.127 |
| | 2006 | 0.001 | 0.102 | −0.119 | 1.056 | 0.14 | −0.094 | −0.174 | 0.585 | 0.369 |
| | 2007 | 0.227 | −0.102 | 1.135 | 0.004 | 0.628 | 0.736 | −0.174 | 0.114 | 1.119 |
| | 2008 | 0.225 | 1.803 | 2.076 | 1.047 | 0.14 | −0.094 | 0.713 | −0.114 | 1.616 |
| | 2009 | 0.227 | 0.102 | 1.06 | 0.004 | 0.524 | 0.094 | −0.174 | 0.114 | 1.119 |
| | 2005 | ok | ok | attention | ok | ok | attention | ok | ok | ok |
| | 2006 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2007 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| | 2008 | ok | ok | attention | ok | ok | ok | ok | ok | ok |
| | 2009 | ok | ok | ok | ok | ok | ok | ok | ok | ok |
| $\chi 2$ test | 2005 | 0.143 | 0.116 | 4.996 | 0.114 | 1.537 | 7.37 | 1.26 | 2.211 | 0.37 |
| | 2006 | 0 | 0.009 | 0.033 | 1.787 | 0.018 | 0.096 | 0.068 | 1.057 | 0.715 |
| | 2007 | 0.143 | 0.024 | 1.836 | 0.114 | 0.944 | 1.236 | 0.068 | 0.012 | 2.49 |
| | 2008 | 0.142 | 3.549 | 4.996 | 1.764 | 0.018 | 0.096 | 1.26 | 0.121 | 4.255 |
| | 2009 | 0.143 | 0.009 | 1.652 | 0.114 | 0.759 | 0.008 | 0.068 | 0.012 | 2.49 |

and observed *(Po)* probability of occurrence of a given first digit *(d)* of the noncurrent liabilities of family owned business, which allows to accept *H0*. Even considering the differences in 2009, related to the digits '5' and '9', the reference value or *Zcritical* is equal to 1.959 and it is higher than *Zt*. Thus, the observed data, in both years, received the 'ok' status, suggesting the absence of bias in the data sets of noncurrent liabilities of family owned business.

Table 5 shows the chi-square test results of noncurrent liabilities on family owned business. The authors conclude to reject the null hypothesis *(Ho)* and there is no significant increase between the observed *(Do)* and expected *(De)* data sets of the sample in 2005 and 2008. The reference value or $\chi 2$ *critical* is equal to 15,507 and in both years it is lower than the calculated value or $\chi 2calc$ *(2005)* is equal to 18,117 and $\chi 2calc$ *(2008)* is equal to 16,202. Adopting the digital distribution provided by Benford Law as a proxy for compliance, the Z-test and $\chi 2$ test results indicated that, preliminarily, there is bias. For example, the $\chi 2$ test results for the analyzed data sets presented bias in 2005 and 2008 in noncurrent liabilities of family owned business.

These results imply roughly the fact that the control of variables involving the study of the role of the family owned business and his nature—participating family or not concentrated or dispersed control—is complex and frequently leads to results are not always consistent with those already found in the literature. Imply, too, of course, the need for more studies under conditions different from those used in this research, since the topic is rich and extensive. Several studies show the cognitive biases of family owned business in different context around the world (Bingham, Dyer, Smith, & Adams, 2010; Burkart, Panunzi, & Shleifer, 2003; Carlock & Ward, 2000). These studies have also shown a series of classifications and results that differ and make it difficult to interpret the relationship between family, founder, managers and controllers with the firm's indebtedness (Brito, Corrar, & Batistella, 2007; Dami, Rogers, Ribeiro, & Sousa, 2007; Forte, 2005; Moreira & Puga, 2000; Perobelli & Fama, 2002; Perobelli, Silveira, & Barros, 2005).

## 3 Discussion

This paper has been researching the effect of ownership on the liability decision with main concern upon the increase of the knowledge on the accounting literature. The effect of ownership has been separated between family and nonfamily owned business. As the family owned business, it was observed that there is an effect between level of debt and businesses run by families. All effects are significant and the control variable in household indebtedness is not statistically significant. These effects were found decreasing in both cases, showing a trend of firms run by relatives or family members are less indebted than the others in the selected sample. So, the authors cannot reject the hypotheses H1 and H3. These evidences confirm the studies of Siqueira (1998), IBGC (2007), Anderson and Reeb (2003), Shleifer and Vishny (1986). Indeed, they show a decline in the investment cost on the family

owned businesses, as well as, the preference for using their own capital. However, firms controlled by the families, also, have a capital structure different from those with non-family owned control, then the authors cannot confirm the H2 hypothesis.

Other explanatory result is explained, due to the importance of applied additional tests that might complement Benford's analysis. It is known that the profile of the family manager and the firms' culture can influence the liability decision. However, there was no focus on this research that allows to make this association and, therefore, it is understood that small distortions may still exist. The effect between these elements could, however, be subject to further studies.

From the point of view of the accounting, the internal use of ownership information for the liability decision making purposes have equal concern on the use of this information for external reporting purposes. In this respect, it can be argued that the incorporation of ownership information into the annual reports of firms reflects the concern of the stakeholders of such information for financing purposes within the wider scope of firm activity. All these concerns reflect the discourse of the ownership issues, which is taking place in the society and is reflected in the media.

Another explanatory result is the misclassification that may occur in the definition of family ownership and family management, as the researcher sets them, other methods may be raised in future research. The ambiguity of these classifications will always exist, because operational definitions arguments are set for this search. It is expected, however, that findings of this research may assist the study of family firms and then it is a starting point for further research. In the research literature, it was not possible to find papers with focus on financial decisions where family owned firms control the business and influence the decision-making process. Indeed, Benford analysis is very important methodology for accounting, in general, and liability decision, in particular, because it does not use aggregated data, rather it is conducted on specific account issue using all the available data (Durtschi et al. 2004: 31).

As future research, the focus on the liability decision is only the starting point, because it deserves more attention allocated to assist managers of the family and non-family owned firms. Although several studies will be made about family business and the family control firms, because more researchers need to evaluate the relation between the management by members of the owning family, influence the family on business decisions and the capital structure of these firms.

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